







**Final Report  
VIII Annual Conference  
of the Club of Madrid**

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# **The Political Dimensions of the World Economic Crisis**

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# Foreword







## Foreword

The financial crisis that sparked in the United States in mid-2007 and turned into a global financial and economic crisis after the collapse of US investment bank Lehman Brothers in September 2008, brought the world close to another Great Depression. The financial collapse has had no precedents since the 1930s, bringing with it a collapse of international trade and the worst world recession in eight decades. It increased unemployment, deteriorated the quality and security of existing employment, and hit migrant workers particularly hard in many parts of the world. A protracted period of poor employment conditions may still lie ahead and place our democratic systems under stress, encouraging social unrest, xenophobic practices against migrants, and already visible protectionist trends.

The crisis made manifest a myriad of problems. It prominently showed that the regulation of financial markets was deficient in the most advanced economies of the world. The Financial Stability Forum created by the Group of 7 after the Asian crisis of 1997 to prevent a new financial collapse simply did not work, and central banks and regulatory authorities in industrial countries proved incapable of identifying and taking action to counteract the emerging problems that led to the collapse. Above all, it demonstrated an excessive confidence in the capacity of financial markets to self-regulate and self-correct in the face of major disturbances.

Furthermore, the financial and economic crisis came on top of other crises: the threat of irreversible changes in our climate system, the food crisis that engulfed the world in 2008, and a social crisis evidenced by the large gap that remains to meet the UN Millennium Development Goals, and to give the poorest of the world a decent standard of living. This conjunction of crises has revealed that we lack the global institutions needed to manage our level of global interdependence. The fragile economic recovery being evidenced still dependent on massive stimulus, should not lead to complacency about the deep challenges that we continue to face as a global family.

During the VII Club of Madrid's General Assembly and Annual Conference, held in Rotterdam in 2008, our Members decided to address the political impact of the world economic crisis, confident that their political experience could add value to the international debate on this topic and pro-actively support, inform and inspire current leaders in the design and adoption of practical recommendations to tackle the political challenges arising from the current crisis.

In preparation for our VIII Annual Conference on "*The Political Dimensions of the World Economic Crisis*", held in November 12-13, 2009 in Madrid, the Club of Madrid carried out a series of regional roundtables that brought our Members and Advisors together with top international thinkers, to analyze the political impact of the crisis from different regional perspectives and to formulate political recommendations that could help face the political and social challenges arising from the crisis. These messages and recommendations are being shared with relevant stakeholders in charge of responding to the social and political challenges generated by the crisis. Four of these regional roundtables – on the European (Barcelona, 26 March 2009), the Latin American (Santiago de

Chile, 13 July 2009), the Arab World (Madrid, 28 October 2009) and the African (Accra, 3 November 2009) perspectives – were successfully held prior to the Conference, and a similar exercise on the political dimensions of the current economic crisis from the BRICS (Brazil, Russia, India, China and South Africa) and Asian perspectives will be held in May and August 2010.

The main findings and recommendations gathered in each of these regional roundtables became the building blocks of the VIII Club of Madrid's Annual Conference and enabled the formulation of practical recommendations, from a global perspective, thereby contributing to the consolidation of a "democracy that delivers" in the context of the current crisis. This publication presents the key messages, conclusions and practical recommendations resulting from the Annual Conference.

The Annual Conference consisted of three plenaries and four working groups, each with a different focus regarding the political and social effects of the world economic crisis: "Employment, Social Welfare, and Democratic Rights and Duties", "The Citizen, the State and the Market", "The Market, Regulatory Frameworks, and Democratic Governability" and "An Institutionalized and Effective International Governance System".

This publication compiles the general background document prepared by the Academic Coordinator of the project, a snap shot of the exchanges that took place in each working group and plenary, the final reports of each of the regional roundtables, and two briefing/issues papers on the crisis from an Asian perspective.

### **The primacy of democratic politics**

The crisis has brought politics back to center stage. It was political leadership that was called to manage the disruptions created by excessive confidence in the markets. It was political leadership that was asked to rebuild the confidence shattered by the global economic crisis. At the national level, it was also political leadership that was called to keep the crisis from turning into major social unrest. And at the global level, it was called upon to coordinate efforts to manage the reality of interdependence in challenging times. In short, politics came back because States were asked to address the social and political consequences of the crisis, and to ensure that the crisis would not end up being yet another 'Great Depression'.

The crisis made patently clear that we need to redraft the relationship between the Citizen, the State and the Market. This is, in a nutshell, the central challenge of democracies today, the essence of the paradigm of better governance that we are being asked to implement. It is only under the framework of democratic politics that politicians have adequate incentives to listen, deliberate, negotiate and bargain. Democratic politics empowers the poor to develop the capacities that allow them to influence political outcomes that can eventually improve their quality of life. It is the only system that provides full public accountability. And it is the only way to generate commitments that are backed by society and build confidence in our future.

This most recent crisis has shown that unregulated markets can generate large costs for citizens. Facing the social effects of crises must, therefore, be at the

center of all macroeconomic policy packages. Social protection systems must be strengthened in countries where they exist, and gradually created in those that lack them. Democratic politics should place the creation of employment and social protection at the center of all recovery packages.

Moreover, democratic politics should recognize that we are experiencing an institutional crisis of global dimensions, and must bridge the huge gap between the depth of our interdependence and the inadequacy of our global institutions. The enhancement of democratic values at the global level requires strengthened multilateralism and equitable participation by developing countries, including small and poor countries in global economic decision making. And democratic accountability requires that States be responsible for the activities undertaken within their jurisdiction but impacting other countries or the global system as a whole.

New forms of global governance must be conceived. They should respect existing multi-polarity, with the US and Europe as indispensable powers, but where developing countries must play a growing role. Cooperation in strong multilateralism, rather than competition among States, is the best strategy to increase and maximize the benefits of our interdependence.

The recognition of the G-20 as the main international forum for coordinating policies to deal with global financial crises has been a step forward. But governance, to be effective, requires four elements: leadership, legitimacy, efficiency, and coherence. The G-20 lacks the formal legitimacy that is at the core of what we need for the future, for no informal forum can replace well functioning global institutions. The institutionalization of a mechanism such as the G-20, through the creation of a representative Global Economic Council, possibly under the United Nations but with the support of the Bretton Woods Institutions as specialized agencies of the United Nations system, and the World Trade Organization should be given serious thought.

## **Regulation to create better markets**

The crisis has made it clear that it is essential to correct the regulatory deficit in finance – the major single cause of the recent crisis. This means promoting comprehensive financial regulations, covering institutions and financial instruments that were previously un- or under-regulated; designing counter-cyclical provisions that create cushions of capital, provisions and liquidity during booms that will increase the capacity of financial institutions to withstand subsequent crises; enacting stronger supervision of systemically important institutions; and defending unsophisticated consumers against “toxic” financial products. We must also create reliable institutions providing strong early warning signals of emerging risk.

Good regulation is not inconsistent with but, rather, improves the functioning of markets. In this sense, better democratic States also engender better markets – markets that avoid financial and economic crises, distribute the benefits of growth in equitable ways, and help to protect our climate.

Accountability and transparency must be required of those institutions responsible for protecting citizens against the malfunctioning of markets, as

part of the checks-and-balances that are at the heart of democracies that deliver. This also means that there should be strong barriers keeping institutions that regulate and supervise financial markets from being captured by the interests of finance, that is, technical independence matched by strong political accountability.

Financial markets are global in their reach and the financial crisis has made it clear that the time has come for deep reforms of the global financial architecture. The institutions entrusted with the regulation of the global economy have proved fragile and incapable of forecasting crises. They have also been unable to adopt the necessary measures to prevent speculation from contaminating all forms of financing, thus creating a significant disequilibrium between financial markets and the real economy.

Beyond current efforts in the area of macroeconomic policy cooperation and regulatory reform led by the G-20, the agenda should be broadened to include: the adoption of strong global principles of financial regulation; a well defined role for capital account regulations within the emerging broader system of financial regulation; the creation of effective institutional mechanisms for macroeconomic policy cooperation; a truly global reserve currency, based on the Special Drawing Rights of the IMF; the creation of a special international court to mediate and arbitrate disputes associated with the over-indebtedness of countries; and enhanced international tax cooperation.

The major responsibility in all these areas should lay on truly representative global institutions: a renewed IMF, charged with managing macroeconomic policy cooperation and the global reserve currency; a well functioning network of regulators; recapitalized multilateral development banks (World Bank and regional development banks); and the creation of a debt restructuring court and improved mechanisms for fiscal cooperation, perhaps building on existing UN mechanisms.

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No effort should be spared to avoid the specter of global financial collapse from haunting us again. The crisis has been an opportunity to strengthen democratic politics as well as to create better markets. It has also been the opportunity to strengthen global multilateral cooperation. It was in recognition of the urgency of the situation and of the opportunities it nevertheless provided, that our Conference took place. We should make every effort not to forget either, learn from our mistakes and act to prevent similar future crises.



**Ricardo Lagos**  
President of the Club of Madrid  
Former President of Chile

# **The Global Economic Crisis: Causes, Evolution and Crucial Policy Issues**





# **The Global Economic Crisis: Causes, Evolution and Crucial Policy Issues**

**By José Antonio Ocampo<sup>1</sup>**

The financial turmoil that erupted in the US in August 2007 became, after the financial meltdown of mid-September 2008, the worst financial crisis and the worst global recession since the Great Depression of the 1930s. The severity of what came to be called the “Great Recession” and the collapse of international trade that accompanied it surprised even experts. The crisis had global and systemic features. It showed, in particular, how dysfunctional the current international financial architecture is to manage today’s global economy. The global policy response was coordinated by the G-20 and had some novel features, but was also partial in scope, leaving aside major issues that must also be included in any comprehensive reform of the international financial architecture.

The macroeconomic and financial policy responses to the crisis were strong though diverse among major economies. The financial meltdown was reversed and there was a recovery of economic activity in some economies, particularly in Asia, during the second quarter of 2009 and of a broader group of countries during the third quarter. Overall, these results represent a major success of Keynesian counter-cyclical macroeconomic policies. However, at the end of 2009 the recovery was still incomplete in the major industrial countries and, particularly, it continued to depend on the large macroeconomic policy stimulus being provided. Furthermore, credit remained subdued, financial stability had not been fully restored, international trade was still depressed and there was agreement that it will take a long time to reverse some of the social costs of the crisis, particularly the deterioration in employment conditions. We may be subject to new unpleasant surprises.

This document summarizes the crucial issues related to the origins and management of the current world economic crisis. The first two sections look at the roots and spread of the crisis. The next two analyze the areas where government actions have concentrated: the macroeconomic stimulus packages, financial bailouts and regulation. The last section considers broader reforms in the international economic architecture which have been excluded so far from negotiations and associated institutional changes.

## **1. The roots of the current crisis**

The peculiarity of the current crisis is, of course, that it originated at the center of the world economy. The collapse of the market for asset-backed securities in the US in August 2007, including the market for subprime mortgages, can be denoted as the start of the financial crisis. However, the European financial system was also and

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from the beginning at the center of the turmoil. The first major bankruptcies took place in Britain (Northern Rock) and Germany (IKB) at the end of 2007. This reflects not only the significant portfolio of US “toxic” securities held by European financial institutions, but also their own problems associated with the collapse of housing bubbles in several countries, higher reliance by European institutions for funding in capital markets vs. deposits, and the serious financial turmoil at the European periphery (Iceland and some Central and Eastern European countries).

The roots of the crisis will continue to be debated for a long time. The major issue was undoubtedly the excessive confidence in the capacity of financial markets to self-regulate and self-correct in the face of disturbances. By now it is clear that the dominant market liberalization paradigm provided a grossly inadequate lens to analyze reality.

The regulatory deficit is now broadly recognized. This problem is most severe in industrial countries, which continued to deregulate their financial systems while many emerging economies took steps to strengthen regulation after their own past financial crises. Equally important were the insufficient supervision of financial institutions and, therefore, the unwillingness or incapacity of authorities to enforce effectively even those regulations that were in place.

At the international level, the Financial Stability Forum (FSF) was created by the G-7 in 1999 “to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to propagate from country to country, thus destabilizing the world economy”. Similarly, after the Asian crisis, the International Monetary Fund (IMF) was given, together with the World Bank, enhanced responsibilities in the surveillance of financial stability. Despite their very useful technical work, the FSF and IMF patently failed in giving clear early warning of serious problems to come, as did the regulators and supervisors in major industrial countries. More serious warnings came from other quarters, particularly, at the institutional level, from the Bank of International Settlements (BIS) and the United Nations.

Aside from the regulatory and supervisory deficit, other factors contributed to the financial meltdown. Major failures in corporate governance and associated incentive schemes are now widely recognized as key problems, particularly the excessive focus on short-term profits and shareholder value, and the tendency to remunerate top managers on the basis of short-term returns.

The expansionary monetary policies of the first half of the 2000s are also accepted as a major contributor to the crisis, though the interpretations differ among analysts (which are not incompatible). Some see it as simply a policy mistake that, through the attempt by financial institutions to increase their returns in a low interest rate environment (the so called “search for yield”), led to very risky investments. Others see it as a reflection of the need to compensate for the weak aggregate demand generated by adverse trends in income distribution throughout the world. Access to credit was needed, according to the second view, to compensate workers for their low earnings, though it came at the cost of building up unsustainable household indebtedness.

Global imbalances also figure prominently in the debate on the origins of the crisis, again with contrasting views. According to one interpretation, Asian and, particularly, Chinese “mercantilism” generated massive surpluses that increased



the demand for US financial assets and kept interest rates – including long-term rates – low. The alternative interpretation emphasizes rather the fact that the crisis that started in Asia and other emerging economies in 1997 made it clear that the world lacks an efficient mechanism to manage financial crises in developing countries, as the current system has been based on IMF lending that is too small relative to the size of today's disturbances and carries excessive conditionality. The world also lacks a mechanism to renegotiate in an orderly way international debts similar to domestic bankruptcy courts. According to this view, the rational response of developing countries to this institutional deficit was to “self-insure” themselves against crises by accumulating large amounts of foreign exchange reserves, a policy that included, during the recent boom, saving a larger proportion of the commodity price boom and absorbing, through reserve accumulation, a larger portion of the excess supply of external financing than was typical in the past.

The role of the US as the “consumer of last resort” during the Asian crisis had dramatically increased the US current account deficit. The very high deficits in later years made one feature of the international monetary system patently clear: the lack of discipline imposed on the major reserve currency country by the current global monetary system, in which a *national* currency is used as the major world currency. This system allows the US not only to pay for its deficit by flooding the global economy with dollar assets but also to essentially impose its monetary policy on the rest of the world. However, this major deficiency of the international financial architecture has not been sufficiently recognized in ongoing debates.

## 2. Intensity and spread of the crisis

Viewed from the perspective of US financial markets and policy responses, the crisis had five distinct phases. The first started with the collapse of the subprime market and, more generally, asset-backed securities in August 2007. The response of the authorities in the US and Europe was to activate the role of central banks as “lenders of last resort” by coordinated efforts to make emergency financing to banks more readily available and at lower interest rates. The US also adopted an early though limited fiscal stimulus. The second phase started with the collapse and rescue of the investment bank Bear Stearns in March 2008. The lack of confidence among financial institutions in the quality of each others' balance sheets increased sharply after that event, generating a much greater use of available central bank credit lines.

The collapse of another investment bank, Lehman Brothers, during the weekend of September 13-14, 2008, and the decision of the US to not rescue it, marked the beginning of the third and, in regards to financial markets, the most dramatic phase of the crisis. During the week that followed, financial markets experienced total paralysis (a “credit freeze”), which included interbank lending and commercial paper. Many other major financial institutions went bankrupt in both the US and Europe and were generally rescued or taken over by governments, in a major correction of what was very soon perceived as a major policy mistake – to let a systemically important institution, such as Lehman, go bankrupt. Authorities in industrial countries responded with an even more massive increase in central bank credit to financial institutions, including many new facilities, strengthening deposit insurance, designing different schemes to

capitalize financial institution with public sector funds and, to a lesser extent, buying toxic assets. Curiously, policies to alleviate household debts, particularly those associated with mortgages, did not figure out in the policy packages; some were introduced later on.

The critical phase was overcome in late October, as reflected in renewed interbank lending and the reduction of interest rates in many segments of the market. This may be denoted as the beginning of a fourth phase, in which financial panic was overcome but financial institutions continued to be seriously undercapitalized or were outright bankrupt but continued to operate under the implicit promise that in the end they would be bailed out. Since the second quarter of 2009 we can talk of a fifth phase, which came to be known as “green shoots”, characterized by a significant reduction in risk premia and a recovery of stock prices but no significant revival or even continued contraction of private lending. In terms of new policy actions, the most remarkable fact during the fourth and fifth phases was the shift by major central banks towards “quantitative easing” – that is, the outright increase in the money supply once central bank interest rates were brought down to zero (or near zero) and therefore ceased to be a useful instrument for further monetary expansion. It also implied that, aside from maintaining high levels of *liquidity*, central banks also focused their attention on reactivating *lending* and reducing the interest rates that borrowers pay.

An economic slowdown was already visible but was not dramatic during the first two phases of the crisis. Although the slowdown was stronger in Europe, there was a tendency to underestimate it in political circles (except in Great Britain), a fact that was reflected in the much more conservative attitude of the European Central Bank and the weaker fiscal stimulus adopted by Continental European countries. Responses in the US were more aggressive on both fronts. The dramatic recession in the industrial world that followed the financial meltdown of mid-September 2008 surpassed the most pessimistic expectations. GDP of industrial countries fell in the last quarter of 2008 and the first quarter of 2009 at an annual rate of 7 to 8%, similar to that during the early phases of the Great Depression, but was followed by a break in the contraction of economic activity during the fifth, “green shoots” phase. Growth recovery was initially uneven and, particularly, largely Asia-based in the second quarter of 2009, but became more broadly based in the third quarter. Most remaining laggards finally joined the recovery in the last quarter of the year, as growth speeded up in several parts of the world economy, including the US.

Although developing countries were partly hit by the first phases of the financial crisis, particularly through reduced availability and higher costs of borrowing, they continued to grow relatively fast during the first semester of 2008 thanks to booming commodity markets and the perception that risks of lending to them were low due to the high levels of foreign exchange reserves they had accumulated. The fall of commodity prices since mid-2008 may be seen, therefore, as the turning point in the spread of industrial country recession to the developing world. In any case, the September 2008 crash was a far more important shock, which was transmitted globally through two major channels: the collapse of international trade (including commodity prices) and the paralysis of private capital markets. A third transmission channel, the fall of migrant workers’ remittances, also became significant in several developing countries.

The collapse in international trade was dramatic: the value of world exports fell 32% between the first semester of 2008 and the same semester in 2009. Although some recovery has taken place since the third quarter of 2009, trade continued to be depressed relative to pre-crisis levels. Indeed, in the third quarter of 2009, the value of world exports remained 26% and export volumes 16% below the levels of the first semester of 2008. Preliminary estimates and projections by IMF and the United Nations in early 2010 indicate that world trade volumes declined by over 12% in 2009 and will only partially recover in 2010 (only about 40% of what they lost in 2009). An implication of the collapse of international trade is that countries more open to international trade and, particularly, manufacturing exporters, were hardest hit in terms of economic activity. This explains why Japan and Germany ended up experiencing very strong recessions, and why most of the first generation of Asian tigers (Korea, Singapore and Taiwan, in particular) and Mexico were also strongly affected. Even China experienced a sharp fall in exports and a virtual GDP stagnation during the last quarter of 2008; although its exports continued depressed through most of 2009, it started to boom again in the second quarter of the year, thanks to its strongly expansionary domestic macroeconomic policies.

The sudden stop of private external financing hit hard the middle income developing countries, including the emerging economies. A critical issue was the paralysis of trade financing, which contributed to the collapse of world trade. Outflows of more volatile capital were severe in the developing world during the last quarter of 2008, leading to sharp depreciations of currencies in several countries. The capital account shock was particularly severe in several countries in Central and Eastern Europe, which had run risky macroeconomic policies during the boom, indeed reminiscent of Latin American patterns in the past. This was reflected in large current account deficits, weak accumulation of foreign exchange reserves, high external debt ratios and lending in domestic markets in foreign currencies, which made debtors very vulnerable to currency depreciations during the crisis. In contrast, although East Asia and Latin America were also hit, the significant accumulation of foreign exchange reserves and the reduction in external indebtedness during the boom, together with healthier financial systems (thanks to stronger regulation adopted after their own prior crises) provided a partial defense against financial contagion.

Only partial information is available on remittances. The World Bank estimates that they fell by 6.1% in 2009. However, this averages very diverging performances across the developing world. The worst affected were Central Asian countries dependent on migrants' remittances from Russia. They were followed by countries in Latin America, North Africa and Central and Eastern Europe that depend on remittances by migrants to the US and Western Europe; in most of these cases, reductions exceeded 10%, with some countries experiencing contractions of over 20%. In contrast, remittances from the Gulf Countries to South Asian and, to a lesser extent, some Sub-Saharan African countries actually increased, and in some cases substantially so.

### **3. The macroeconomic policy response**

The global recession called for strong policy responses. The International Labour Organization (ILO) estimated early in the year that the crisis would increase global unemployment in 2009 by 30 to 50 million people. This led ILO to launch

in June 2009 a “Global Jobs Pact”. The United Nations also estimated that there would be 72.5 million additional persons in extreme poverty, relative to a scenario where the growth expectation before the crisis would have been fulfilled. Although the strong recovery packages were able to avert the worst case scenario, there is a clear consensus that employment conditions will take a long time to normalize.

Industrial countries adopted expansionary monetary, credit and fiscal policies, but with significant asymmetries among them. Continental Europe lagged in all these dimensions relative to the US, the UK and Japan, as reflected both in the smaller size of fiscal packages and the lags of the European Central Bank in adopting more expansionary policies. China, along with a few other developing countries, also adopted strong expansionary fiscal and credit policies. On average, however, industrial country programs were more aggressive, reflecting the more limited room of maneuver that emerging and developing countries have to adopt counter-cyclical macroeconomic policies. The IMF estimated that the average autonomous fiscal stimulus in the G-20 economies was around 2% of GDP. Industrial countries’ central bank interest rates were also set at historical minima and all adopted some form of “quantitative easing”.

Beyond the short-term, the crucial question is whether there will be a prolonged period of slow economic growth. The strong adjustment in the portfolios of private agents (including households), the broad-based desire to reduce indebtedness (financial deleveraging) and the excess productive capacity available indicates that private sector demand (both consumption and investment) will continue to be weak. This has been the experience with financial crises in many countries. The economic and social costs of this scenario would be large, as the experiences of Japan and Latin America during their “lost decades” indicate, as well as that of sub-Saharan Africa during its “lost quarter century”. The international and domestic political implications are also deep, and could lead to a resurgence of protectionism under different guises (a factor that has been limited so far), as well as mounting political tensions within countries, which would stress the capacity of democratic regimes to address conflict through institutional channels. This implies that expansionary macroeconomic policies may be needed for a relatively long period and that withdrawing existing stimulus could be very costly. In any case, the rapid rise of public sector debts that is taking place will limit the possibility of maintaining aggressive expansionary fiscal policies for prolonged periods.

Global imbalances decreased relative to the boom years but must be closely watched, particularly in light of the renewed weakening of the US dollar since the second quarter of 2009. In any case, relying excessively on the expansionary policies of the world’s major deficit country, the United States, runs the risk of igniting (or, rather, reigniting) fears of disorderly adjustment to global imbalances, which would add another highly undesirable dimension to the current crisis. More generally, relying on export-led recoveries seems highly undesirable in the face of the collapse of world trade.

The fact that many developing countries had accumulated large amounts of foreign exchange reserves during the recent boom and had lowered external and public sector debts, imply that they had more space to adopt expansionary macroeconomic policies than was typical during past crises. But there was

an initial consensus that some emerging and developing economies were in a weak position and, therefore, that new financing mechanisms had to be put in place, given the strong retrenchment of private capital from the developing world that characterized the initial phase of the crisis. The problem here was the size of the shock relative to that of existing multilateral financing mechanisms. The Institute of International Finance (IIF) estimated early in 2009 that emerging markets would receive net negative private capital flows equivalent to \$30 billion in 2009 vs. net positive flows of \$632 billion in 2007. With the parameters that were in place before the crisis, multilateral financial institutions would have added only \$28 billion in net resources – i.e., about 4% of the shortfall!

This was the reason behind the April 2 G-20 decision to launch a major initiative to give additional resources to the major international financial institutions. The IMF was the recipient of most resource injections. A special issue of Special Drawing Rights (SDRs) for \$250 billion was also adopted, with developing countries receiving slightly under 40% of the allocation according to current quotas. Together with a smaller allocation, for 21.4 billion SDRs, approved by the IMF in September 1997 but which was not effective until it was finally approved by US Congress in June 2009, SDR allocations reached the equivalent of \$283 billion.

The G-20 decisions were preceded by a major reform of IMF credit lines in March, including the creation of a Flexible Credit Line, which allows countries with strong policies to access precautionary resources on a large scale with no conditionality, the doubling of other credit lines and the decision to make disbursements independently of whether countries meet structural conditionality. Fiscal targets were also softened relative to past IMF patterns. There is, however, the fear that the new IMF credit strategy would provide funds only for countries with very strong conditions, which may not need them, as well as those in severe need, but leave most developing country members without any support.

This is the reason why counter-cyclical actions by multilateral development banks played a crucial role, as they benefited a larger number of developing countries. Multilateral banks stretched their lending capacity, but additional capitalizations are now required for all of them. For the poorest countries, ODA with a significant component of transfers was required to avoid a debt buildup, which would be highly undesirable after the major debt reduction programs that were implemented in recent years – the Heavily Indebted Poor Countries (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI). However, there was no major G-20 initiative in this area, aside from the weakly defined food security program approved by the G-8 in Italy in July and supported by the G-20 in its September 24-25 Pittsburgh Summit.

A final issue was the institutional framework for macroeconomic policy coordination. The solution in this regard was not to place the IMF at the center of this effort rather than continuing to rely on informal mechanisms – in this occasion the G-20. The solution adopted at Pittsburgh designated the G-20 as “the premier forum of our international economic cooperation” but under multilateral surveillance by the IMF. This solution only succeeds in a very partial way in placing the IMF back at the center of global macroeconomic policy coordination, as its original design envisioned.

#### **4. Financial sector bailouts and regulatory measures**

Industrial countries' monetary and credit policies were generally more aggressive than fiscal policies. Financial sector bailouts fell somewhere in between. And whereas Continental Europe dragged its feet on fiscal policy, the US was the reluctant partner in this case. There was also initially a clear lack of coordination of financial rescue packages at the global level. In the US, the bailout package proposed by the Bush administration was approved with the support of the opposition, as a majority of Republicans refused to do so. Even then, there was a revealed reluctance by the US government to take stakes in the banks. In Europe, governments announced in a disorganized way a series of initiatives that competed with each other, particularly in terms of deposit insurance. Responses were placed on a better track after Great Britain announced its bailout package on October 7.

The most important measure was the capitalization with public funds of several financial institutions, particularly those of systemic importance. The second ingredient was enhanced deposit insurance and government guarantees on new lending. The third was the creation of mechanisms to buy "toxic assets", but this was limited in practice given the technical difficulties in valuing complex and heterogeneous financial assets. The rescue of Citibank in November 2008 and the British package of January 2009 adopted a mix between the second and third types of interventions, as governments assumed a partial public sector guarantee on bank losses from toxic assets. Curiously, as pointed out, fewer initiatives were taken to ease debtors' burdens, particularly in the case of mortgages.

A major effort to stabilize financial institutions was crucial, to avoid a protracted distrust in these institutions that affected Japan during its lost decade. There were clear advances in this area but, as of early 2010, financial stability had not been fully restored. Aside from their fiscal costs, an equally important problem was the limited transparency of the associated bailout packages. There were clear deficits in this regard in several major countries.

An important issue was also the distortions in international finance and trade that the bailouts generated. The fact that industrial countries provided large amount of resources to rescue their financial system and offered guarantees that developing countries could not match generated new asymmetries in the international system. Aside from its financial implications, these interventions distorted competition in international trade, particularly when subsidies were sectoral in nature, such as those granted to the automobile sector in several countries. Fiscal and bailout packages also brought with them protectionist clauses, such as the "Buy American" provisions and the preference for hiring American workers included in the US fiscal stimulus.

A major advance in the international debate was the recognition that the current crisis was clearly associated with inadequate regulation and supervision of financial activities. It is in this area that the G-20 played the most useful role, particularly in agreeing on certain principles, though their concrete implementation was still subject to much debate as of early 2010. The first agreed principle is that regulations must be comprehensive or at least much broader in scope to avoid the massive loopholes through non-banking intermediation that contributed to the current turmoil. This includes regulating hedge funds (or, more broadly,



alternative investment funds), security dealers and the types of transactions that led to the current crisis, particularly securitization and derivatives. It should also force all capital markets to be open and transparent and thus limit over-the-counter operations. It is also agreed that systemically important financial intermediaries must be subject to particularly strict supervision, and perhaps to stronger regulatory standards, and that credit rating agencies and compensation practices in financial institutions should be regulated.

A second major advance was the recognition that prudential regulations should have a counter-cyclical focus, thus forcing financial institutions to accumulate increasing capital (or reserves that cannot be distributed as profits), provisions for loan losses and liquidity cushions during booms. Many have also argued that absolute limits on leverage (the ratio of assets to the capital of institutions) should be established. Accounting rules continue to be subject to much debate. Pricing assets according to their market value (when it is available) may be preferable for reasons of transparency, but this requires the adoption of mechanisms (such as counter-cyclical loan-to-value ratios) to avoid asset price bubbles from feeding into the credit expansion, and asset price busts from speeding up the credit squeeze. Accounting rules as well as liquidity requirements should also take into account the nature of the funding used by the financial institution (short- vs. long-term).

Consumer protection also figures prominently in some of the proposals, such as the recommendation to create a Financial Safety Commission in the US. In light of the amount of toxic mortgages and highly risky investment vehicles offered to unsophisticated households during recent years, this function should be clearly enhanced, as should the principle that financial instruments offered to unsophisticated agents should be as simple as possible, as complexity brings with it information problems and difficulties for markets to price the associated instruments. The current wave of bailouts is likely to result in higher concentration in the financial industry. The possibility of breaking up very large institutions or severely restrict their risky activities has been incorporated in some proposals by US, UK and Swiss authorities. Finally, and very importantly, it is essential to guarantee that prudential regulations that are in place are effectively implemented and, therefore, that supervision is done with the highest standards. As pointed out, some of the major failures that led to the current crisis came as a result of lack of supervision and implementation of existing regulations. So, increased surveillance and clear accountability mechanisms would also have to be introduced in all regulatory and supervisory bodies, both national and international.

As in the case of macroeconomic policy coordination, one of the major gaps in the current regulatory debate relates to the institutional frameworks that should be put in place. Creating a single world financial regulator is probably not viable or, for that matter, desirable, given different regulatory traditions around the world. So, the system that is designed in this area should be based on a well functioning *network* of national and regional authorities (which is still missing in the EU) and include truly international supervision of financial institutions with a global reach (such as the college of supervisors proposed by the G-20). There seems to be agreement that the IMF should *not* be at the center of the regulatory system. The Financial Stability Forum (now Board) and the Basle Committee on Banking Supervision and similar institutions are better placed. However, despite their recent broadening of membership to include all G-20 members, a major

problem of these institutions is the control by major industrialized countries, which even reserve for themselves the right to choose who is a member. Thus, the design of a truly representative institution that serves as the apex of world financial regulation should be on the agenda. One alternative would be to give this responsibility to the BIS, but this would require making it a truly global institution with political accountability.

### 5. The broader agenda

Current international negotiations have concentrated on the coordination of macroeconomic policy packages and strengthening financial regulation. These issues do not exhaust, however, the agenda of international financial reform, which include at least three other topics: the need for a new international monetary (or global reserve) system, the role of capital account regulations in the global order, and the need for a debt workout mechanism at the international level. Institutional issues are equally important. The preference for informal organizations with restricted membership chosen by the major industrial countries is problematic, as is the inadequate representation of developing countries in international economic decision making in general.

The current international monetary system, which followed the dual gold-dollar system created at Bretton Woods, is essentially based on the use of a *national* currency (the US dollar) as the major global currency. It is secondarily a system based on the competition among national currencies (regional in the case of the euro) as reserve currencies. This system is inequitable and unstable. It is inequitable because it forces developing countries to transfer resources to those issuing reserve currencies. This transfer has actually increased over time due to the realization by developing countries that “self-insurance” in the form of large foreign exchange reserves is the only defense they have in a world of acute financial instability.

The system is also unstable because it is plagued by cycles of confidence in the US dollar: periods in which the US runs large deficits and floods the world with dollar assets, followed by others in which the credibility in the dollar as a reserve currency improves. During both phases of this cycle, the US adopts its monetary policies without any consideration as to their international impact. A system based on competing reserve currencies, such as the one we may be moving towards, would not solve the inequities of the current system and could worsen another element of instability: that among the exchange rates of the alternative reserve currencies.

The deficiencies of current arrangements are why the world monetary system should be based on a truly global reserve currency: a fiduciary currency backed by the central banks of the world. This is what was hoped for when the Special Drawing Rights (SDRs) were created in the 1960s. This process must thus be completed, by transforming the SDRs into such global currency and eventually allowing it to be used in some private financial transactions. Among other advantages, this system would provide a mechanism for the IMF to play a more active role during crises, by issuing SDRs in a counter-cyclical way. Indeed, a large counter-cyclical issue of SDRs is the best mechanism to finance large official support to developing countries during crises. This would be the global equivalent to what the major central banks of the world did on a massive scale



since September 2008. Regular issues of SDRs would also bring the size of IMF lending capacity to one more consistent with the magnitude of today's financial shocks. A major reform of IMF conditionality is necessary, anyway, to make it attractive again for developing countries to use its facilities rather than rely on "self insurance" through foreign exchange reserve accumulation.

In relation to regulations of capital flows, it must be recalled that the IMF was created on the presumption that capital account regulations could be used if necessary by any country to achieve its domestic macroeconomic and financial policy objectives. The broad based trend towards capital market liberalization has facilitated the spread (or contagion) of both booms and crises. Since developing countries are subject to pro-cyclical swings (floods of capital during booms followed by scarcity of financing during crises), they also have limited policy space to counteract such swings. Furthermore, since they usually borrow in foreign currencies, exchange rate depreciation during crises generates significant wealth losses (as several countries of Central and Eastern Europe rediscovered during the recent crisis). Under these conditions, external payments crisis are easily transformed into domestic financial crises.

In the ongoing debate on the role of stronger financial regulation, there should therefore be an open discussion on the use of *capital account* regulations to strengthen financial stability. Those regulations can be useful to mitigate contagion during both booms and crises, playing therefore the role of "circuit breakers" in international finance, in the same way such breakers play a useful role in electricity networks. They can also help improve financial stability in individual countries. Therefore, the regulatory structure that must be developed for financial stability should include provisions that apply to cross-border capital movements, such as: making cross-border flows subject to taxes (the decision adopted in October 2009 by Brazil) or reserve requirements (i.e., deposits in central banks made by agents who bring capital into a country) to prevent excessive capital inflows, particularly short-term inflows during booms; minimum stay periods, similar indeed to those that mutual funds impose on investors to guarantee the stability of their deposits; and prohibitions to lend in foreign currencies to economic agents that do not have revenues in those currencies. In this regard, the IMF should not only tolerate but actually advise countries on what regulations could play a positive role under a given circumstance. The absence of any discussion of capital account issues is, therefore, a major deficiency of ongoing debates on financial regulation.

The discussions that followed in the wake of the Asian crisis indicated that the lack of an institutional framework to manage debt overhangs at the international level – i.e., a court similar to those created to manage bankruptcies in national economies, the decisions of which are legally binding – is one of the major deficiencies of the current international financial architecture. The only regular institutional mechanism in place is the Paris Club, which deals exclusively with official financing. The system has relied in the past on traumatic individual debt renegotiations or on ad-hoc mechanisms, such as the Baker and Brady Plans of the 1980s and initiatives such as HIPC and MDRI since the mid-1990s. The problem of all these mechanisms has been that they generally come too late, after high indebtedness has had devastating effects on countries. The system is also inequitable, as it does not treat all debtors or all creditors with uniform rules.

The discussion of the new international financial architecture should solve this problem by creating an international debt court, which would serve both as mediator and eventual arbitrator of sovereign loans and, possibly, some private sector loans. Negotiations would be triggered by defaults from debtor countries, and should be based on the principle of a “fresh start”, which would leave a sustainable debt burden that would allow borrowers to make a (relatively) swift return to markets. Furthermore, active use of multilateral development bank lending and guarantees could play a role in financing countries while negotiations are in place and supporting their return to markets.

The major institutional drawback of current initiatives in several areas is the tendency to rely on informal structures. These arrangements are problematic, not only because they exclude small and medium-sized countries but also because they lack institutionalized mechanism to guarantee a follow up to agreed decisions. This is why the new governance system must be founded on *representative institutions*, not on any “G”, which will always face problems of legitimacy. And it is necessary, for the same reason, to involve the United Nations, the most representative global institution, perhaps by taking the step, recommended in the past by many, of creating a Global Economic Council in the United Nations, with effective powers of coordination over the system of global economic and social governance. Such a body would have to be based on a constituency system, to allow the indirect representation of small and medium-sized countries while keeping the size of the Council small enough to facilitate decision making. In contrast to these proposals, one of the striking features of all three G-20 Summit communiqués was the almost complete marginalization of the United Nations from the emerging economic governance structures.

This process should, furthermore, place at the center of international reforms efforts the discussion of voice and representation of developing countries in international economic decision making and norm setting. This includes not only the IMF, the only place where some (though extremely modest) reforms have been adopted, but also the World Bank (where such discussion is ongoing), the BIS, the Basle Committee on Banking Supervision and other world regulatory bodies. The decisions taken by the G-20 at Pittsburgh, to shift 5% of IMF quota and slightly under 5% of that in the World Bank to unrepresented countries are surprisingly modest relative to the inequities that characterize current quota systems.

Finally, the institutional design should adequately take into account the role of regional institutions. Indeed, in a heterogeneous international community, the creation of *networks* of global, regional and national institutions will provide a better system of governance than arrangements based on single global organizations. Regional and sub-regional institutions give stronger voice and sense of ownership to smaller countries, and are therefore more likely to respond to their demands. In some areas this is recognized today, such as in the system of multilateral development banks, where the World Bank is complemented by regional development banks and, in some parts of the world sub-regional (in Latin America and the Caribbean, in particular) and inter-regional banks (the Islamic Development Bank).

The recognition of the role of regional institutions is urgent in the monetary area, where the IMF should make more active use of regional institutions, such as the Chiang Mai Initiative or the Latin American Reserve Fund, and support their

creation in other parts of the developing world. Indeed, the IMF of the future should be seen as the apex of a network of regional reserve funds – that is, a system closer in design to the European Central Bank or the Federal Reserve System than to the unique global institution it now is. Similar institutional design could be adopted for macroeconomic policy coordination, financial policies and for the international debt court.

The most ambitious agenda of reform, which captures most of the issues outlined above, is that proposed by the Commission of Experts of the UN General Assembly on Reforms of the International Monetary and Financial System (the Stiglitz Commission). The June 24-26 UN Conference on the World Financial and Economic Crisis and Its Impacts on Development approved, in turn, the most ambitious agenda agreed so far at the intergovernmental level to face the current crisis. It should be added that the 2002 Conference on Financing had approved, in turn, the Monterrey Consensus, the most ambitious agenda in the area of global financial reform, but one that has been significantly lacking in implementation.

The June 2009 UN Conference recognized, among other issues, the need to discuss reforms of the global reserve system and more ambitious debt restructuring mechanisms, the need for deeper governance reforms in multilateral financial institutions and standard setting bodies, and the role of regional organizations. It also recognized the role of the United Nations in the reform efforts, particularly as an inclusive forum for debate, but shied away from the more ambitious call by the Stiglitz Commission and similar proposals in the past to create a Global Economic Council. All these issues should be brought into the global agenda.



# **Democratic Practice and Governance: Instruments to Address the World Economic Crisis**





# **Democratic Practice and Governance: Instruments to Address the World Economic Crisis**

**By Jorge I. Domínguez<sup>1</sup>**

The world economic crisis that began in 2007 and exploded in 2008 made it apparent that financial markets were insufficiently self-regulating, transparency was woefully deficient, and the economics profession as well as central banks and international financial organizations were slow to anticipate the economic catastrophe, honorable exceptions notwithstanding. The consequences of the financial crisis on the economies across the globe have been severe for all and devastating for many, setting back the hopes of the prosperous, gravely threatening the livelihood of the majority, and plunging the poor into despair.

Politics is back, therefore, as Ricardo Lagos, president of the Club of Madrid and Chile's former president, made clear in his opening remarks to the annual conference of the Club of Madrid in November 2009. Politics is back because only sovereign governments have been capable of pumping liquidity into the world's financial systems to avoid a collapse of the payments system. Politics is back because only states could ensure through countercyclical policies that the crisis would result only in a Great Recession, not a Great Depression. Politics is back because a better and tighter regulatory framework must be designed to reduce the likelihood of future market imprudence and hold accountable those who have mishandled the resources entrusted to them. Politics is back especially in democratic political systems because states must address the consequences of the crisis on the poor and assist those of modest means to edge back from the economic abyss.

The consideration of politics was back as well at the Club of Madrid conference because its Members – former presidents and prime ministers of democratic countries – are knowledgeable about various topics but in particular they are good at politics.

Politics is not a magic wand to make deep structural problems disappear or to sugar-coat the tragedies of the present. The role of politics raises three broad questions, and a specific one, as we ponder what may be done next:

- Will the public elect the best leaders if politics is back?
- Will states respond effectively to address the ongoing economic crisis?
- Will politicians choose wisely once elected and in charge of the state?
- More generally, will democracies deliver?

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1. The General Rapporteur for a conference is like a fluttering butterfly that walks in and out of working group sessions, listens to plenary sessions, and seeks to milk the honey from the very interesting ideas that the Members of the Club of Madrid – former presidents and prime ministers of democratic countries – and their guests discussed over several intense sessions. I heard only some discussions because working group sessions met simultaneously. The result is necessarily incomplete, reliant on impressions and themes, and not at all a transcript of what was said in detail. It is my hope to have been faithful to the conference purposes, accurate in conveying the points that I did hear, constructive in building bridges between somewhat disparate sessions, and loyal to the Club of Madrid's commitments to democracies that deliver. I am grateful to the Club of Madrid for giving me this opportunity and to its Members for their insights. All mistakes, of course, are mine alone.

*The public does not always elect the best leaders.* Alas, the Members of the Club of Madrid know this fact too well; if the answer were yes, the Club of Madrid would have many fewer members. Good politicians and responsible political parties often lose elections. Electoral politics, especially during hard times for economies and societies, often face the risk that populist demagogues may be elected. As a result of those elections, more severe hardships may appear in due course. Electoral democracy provides no guarantee that the public will choose wisely.

Democratic electorates can, however, hold presidents, prime ministers, and political parties accountable. They do so when citizens engage in what is called retrospective voting. They look back on government performance in the recent past and, when they find it wanting, defeat the incumbents. In national elections held in 2009, for example, electorates as different as those of Iceland, Japan, and Argentina defeated the incumbents who had governed them badly. They made the right decision.

Democracy may hold politicians accountable. Democracy may be a peaceful and effective instrument to re-chart the path to the future.

*States may respond badly.* As the Club of Madrid was holding its conference, there was news that Venezuela, one of the leading petroleum producers in the world that is also endowed of vast natural gas and hydroelectric power resources, had been rationing electricity and suffering severe power shortages. States may grow very big but that is no guarantee that they would be competent or effective. States may, indeed, respond quite ineptly to economic circumstances.

Responses may be improvised. Responses may be so informal that citizens and social and economic actors cannot comprehend the rules by which they should abide. Heads of state may have limited time horizons and privilege short-term quick-fixes to long-term solutions. The key, therefore, is to remain focused: Informal solutions are often necessary in the face of a severe crisis, quick-thinking may be essential, but political leaders should be committed to fashion new structures for the longer run<sup>2</sup>.

States may also respond badly because public officials are under-informed; in turn, this is so because the experts, too, are under-informed. It is often the case the small changes may accumulate, converge almost imperceptibly, and lead in time to systemic catastrophes. The end-of-decade Great Recession began in such a fashion, as trouble started in seemingly unrelated events until nearly every asset turned down and nearly every safeguard failed.

*The utility of democratic constitutionalism.* In order to think about how states are governed, focus on the kind and quality of the political regime. The Club of Madrid highlights the value of democracy for its own sake. In our discussions, we came to understand the utility of democracy as well.

Democratic constitutionalism is an invention of the last century and a half. It becomes possible only with universal suffrage. It becomes effective only when

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<sup>2</sup> See statement by Wim Kok, former prime minister of the Netherlands and new president of the Club of Madrid, in the final report by Richard Youngs on the roundtable, 'The Political Dimensions of the World Economic Crisis: a European Perspective', in the appendix.



democratic majorities choose constitutional self-restraint. Democratic constitutionalism can legitimate state action with regard to markets in ways that dictatorships cannot.

Democratic constitutionalism may provide checks and constraints on state action. It does so by means of the rule of law and the establishment of institutions, which have significant authority to deploy their sufficient power. Democratic constitutionalism may empower states to act and, in severe crises, embolden them to do so backed by national majorities. Constitutional democracies can and should regulate the banks and other systematic financial institutions; they can and should provide supervision of individual banks in the context of regulated financial markets.

*Beyond the worldwide economic crisis.* It would be better if the world were simply mired in a worldwide economic crisis. Instead, this economic crisis has also generated a worldwide social emergency. The task is especially salient for democracies because, above all, democracies must be committed to support the capacities of majorities to shape the future.

Much progress had been made during the preceding decade and a half in reducing poverty across the world. As a result of the Great Recession, there has been a huge setback for the results of anti-poverty efforts and there is evidence of alarming retrogression.

Similarly, it is uncertain whether governments are addressing the economic crisis effectively. It is also uncertain whether they are addressing successfully the political crisis that threatens the governing coalition. But it is certain that governments across the globe have paid remarkably little attention to the social crisis, a point that the former prime minister of Portugal, Antonio Guterres, made forcefully at the Club of Madrid meeting.

The world's commitment to address poverty in all its forms seems to have weakened dramatically. There is a risk of the destruction of social protection in the countries that have such institutions and a continued failure to create socially protective institutions in countries that lack them. Public services worldwide have been impaired, nowhere more so than in sub-Saharan Africa.

States – especially those with democratic regimes – should act to sustain social protections amidst economic crisis. In particular, states should empower the poor to develop their own personal capacities to take charge of their lives, and not merely remain as the wards of others.

The ethical foundation of the relationship between markets and democracy is not just the enrichment of the few but, rather, the improvement of the capacities of all.

*How may politicians lead?* Democracy is not established with the snap of fingers nor sustained merely through pious wishes. Democracy is not just the final outcome of a long process of political change, though it may be so as well. Democracy is not a political system in a steady state. Democracy is an ongoing process in which citizens and their leaders engage every day, not just every so many years when elections are held. In particular, in democratic political systems, politicians should be working at the ongoing process of democracy all

the time. Yes, politicians must engage in politics in democratic regimes and it is both right and useful that they should do so. Consider a couple of reasons.

First, in order to lead, leaders must also be good listeners. This is probably the case in every society but even more so in democratic political systems. The more pluricultural and multilingual the society, the greater its variety of communities of faith and other forms of belief, the more important it is that political leaders should be good listeners – a point made at the meeting from her own experience by New Zealand's former premier minister Jenny Shipley<sup>3</sup>.

Democracies can deliver good outcomes because they give politicians powerful incentives to listen. If politicians do not listen, they will not win elections. If incumbents do not listen, they will lose power. If factions within a political party or coalition do not listen, their capacity to win and rule will be seriously harmed. Democratic politics can serve us well in the economic crisis and social emergency because democratic politicians must listen to their people, their allies, and their adversaries. Democratic politicians must listen to long speeches and at times give some of their own.

Second, and just as importantly, democratic politicians, as a normal part of their job, must deliberate, must negotiate, and must bargain. Democratic politicians must look for ways to build a consensus large enough to make it possible for those who rule to do so responsibly and effectively. The more they deliberate and negotiate, the more democratic politicians are likely to deliver policies that the society would support.

*Committing the future.* Democracies do not work like a vaccination against an illness. Democracy is not a vaccination against political stupidity, state ineptitude, plutocratic greed, and public cynicism. But democracies are especially effective at committing the future.

Leading public officials in democratic countries work with various political parties and, in parliamentary systems, must often negotiate coalitions. The process of construction of a coalition, or of a party large enough to win by itself the consent of the governed, must often incorporate people who may disagree on significant questions. Large political parties or coalitions often include dissonant voices. In making agreements among those who agree on core concerns though not on every details, democratic politicians are not just committing themselves. They are not just committing their faction or their political party. Democratic agreements between parties or factions seek to bind the *other* politicians, factions, or parties that belong to the coalition, with regard to the future.

In an authoritarian regime, the dictator can commit his government only until the day he dies or is overthrown.

Democratic politics is uniquely effective at making sufficient agreements today to ensure that the most important will endure into the future. This is not a guarantee, but it is a political process at which democracies may be more effective than dictatorships. Democratic politics requires a lot of work and

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3. Shipley, and the former president of Mauritius, Cassam Uteem, co-chair the Club of Madrid's project on "shared societies," which focuses specifically on societies of this sort.

commitment during campaigns for public office and in government itself. A key objective of such work in democratic political regimes is to increase the likelihood that the policies of today will remain the policies of tomorrow thanks to the consent of the rulers, their occasional adversaries, and the ruled.

*Conclusions.* Democratic politics, therefore, may help our countries address the economic crisis and social emergency in a number of ways, several of which deserve reiteration.

1. Democratic politics is more likely to provide for means of public accountability because retrospective voting in free and competitive elections may remove from office those who have governed badly.
2. Democratic politics is more effective at legitimating state action in regulating financial markets and supervising the banks because office holders are sustained by the support of the majority, not the mere whim of some rulers.
3. Democratic politics may empower the capacities of the poor so that they take charge of their lives precisely because in most countries those with low income constitute the democratic majority.
4. Democratic politics generates powerful incentives for politicians to listen so they can win elections and reelections.
5. Democratic politics fosters deliberation and negotiation as a public strategy to enable politicians to govern as they must.
6. Democratic politics may be uniquely effective at committing the future credibly because it does so by means of the consent of the governed.

Democracies can deliver, therefore, more effective responses to this economic crisis and social emergency. Democracies can deliver because they are especially adept at shaping the wise restraints that make us free.



# **Employment, Social Welfare, and Democratic Rights and Duties**





# Employment, Social Welfare, and Democratic Rights and Duties

By Richard Simeon

The sweeping global economic crisis, from which we are only beginning to recover – tentatively and unevenly – has had, and will continue to have, multiple consequences for employment, social and economic well-being, and for democratic politics. These were the central concerns of Working Group 1.

The group explored first the repercussions and implications of global economic crisis. These repercussions of course play out differently in different countries. Some survived the crisis relatively unscathed; others were deeply affected. But in every country, in its own way, the crisis posed major challenges to democratic institutions, and to political leadership.

Second, the group explored institutional and policy changes that might help renew the social contract and foster relationships of trust and confidence that will allow governments to act effectively to mitigate the consequences of short-run failure, while building the foundation for long-term growth and equality.

Democracy and economic success, members of the working group agreed, go together. But we also agreed that the relationship is seldom simple.

This Report has two sections. The first is **diagnosis**: what are the consequences of economic crisis for employment, welfare, and democratic rights and duties? The second is **prescription and recommendation**: what is the role of government in the face of economic crisis? If the crisis threatens workers or increases inequalities, what is then the responsibility of government to mitigate its effects, and, more importantly, to plan for future economic growth?

## I. Diagnosis

Seven effects of the crisis were especially important to the group.

### *1. Increased poverty and unemployment*

In the decade prior to the economic crisis, economic growth in many parts of the world was impressive. Some developing economies stood out – China, India, and Brazil, among others – but growth was also strong many other countries in Africa, Latin America, and Asia. These successes were also associated with quite dramatic reductions in levels of poverty in many of these countries and with higher levels of investment and improved employment prospects for workers.

Moreover, the economic crisis appears not to have been as deep and long-lived as many had feared. Government policy responses in many parts of the world – both developed and developing – appear to have stanching the worst of the wounds.

Nevertheless the speakers, commentators, and participants in Group 1 were anything but complacent. They noted how uneven earlier growth had been. They recalled how recent was an earlier 'lost decade' of growth, and how important it was to avoid another. They emphasized that recovery in employment often lags earlier indicators of recovery. They pointed to continuing high levels of unemployment and under-employment, especially among youth.

### *2. Increased inequality within and between nations*

Participants in Group 1 also stressed how dramatic and persistent economic inequality remains, both within countries and between them. Little progress had been made in this respect, even in the preceding growth years; indeed in some countries inequality had increased with most of the benefits flowing to the wealthy and the most highly skilled and educated. The worry now is that any progress the world may have made is likely to be reversed by the economic crisis. Participants believed that while the evidence shows that democracy had survived, even under conditions of high inequality, in the long run deep inequality is a threat to democratic values, and its persistence is an indicator of a democratic deficit. As the Club of Madrid has stressed, 'democracy that delivers' is critical to its long-run success.

### *3. Increased vulnerability and insecurity for many citizens*

The economic crisis underlined how volatile the global economy has become. Citizens and whole countries are vulnerable to shifts in technology, trade flows, investment patterns, and the like. And no longer can workers depend on the social safety net to protect them against the winds of economic change. Whether it be employment insurance, pensions, child welfare, or health care, governments have fewer resources to protect their citizens and prepare them to compete more effectively in the future.

### *4. A resulting increased focus on self-preservation and protection, and a potential erosion of the social contract*

Citizens and workers are increasingly thrown back to depend on their own resources. The danger in a volatile, uncertain world of scarce resources is that the social contract that binds citizens to citizens in a kind of gigantic mutual insurance scheme may erode. The Group worried about a world of 'every man (too often only men) for himself'. This manifests itself both in the actions of individuals ('sauve qui peut') and countries, where the temptation to protect one's own industries through protectionist measures is understandably strong, and often hard for governments to resist.

### *5. As a result, an increasing potential for conflict not only between rich and poor, but also between ethnic, linguistic, religious and cultural groups within states*

Here is where the Club de Madrid's commitment to reconciling differences through its Shared Societies program and its concern about the effects of the economic crisis come together. Conflicts rooted in language, ethnicity, race, and religion almost always have behind them an economic dimension. This can range from struggles between pastoralists and farmers over land and water in many African countries (deeply aggravated by other factors such as climate change),



competition over ownership and control of natural resources in contested areas in Africa, the Middle East and Latin America, or competition between native residents and immigrants for jobs in Europe and North America.

Such conflicts are by no means new, but they are very likely to be exacerbated by the economic crisis. This plays out in many ways. To take one example, the years of economic boom brought many workers from Africa and Asia to Western Europe, fuelling a number of anti-immigrant political parties and harsher laws against immigrants and refugees. The economic crisis had several further effects. First, there has been a dramatic decrease in remittances from immigrant workers to their home countries – these make up significant proportions of GDP in many poorer countries, so the reduction in transfers may have serious consequences. Second, a large flow of newly vulnerable workers from richer countries have traveled back to their home countries, likely increasing employment problems there. And third, there may be sharply increasing tension between immigrants and native workers in many countries. Managing these tensions is a major challenge facing governments in these countries.

*6. A potential loss of confidence and trust in governments, with a resulting loss of legitimacy and effectiveness*

Much of this report has emphasized the broad conclusion of this conference – that politics is back. The crisis creates an enormous agenda that governments and leaders must confront. Yet much evidence demonstrates that trust in political leaders, and faith in their competence and honesty, has declined dramatically in many parts of the world. Herein lies a dilemma: at the very moment when effective, dynamic political leadership seems most essential, the potential for such leadership is lacking. Thus the capacity of governments to mobilize the resources to manage the crisis and its long-term effects is weakened, as is their ability to negotiate in the international arena and to motivate citizens in the common challenges they now face.

*7. And, as a result, there is the danger that populist, authoritarian leaders claiming magic solutions will come to the fore, potentially challenging democratic rights*

In this context, there is always the danger that populist, authoritarian leaders may exploit the crisis in order to strengthen their own rule. While such efforts may win short-run success and support, the likelihood of long-run success is low. In meantime, free speech and the rights of minorities are likely to be suppressed and corruption to be increased. As has been noted by many commentators, threats to human rights are likely to be low when things are going well, and to be threatened in hard times.

None of these challenges is new; they have long been challenges to democratic governance. But the crisis is likely to deepen and intensify them, and to make solutions more difficult.

## **II. Seeking Solutions**

This was not a group of economic policy experts, primed to provide a road-map to renewed prosperity. But the group did agree on certain basic principles that

should underpin policy developments; and made it clear that in the long run democracy, openness, accountability, and citizen participation provide the most solid platform for sustained economic success that will share its benefits widely across the country. It is false to claim that in an economic crisis 'democracy is a luxury we can no longer afford'. On the contrary, democracy provides potent safeguards against political error, and provides government with the popular support and legitimacy that is required for them to act effectively.

### *1. Renewing the social contract, or social compact*

This was perhaps the strongest commitment of participants in Group 1. This, they said, was not the time to be weakening or abandoning the social contract between governments and workers. Rather, this is the time to be reinforcing and strengthening it. This is a role for businesses, unions and civil society in general, but it is also a central role for governments.

### *2. Protecting the rights of workers*

The group stressed that workers especially at the lower end of the income scale and the young have borne the brunt of the crisis – a crisis they did not cause and over which they have very little control. Hence, there is a central role for governments.

### *3. Managing migration in an era of wrenching economic change*

The mobility of workers is one of the most important phenomena of our times. It occurs within countries, as in the massive movement from rural to urban areas, and between countries. It is often benign, offering skilled workers opportunities that may not be available to them at home, and thereby enhancing the free flow of ideas in a global economy. But it also has a dark side, as in human trafficking, exploitation of migrant workers, and 'ethnic cleansing' that results in large numbers of internally displaced persons in many countries. This too is a profound challenge both to individual governments and to international institutions.

### *4. Re-balancing the relationship between state and market*

The relationship between the state and the market is always in flux. When the state appears to be failing, market solutions come to the fore; when the market fails, the state must step in. This is one of those times. In the post World War Two period, western countries, mindful of the excesses of the Great Depression and the Nazi period turned to building the social safety net and managing the economy through Keynesian economics; post-colonial developing states looked to strong central government leadership in promoting economic development. By the 1970s, both these trends were called into question, and market liberalism, hostile to the state, emerged as the dominant driver of policy. Now the wheel has turned once again as the costs of the unfettered market became apparent. Once again, the state is back in.

But it is never all or nothing; and each country – hopefully coordinated with international economic institutions that are responsive to the whole global economy, and not just a few – will have to find their own way. Group 1 suggested

two primary roles for the state in a globalized the economy. The first is to be a buffer between its own citizens and the vagaries of the global market – this suggests strong social safety nets. The second is to prepare their citizens to participate fully and successfully in the global market-place. This implies a powerful emphasis on training and education.

*5. Re-building relationships of trust and confidence between citizens and citizens, citizens and governments, and governments and governments in the international arena*

This may be the most challenging, but also most fundamental, task. For it is out of the combination of the energy, dynamism, imagination and creativity of individuals as citizens and workers, with the leadership of organizations such as labor and business, and the mobilization of resources by governments that are skilled, competent, open and accountable that economic growth and political democracy thrive together.



# **The Citizen, the State and the Market**





# The Citizen, the State and the Market

By Bolívar Lamounier

The impact of the worldwide economic crisis was not homogeneous across regions and countries. This accounts for some variations in the post-crisis climate, more pessimistic in some countries than in others. The Group called “Citizens, States and Markets” reflected such variations, but, on the whole, the tone of the meeting was rather pessimistic.

Participants expressed strong concern about the sequels of the crisis. A recurring theme was that the crisis impacted deeply on social and political structures, converging with other crises and thus leaving long lasting scars. Geraldine Fraser-Moleketi suggested that we should think in terms of multiple crises taking place all at once. Bondevik, former prime minister of Norway, agreed. In the short run, he indicated, “increasing poverty is unavoidable, and it is already taking place; a deep and long economic recession looms with high unemployment, shrinking tax receipts, lower exports and trade, decreasing tourism, less consumption and ultimately the spectre of deflation”. Indeed, “the financial crisis must be seen in connection to other crises in the world of today. Because we are experiencing an accumulation of at least four crises mutually feeding on each other, namely the financial and economic crisis, the climate change crisis, the food and hunger crisis, and the oil and energy crisis”. Along the same lines, Patterson, former prime minister of Jamaica stressed that the crisis “... goes well beyond financial and monetary; what we are dealing with is really a threat of a collapse of the whole global system of governance”.

Democracy, of course, was at the center of the debate. Kim Campbell, former prime minister of Canada, expressed concern that the notion of democracy itself could be damaged, if people were to lose confidence in the ability of the democratic state to deal with the problems created or aggravated by the crisis. Ingrid Srinath concurred: “I think the whole risk of seeing market failures as failures of democracy is huge”. In many countries, she said, a model of authoritarian or State capitalism may garner more support than capitalist democracy properly.

Several participants took up these issues in more positive terms. “In essence” – said Fraser-Moleketi, somewhat holistically – “... [there is a need] to reenergize the human rights approach to human development, readjust the current global governance accountability arrangements, reconfigure current social processes, and consider the global social compact around common issues such as hunger and other areas, bearing in mind that such a global social contract is required if we want to ensure that we are able to ameliorate such crisis”. Patterson focused on the role of the State and on the individual. “The choice that we face today is not between State ownership and dominance of the State vs. the avarices of financial conglomerates (...); we have to find the right mix, the right balance”. “The citizen – he said – ought to come first: what we are dealing with is the primacy of people, [of] the human being”. In a democratic society, he added, the citizen has at least three distinctive roles: voter, consumer and tax-payer.

For Fraser-Moleketi, "... the State [should be seen] as the bridge between what I refer to as the process, which is the markets, and the outcomes which is what I refer to human well-being". Patterson, again: "we can all agree that the state has the responsibility to create the environment that stimulates economic growth and social development, and the building of human capital. It also has to provide the legislative framework. The State has to develop the institutional capacity to monitor and ensure accountability; accountability to the people in which the market conditions prevail. The State itself is a major provider of services, and a very significant player in the purchases of both goods and services. Civil society has to make the critical difference. It is, if I may say so, the grease between the State, the market and the rights and liberties of the Citizen."

The moderator, Peter Eigen, summarized this part of the discussion as follows: "It's fair to say we've all agreed that there has to be a better and stronger guidance to the private sector by the State. And that it has to strengthen the state, not necessarily enlarge it, not necessarily invite it to participate in the economic activities themselves as commercial actors. Most of us also agreed that civil society organizations can become important actors to help the State to recover the capacity to spread its wings as wide as necessary in order to regulate a globalized economy which has to a large extent, escaped political shaping".

Bondevik emphasized the depth and destructiveness of the crisis, but he also praised the commitment of the G-20 to an open global economy, rejecting protectionism and the temptation of turning inwards in times of uncertainty. "Essential to economic growth and prosperity", he said, the economic opening of the last few decades has lifted millions out of poverty the world over. In his presentation, Victor Rico also stressed poverty reduction and reflected on its significance in the Latin American context: "The reduction in poverty has been more or less homogeneous across Latin America. It has permitted Latin American countries to respond more effectively to the current economic crisis in its political and social aspects but also in economic terms ... because one of the positive legacies of the so-called Washington consensus has been the macroeconomic equilibrium has also come to be seen as a social good. No one disputes any longer that a macroeconomic equilibrium is a good thing". Regrettably, however, the positive trends to which Rico referred coexisted with the reemergence of anti-democratic governments in some countries. In his own words: "Unfortunately, the development of social and economic citizenship has occurred to the detriment of social and political citizenship, which has suffered constraints on freedom of expression, political association and political participation. The challenge, therefore, is how to shape a virtuous cycle involving a strong State, a strong Market, and a citizenship empowered in its political economic and social dimensions".

It is evident, therefore, that the title "Citizens, States and Markets" adequately expressed the cast of mind of the participants. They felt uncomfortable with the traditional state-market dichotomy and agreed that we should analyze a conceptual triangle involving the State, the market and civil society – the latter term, in my view, including the citizens, associations, and representative institutions such as legislatures and political parties.

At the ideological level, a result of the crisis was of course the resurgence of anti-market conceptions. With these in mind, Kim Campbell offered a



reflection on the role of markets: “The market is the mechanism by which the many thousands and thousands and thousands of decisions that go in to the economic interactions of people, can be carried out. And one of the things that is very clear is that States are not good at that, governments cannot run economies, the people who manage bureaucracies do not have the skills or the understanding to take risks, or make the many decisions every day that go into interactions, trade and investments. I would also point out that regulation does work. In other words, there are things that we can do to try to make markets operate in ways that are honest, transparent and functional”.

Concerning the financial system, Mmasekgoa Masire-Mwamba, Deputy Secretary of the General Commonwealth Secretariat, observed that the issue is more complex, because there has already been a lot of regulation; the main challenge, given the scope, scale and complexity of the crisis, is that a lot of what has occurred did happen within the rules. What has been lacking is the State’s ability, willingness and maybe even capacity to hold the financial markets accountable”. She also stated that “we need a more value-based system of regulation”.

In this rapporteur’s view, there was in the group a consensus that States need to do more and better. The problem, of course, is that we must guard against deifying the State, either because in many cases they are corrupt or patrimonial, or because they simply lack the resources and capabilities to regulate the markets adequately. Kim Campbell: “So we have to look at how to strengthen the State, that is, how the State can have the capacity to create the needed policies, how to make politicians more knowledgeable and understanding, and be supported by skilled people, and how the government and the [regulatory] agencies independent and not corrupt”.

Grzegorz Ekiert also emphasized the role of national States. The consequences of this economic crisis – he said – “are and will be greater for national governments, which will have to deal with poverty, unemployment and the appearance of tensions. We really need to focus on how the states need to be reconfigured as the result of the current crisis. I plea for thinking not only about the international system, not only about civil society organizations, not only about citizens and the rights of citizens, but also about capacities of the State and how the State needs to change in the coming years and decades, in order to be able to respond to those challenges”. Ekiert’s view was qualified by Mario Pezzini (Deputy Director, Public Governance and Territorial Development, OECD) who raised the issue of investment targeting more generally: “We are saying that public investment is to be targeted temporarily and in timely fashion. We have discussed a lot about the transient and matters of timing but not enough about the targeting; how this stimulus money has been spent up to now. For many years, we cut public investment: now we are confronted with a big mess and we have to decide where to locate this investment”. At least in Europe, Pezzini insisted, local governments have a fundamental role, and should share resources accordingly.

Peter Eigen welcomed the triangular conceptual framework, which the whole group also supported. The paradigm of the nation-state as the main source of legitimate power and governance requires complementation, Eigen said; indeed, the triangular relationship between State, private sector and civil society organizations [must be viewed] as a new paradigm for better governance in the future.

We must be careful, however, not to overestimate the capacity of civil society; at the very least, we should not forget the large body of literature on collective action problems – i.e. difficulties that organizations face when trying to act together as if they were unitary actors. Ingrid Srinath (Secretary General of Civicus) called attention to the matter of resources: “We have yet to grapple with the problem of resource asymmetry across these three players. The more directly a civil society organization or group of organizations actually engage in playing that watchdog role, the less likely it is to attract funding from the other two sources”. Peter Eigen expanded on this point: “one has to make sure that civil society wants to play an important role as part of [the system of] governance. Such organizations have to grow into this role, become informed and strengthened in terms of modernizing their management transparency, and their own governance, which of course includes the question of the funding”.

Campbell offered an important remark on the relationship between individuals and associations: “civil society is a great thing, but the ultimate unit of a society is the citizen. And in free societies the citizens are the ultimate decision-makers through their voting, and their choices regarding joining civil societies and various organizations”.

Apart from rethinking the system of financial regulation – a cross-cutting recommendation in the whole conference –, and recognizing that specific practical recommendations were not our objective in view of the enormous diversity of national contexts, group participants made several valuable indications likely to be valuable from the standpoint of broader policy choices.

Ekiert suggested that we should not expect too much from the State. The problem, he added, is not just that the capacity of States is limited but also that they create or aggravate problems when they try to do too much. Such advice seems particularly important in connection with the crisis because Ekiert at the same time recognizes that states must now be proactive, vigilant, and able to respond rapidly to unexpected challenges.

Also prescriptively, Yun-Han Chu (Research Fellow, Institute of Political Sciences, Academia Sinica) made thoughtful remarks. In the short run, he argued, the most urgent task is to restore the checks and balances between the State and the markets, especially between the State and the financial market. We all recognize, he noted, that the scope, scale, and complexity of the challenge are vast, global in nature and well beyond the jurisdiction and capacity of the nation-state. They require national, regional, and global responses at the same time. We have to restore the nation-state as one of, not the only, but one of the critical and relevant important actors. The nation-state can be empowered through a proper multilateral and regional arrangement. Otherwise, the multinational financial market and multinational corporations are simply too powerful for any national government to attempt to regulate.

Another fundamental task, he argued, is to develop a common vision for a balanced, sustainable and virtuous triangular relationship between citizens, market, and State. For Chu a balanced, sustainable, and virtuous triangular relationship entails two elements. On one hand, a constructive partnership must develop between each of the three parts, through dialogue, engagement, mutual accommodation and collaboration. On the other, a prudential system and practices of checks and balances must also develop in each of the three

poles of the triangle. Each pole should have its own autonomy, identity, and objective, and try to work with the other two seeking common ground. All three actors have responsibilities.

Nongovernmental organizations (NGOs) can exert checks on the conduct of the corporate sector, on behalf of consumer, labor, local community, and environmental interests. However, each pole in the triangular relationship ought to exercise such checks with reasonable restraint. Without prudence, the democratic system tends to be overburdened and problems of excessive polarization, politicization, or even lack of governability tend to appear. So, Chu argued, the most important responsibility of the State and of civil society actors, under the current circumstances is truthfulness which is essential if political leaders are to turn the crisis into a window opportunity to introduce fundamental reforms.

Finally, Chu pointed out that none of these suggestions is ideologically anti-market. These are market-oriented prescriptions because they are meant to enhance the long-term sustainability of the free-market and free-trade.

Campbell also sketched a philosophy regarding the primacy of politics, staying away from holistic theories of the State while emphasizing the importance of values for political action: “The responsibility to make decisions and to direct institutions – she said –, never goes away. In democratic societies, the State is what we make of it, it has the powers that we give it, the ideological predispositions that we bring to it, and whether the government is big or small. It is the skill of the people who are in the government and the ability and ethics of the people who operate in it”.

Indeed, the quality of the “political class” and the degree of allegiance and esteem it gets from the public are key elements in the functioning of a democracy. Rojas Aravena (director of the Latin American Faculty of Social Sciences -Flacso) rightly observed that the decline in support for politicians, legislatures, and political parties is one of the most worrisome aspects of democracy in contemporary Latin America.

Indeed, what undermines the legitimacy of democratic institutions in the region nowadays is not the lack of political rights or participation opportunities (except for some cases of authoritarian populism and the case of Cuba), but rather the lack of effectiveness of the states and the precarious standing in which politicians and representative institutions are held.

In Brazil, for example, the vote is allowed from the age of 16; the total electorate is now over 130 million voters, 70% of the population. There is no question that political rights are in place. What undermines the legitimacy of democracy, first and foremost, is the ineffectiveness of the governments, at all three levels of the federation, in meeting people’s needs and expectations.

The other factor, as indicated, is the low standing in which politicians are held. The Group emphasized the observation that citizens devalue politics, with or without reason, but also that the politicians themselves do a lot to reinforce the public’s negative evaluations. Politicians also devalue politics. I would therefore like to conclude this report on the idea of the primacy of politics. There is a need for political will and leadership but this may well require efforts to recapture the value of political activity and to re-value the vocation of politics. This may well be one of the conditions to turn the crisis into opportunity.



# **The Market, Regulatory Frameworks and Democratic Governability**





# The Market, Regulatory Frameworks and Democratic Governability

By Lucinio Muñoz

*"Nobody was prepared for this type of tsunami that all of a sudden occurred; we didn't see it coming"* Wim Kok, former Prime Minister of the Netherlands

The most recent global financial crisis "tsunami" had its epicentre in the financial markets of the United States and Europe but its impact has been suffered on a global scale and its seismic waves have affected not only international financial markets but also national economies and citizens all over the world. Substantial amounts of taxpayers' money have been transferred from public budgets to private institutions, as governments have felt compelled to bail out banks and insurance companies in order to avoid the collapse of their financial systems. This financial cataclysm has caused severe economic disruption and it has had profound worldwide political implications.

Painful as it has been, the crisis could be an opportunity to reflect on how financial markets can be managed more effectively through the use of highly technical standards and regulations that address the deficiencies that caused this crisis in the first place and protect citizens from the most pernicious effects of future potential financial troubles, while at the same time allow for the efficient functioning of those financial markets. In the light of this financial crisis, the aim of this working group was to review the relationships between the market and democratic governance, explore the role of regulatory frameworks in this context, and suggest some concrete policy proposals.

This account of the discussions of Working Group 3 is divided into three parts: the first is dedicated to the diagnosis, reviewing the causes of the crisis; the second summarizes the discussions dedicated to draw some "lessons learnt" and suggests some policy proposals; the final section reports the reflections of the Working Group on the impact of the important challenges that the crisis has posed to democratic political leadership.

## 1. Diagnosis: The causes of the financial crisis

Jorge Quiroga, member of the Club of Madrid and former President of Bolivia, highlighted important global macro-economic imbalances that contributed to the creation and widening of the crisis. The pre-crisis international financial bonanza was built on weak foundations as it was based in what Niall Ferguson had called "Chimerica"<sup>i</sup>. Global wealth creation was the result of saving by the Chinese and overspending by the Americans, a situation that was not sustainable in the long run and that may have been the breeding ground for the crisis.

Deficient regulation, lack of effective supervision, and excess confidence in the self-regulatory capacity of the financial markets were highlighted as having

played a crucial role in the making and in the subsequent development of the financial crisis. Deficient regulation and lack of efficient supervision referred both to situations utterly lacking in regulation (such as the so-called shadow financial system) and to those where existing rules were implemented either inadequately or not at all (rules on minimum capital requirements were not applied in some major jurisdictions).

President Quiroga argued that even certain regulations in the United States contributed to the creation and amplification of the crisis. Among those, Quiroga mentioned: the 1999 repeal of the Glass-Steagall Act (the 1933 Act that mandated the separation of commercial and investment banking), the 2000 Commodity Futures Modernization Act that allowed the unregulated explosion of credit default swaps contracts<sup>ii</sup>, and the US legislation, developed through the years, that allowed Fannie Mae and Freddie Mac to reach leverages of 100 to 1<sup>iii</sup>.

Another of the concurrent causes for the crisis, WG members agreed, was the role played by credit rating agencies, which failed to play their function in diagnosing the increased level of risk and predicting the crisis. Some analysts accused them of having contributed to the financial debacle by their too-complacent attitude and even complicity with the issuers of some of the instruments that later defaulted.

Javier Santiso, Director of the OCDE Development Centre and Nkosana Moyo, Vice President and Executive Operating Officer of the African Development Bank, both experts serving this Working Group, also pointed out to the very important role that the lack of information or had played in the origins of the crisis. Santiso<sup>iv</sup> stressed that this has been a “cognitive crisis”. The systemic risk had been grossly underestimated by most supervisors. This deficient assessment, Santiso noted, could have been caused by “cognitive collusion” whereby dissonant voices may have been purposely sidelined or even silenced. Nkosana Moyo<sup>v</sup> highlighted some important deficiencies in the actual implementation of supervision. On the one hand, in-house supervision within banks failed because internal supervisors did not have the necessary knowledge to supervise efficiently the job of the traders and practitioners; on the other, external supervision by public authorities may have also failed because of the asymmetry of knowledge and information between day-to-day private traders and public supervisors.

The lack of a comprehensive, coherent, and coordinated approach among regulators and supervisors at the national and international levels may have added to the extent and gravity of the crisis. In the very beginning, in the absence of an internationally coordinated framework, some countries even resorted to some “beggar-thy-neighbour” policies<sup>vi</sup>. The creation of the G-20 as the main international forum for coordinating policies to deal with the international financial crisis, although far from perfect in terms of its global representativeness, was seen as an improvement over the preceding situation. Participants acknowledged that it had succeeded in containing the crisis and delivering some significant outcomes.

Greed, excess, unconstrained ambition and even criminal misbehaviour<sup>vii</sup> were also mentioned among the causes of the financial crisis. The pre-crisis environment was focused almost exclusively on short-term benefits and privileged risk-taking casino-like financial activities at the expense of long-term traditional utility-type banking. The incentives that prevailed in the financial sector encouraged the global craving for risk, nurturing the crisis. While incentive



systems in fiercely competitive financial markets increasingly encouraged risk-taking behaviours by firms and individuals, the existing supervisory systems could not cope with this higher level of risk and complexity.

In relation with the incentives to individuals, the issue of bonuses and compensations paid in the financial sector has also often been mentioned as one of the causes of the crisis. However, some participants in the Working Group pointed out that, despite its popular impact and media interest, this issue should be considered within the broader framework of incentives and that it should not be regarded as “the main” item on the reform agenda<sup>viii</sup>.

## **2. Prescription: Lessons learnt and policy proposals**

The first part of this section summarizes the WG’s conclusions on the lessons learnt and the main general principles drawn from the discussions. Specific policy proposals are discussed in the second part.

### *2.1. Lessons learnt and general principles*

Participants in the WG broadly agreed on the following: (i) There is no contradiction between the state and the markets; quite the contrary, efficient states are necessary to have efficient markets; (ii) Regulation is not an ideology, but a pragmatic way to reconcile the need for state intervention with the efficient functioning of the markets (iii) A careful design the regulatory systems is crucial.

#### **(i) There is no contradiction between state and markets**

One consequence of the financial crisis has been the revival of the recurring debate about the relationship between the state and the markets. On one end, staunch critics of capitalism stress market failures and argue that this financial crisis has given a fatal blow to the capitalist system as a whole and proved the failure of the market system, which is intrinsically based on the unfettered forces of finance. At the other end, critics of state intervention in the economy stress state failures and retort that, in fact, the financial sector is one of the most heavily regulated in modern economies. This crisis has not been caused, they argue, by the free functioning of markets but, on the contrary, by ill-fated state’s intervention through deficient regulation.

The Working Group’s main conclusion was that there can be no contradiction between the state and the markets. Otaviano Canuto, Vice President for Poverty Reduction and Economic Management at the World Bank, noted: “We simply cannot understand this confrontation between state and markets; there is no such thing. Markets do not exist in a vacuum. Effective governments are necessary to effectively manage market risks and enable the proper functioning of markets. Sir Arthur Lewis, the Nobel Prize winner, said once that “governments can fail either because they do too little or because they do too much.” What matters is that “one needs effective government to have effective markets”.

This mutually reinforcing relationship between effective markets and effective government is directly related to the Club of Madrid’s mission of promoting effective democracies or, as stated in the organization’s motto, “promoting democracy that delivers”.

Former Ghanaian President and Club of Madrid member John Kufour also emphasized the futility of the discussion of the state versus the markets and pointed out that politicians should act in a more pragmatic way and “should stop demonizing the markets”. He suggested the possibility of bringing back the classical term “political economy” to underscore the necessary interdependence of politics, economics, and the markets.

Former Prime Minister of Bosnia Herzegovina and member of the Club of Madrid Zlatko Lagumdzija also touched on this point. “Not so long ago”, he said, “the widespread belief among many economists and politicians was that government had to get out of business and that market laws were like natural laws: you do not discuss market laws as you do not discuss the law of gravity”. He also stressed the need of finding the right balance between markets and state intervention through regulation<sup>ix</sup>. Regulation should rein those potentially unfettered market forces and make sure that the right balance is struck so markets have a positive impact on society.

### (ii) Regulation is not a matter of ideology

“Regulation is no longer a matter of ideology; it is a matter of pragmatism”. Otaviano Canuto thus summarized another one of the general conclusions of the Working Group. He stressed that it is not a matter of more regulation but of better regulation; he emphasized the need for a careful design of the regulatory systems. Markets may first have been over-regulated, then de-regulated, and now they need to be re-regulated.

### (iii) Need of a careful design of the regulatory systems

The design of the regulatory system is critical. Canuto pointed out, first, that the right kind of incentives had to be set for financial institutions, financial managers, and the regulators<sup>x</sup>. Second, the system should have embedded a high degree of crisis preparedness, as financial crises and catastrophic events are bound to happen again. Third, regulators need to draw on market signals to overcome information problems and improve their ability to track risk in and out of crisis.

Another important prescription was that any regulatory framework has to be designed to be both comprehensive and inclusive. It should be comprehensive in order to include all parts of the financial systems<sup>xi</sup>. As stated before, one of the perceived causes of this last financial crisis was the fact that some institutions of the “shadow financial system” escaped regulation and supervision through the many holes and gaps of the system.

Regulation has to be inclusive too. Regulation should not be just a matter between government officials and the banks. It has to factor in the voice and interests of the multiple stake-holders that are affected by it. The roots of the problem may lie in a few actors but the consequences of this crisis are systemic, affecting a very wide range of people. Former President Kufuor linked this point to the very heart of political representation<sup>xii</sup>: “When working on regulatory issues”, he said, “we have to make sure that we address this matter so that, besides listening to the technocrats, the entire community is taken into account and would get the necessary hearing through the political system”.

Joseph Janning, Senior Director of the International Governance Program of the Bertelsmann Foundation, who acted as moderator of the Working Group,

took the discussion a step forward and referred not merely to the actual design of regulation but to the “social environment” in which regulation has to be applied. Thus he advocated the inclusion of values and moral judgements into the equation to strengthen the effectiveness of regulation<sup>xiii</sup>. There is a need to include a moral dimension to regulation, which should be based on commonly shared values such as that legitimate short-term individual interests should be compatible with the longer term interests of the society and its citizens. In addition, Andrea Monari, responsible for the European office of the Asian Development Bank, stressed the need to incorporate in the discussion the issues of competence and responsibility in the financial sector.

## *2.2. Lessons learnt and policy prescriptions<sup>xiv</sup>*

### *(i) New tools and early warning systems*

As Javier Santiso pointed out, this has been a cognitive crisis. The unfolding of the crisis has featured unusual speed, reach, and impact. The global system failed in its predictive and preventive capabilities. With a very few exceptions, nobody saw the imminence or the gravity of the crisis until it was too late. Moreover, there was little tolerance for “cognitive dissonance” from those institutions and individuals who warned against the mounting amount of risk in the system. Thus, one lesson learnt is the need to develop new predictive tools and new early warning measures to increase the system’s prevention and risk-management capabilities. Cognitive dissonance may play an important crisis-preventing role.

These new tools, measurements, and indexes must be more comprehensive, taking into account not only economic parameters like gross domestic product but also other social, cultural, and developmental aspects, such of those considered in the human development index.<sup>xv</sup>

### *(ii) A balanced global economy, a less asymmetric approach*

Participants believed that the existence of important global macro-economic imbalances had contributed to the creation and widening of the crisis. Members of the WG suggested that one prescription should be to build the new system on more solid global macro-economic foundations. In this respect, having a more balanced global economy would make the system less crisis-prone, more resilient, and less vulnerable to sudden changes in market conditions. Former President Quiroga highlighted the medium term risk-generating potential of the current global exchange rate system and he suggested changing to a system based on a currency with a more diversified base such as the SDRs (Special Drawing Rights)<sup>xvi</sup>.

Regarding the reaction of international financial institutions to the measures taken to deal with this crisis by the governments of industrialized countries, President García highlighted the asymmetry between international policy-makers’ current blessing of the resulting huge fiscal deficits and their reactions in previous crisis that had mainly affected developing countries<sup>xvii</sup>.

### *(iii) Coordinated, comprehensive and coherent new supervisory and regulatory Frameworks*

The financial crisis has evidenced the failure of the national and global financial systems to properly assess and deal with the adverse consequences of

increased systemic fragility, which is a negative by-product of the integration of financial markets. This evidence may have provided the sense of urgency to propel national governments to undertake a complex but much-needed reform in their financial supervisory and regulatory systems. Moreover, one “positive” result of the recent international financial crisis may be the emergence of a new worldwide awareness of the need to overhaul and strengthen the global financial system in a coordinated way. Authorities must seize the opportunity to transform the negative energy generated by the crisis into a positive thrust to make the international financial system more efficient, resilient, and just.

There was a broad agreement on the need to support the development of new supervisory and regulatory frameworks, which are efficient (regulators have to make sure that policies are actionable, reasonable, cost-effective, and cost-efficient), coordinated (internationally coordinated solutions to address problems in the global and highly interconnected financial markets), coherent and consistent at national level and on a cross-border basis<sup>xviii</sup>, and comprehensive (no regulatory gaps should allow institutions to circumvent regulations and the perimeter of regulation and supervision should be extended to all financial institutions).

The rules that exist should be effectively applied in practice. Some participants argued for a “back to basics” approach in financial regulation. There was a feeling that, if existing rules<sup>xix</sup> had been applied before the crisis, some of the ensuing problems might have been avoided.

President Enrique García also stressed that financial policies and regulation should take into account both the short-term issues of market stability and also efficiency and growth in the medium and long-term, taking into consideration as a general policy both equity and inclusion<sup>xx</sup>.

The three following specific issues were also discussed bearing on regulation.

### a) “Too-big-to-fail issue”/“universal versus narrow banking”

There was intense discussion in the WG about the risks posed to the global financial system by the “too big/too inter-connected to fail institutions”<sup>xxi</sup>. These institutions based their growth on the concept of universal banking, which encompasses both commercial banking and investment banking.

Some participants felt strongly that one lesson learnt from this crisis is the need to challenge the concept of universal banking. For instance, Nkosana Moyo vehemently defended the convenience of splitting traditional commercial banking (also referred to as public utility banking) from investment banking (pejoratively called “casino banking”)<sup>xxii</sup>. Others, such as Otaviano Canuto, doubted that adopting a “narrow banking” model, with a very sharp division between commercial and investment banks, would help to cope with future crisis; he warned that a too clear-cut separation might make things even worse, increasing overall instability<sup>xxiii</sup>.

In any case, there was broad agreement that any regulation both at macro- and micro-prudential levels should require from financial institutions an adequate level of risk-adjusted capital<sup>xiv</sup>.

## b) Need to increase crisis preparedness and develop mitigation measures

At national and international levels, institutions should increase their degree of crisis preparedness. We cannot prevent catastrophes but we have to be prepared to face them<sup>xv</sup>. “The belief that appropriate regulation can ensure that speculative activities do not result in failures is a delusion”, Mr. Moyo concluded.

As we cannot prevent the “impossible” from happening, more attention should be paid to mitigation measures that reduce the negative impact of those unexpected events, participants agreed. As an example of those mitigation and prevention measures, Mr Koyo advanced the concept of “balkanization”<sup>xxvi</sup> meaning that financial regulation should be designed to ensure that the potential impact of a catastrophic event can be kept as isolated as possible so that it does not spread and cause fatal damage to other parts of the system.

## c) Reconcile the need of technical independent supervisory authorities with the needs of democratic political accountability.

One issue was identified from the start regarding how regulation and supervision should be organized in democratic societies. Two objectives must be reconciled, namely, to ensure that supervision remains in the hands of highly competent technical bodies independent from political interference while, on the other hand, also ensuring that they be democratically accountable.

Regulation must meet high technical standards, which can only be guaranteed if they are in the hands of independent and highly technical bodies, detached from daily political pressure. President Kufuor stated the general principle regarding the need to reconcile technical independence with political accountability: “There needs to be pragmatic governance and, at the same time, we need to bring in people’s interests as represented through parliaments”.

President García postulated some basic principles to deal with this reconciliation between independence and democratic accountability. He argued that too much political interference should be avoided, yet parliaments should participate in the appointment of the directors of the supervisory agencies and in the subsequent control of their activities. Supervisory agencies should have clear mandates and keep their independence from the executive branch. Their directors should be given guarantees that they cannot be arbitrarily removed from their positions.

There was a debate regarding how to organize supervision at a national level and the role of central banks and supervisory authorities. Some defended a sharp division of tasks and the exclusion of central banks from day-to-day supervisory tasks while others argued that central banks should be directly involved in the supervision of individual banks to control systemic risks<sup>xxvii</sup>.

No matter what model is finally adopted, the system must be efficiently organized. There should be a clear identification and assignment of competences, tasks, and responsibilities among supervisors. The system should also be as simple as possible. This crisis has shown that a too-complex system with many different overlapping supervisory agencies may have resulted, paradoxically, in a lack

of effective supervision. Peter Kelly, Chairman of the Board of Directors of the International Foundation for Electoral Systems, noted: “Where everyone is in charge of everything, no one is in charge of anything”<sup>xxviii</sup>.

### (iv) Strengthened international financial architecture

The global financial crisis has raised international awareness that supervision and regulation must be internationally coordinated in order to be effective. A coherent global framework should replace the current patchwork of juxtaposed national systems.

One obvious impediment to achieve this goal of international coordination is the lack of an adequate international institutional framework. This crisis highlighted the utility of adapting the international financial architecture to the new challenges faced by the international community.

The existing Bretton Woods institutions lacked the capacity to respond at the speed and with the intensity required. The world faces the ever-pending issue of reforming international governance. Participants recognized the important role played by the G20, which managed effectively to coordinate the international response to the global financial crisis, despite its lack of worldwide representativeness<sup>xxix</sup>.

The roles of the international financial institutions (IFIs), including the International Monetary Fund, the World Bank, and all the regional banks, should be reviewed. The roles of the different institutions in the new international landscape drawn by the crisis should also be clarified.

The WG also stressed the urgent need to recapitalize the IFIs so they can continue playing their role in the new international environment. Participants feared that the financial consequences of the crisis may result in a situation of scarce resources that may hit poor countries particularly hard. If not adequately capitalized, the IFIs may be unable to provide financial transfers and social safety nets to poor countries. They may also fail to assist such countries with technical assistance and advisory support<sup>xxx</sup>.

### (v) New Regulation for Rating Agencies

The role of rating agencies should be reconsidered in the light of their poor performance during this financial crisis. President Quiroga proposed that they should either be converted into public services or, to avoid conflicts of interest, be paid by some entity other than the issuers of the securities to be rated.

## **3. Conclusions: Big challenges to democratic political leadership**

Wim Kok, Former Prime Minister of the Netherlands, summarized the main challenges to political leaders in democratic countries: “In Europe, this crisis has caused a general lack of trust in leadership in the financial sector, more broadly in the corporate sector, and even more broadly, in political leadership. Private financial systems have created such a mess that governments and

public authorities have had to get involved and put huge amounts of public money to bail out financial institutions. Ordinary people in our countries say: 'the rich and the privileged have caused the crisis, the government pays for repairing the more severe consequences and, finally we pay the bills'".

This crisis has posed difficult challenges to democratic political leaders who must manage its political, social and economic consequences by trying to reconcile efficiency and equity. The crisis has created a profound sense of unfairness. People perceive a socialization of the losses versus the private appropriation of benefits by financial institutions.

Democratic leaders face the difficult challenge of regaining the credibility and will to seize the opportunity to lead toward much-needed reform while at the same time not succumbing to populist short-term pressures that may stifle economic prospects and endanger the possibilities of growth via innovation and productivity. Politicians will face increased pressure to be more strict and rigid in regulating financial markets; this rigidity may limit the growth potential of our economies. Public support for the financial system has created big fiscal deficits; only sustained growth may reduce those deficits.

Enrique García warned about the danger that policy makers may not pay enough attention to the medium and long-term economic challenges if they concentrate just on short-term highly sensitive political issues. The sheer magnitude of the fiscal stimulus makes it a "one-shot" policy; unless it succeeds in revitalizing our economies, the world's future may look bleak<sup>xxxi</sup>.

The WG ended with two notes of caution. First, some expressed concern that the next bubble may already be in the making and that, as financial markets return to normality, policy makers may return to a "business-as-usual" mode. Second, at the end of the meeting, the moderator polled the participants, asking them to raise their hands if they believed that the crisis will be over and that the much-heralded reform measures will have been taken by the Spring of 2011: not a single hand was raised. May history prove us wrong.

## NOTES

i In President **Quiroga's** terms: "China manufactures, China saves, China has an appreciated exchange rate. The Americans consume, they run up debts, they built up houses, they buy flat screens, refrigerators, microwaves..."

ii Quoting former New York Insurance Superintendent, Eric **Dinallo**, those contracts that allow investors to speculate on the creditworthiness of borrowers "were more dangerous than gambling as, unlike what happens with casinos, swaps sellers aren't required to keep funds to pay losing wagers".

iii Much higher than the 8% Basel ratio of capital to assets that had been widely applied in Latin America, which was less severely hit by the crisis as a result.

iv Javier **Santiso** had centred his presentation on the inter-actions between financial markets and elections in Latin America. He concluded that the data show that elections have had a very significant impact on financial markets acting as "confidence multipliers"

v Nkosana **Moyo** argued that markets in general, and financial markets in particular, work and adjust and make corrections even after catastrophic events. He pointed out that many commentators may have confused catastrophic adjustments with lack of market correction because generally accepted assumptions had never taken into account the possibility of a catastrophic market correction.

vi At the outset of the crisis, some countries announced “buy-national” clauses. Participants warned against the global threat of a rise in protectionism. “We have to protect ourselves from protectionism”, President **Quiroga** strongly advocated.

vii President **Quiroga** said that some of the episodes of the crisis should not be described as market failures but as mere “rip-offs and swindles”.

viii “Every time the G-20 meets, one of the top issues on the public agenda is the issue of bonuses and compensations in the financial sector. I don’t want to underestimate the importance of bonuses”, said **Prime Minister Kok**, “but that’s not the heart of the problem”.

ix **PM Lagumdzija** advanced a telling analogy between markets and atomic energy. “Fifty years ago atomic energy was the first invention of mankind that could be either used for destruction or for the well-being of our societies. I think we need to treat markets as atomic energy”.

x “Before giving them more power, one needs to take into account the complexity of the political and economic relationships between the regulators and their regulated subjects”, **Canuto** said.

xi Former President **Quiroga** expressed this need for comprehensiveness as follows: “I think that having prudential capital regulations applied to financial institutions, under whatever guise they may present themselves, is something that has to be at the front and at the centre of any market regulation”.

xii President **Kufuor** also touched on this point: “The stakeholders are not just the bankers. Financial collapse has repercussions on other stakeholders like the employees in the banking system, bank customers and mortgage holders, taxpayers and a whole lot of people” “Regulation”– continued President Kufuor – “has to take into account what it needs to protect and the political system must be there in order to protect, first and foremost, the people that tend to be the biggest sufferers in any financial crisis”.

xiii “What we’ve learned in this financial crisis”, **Janning** said, “is that it seems that market decisions are taken, absolutely free of any value base. There is no other element of constraint when seeking to optimize profits that specific laws and regulations. In our normal actions as citizens people do exercise some self-constraint and do not only not do those things that are explicitly forbidden by law, but we also abide by a set of common values or social codes of conduct”

xiv Prime Minister **Lagumdzija**, argued that current State interventions have to be treated as “surgery after having had a very bad car accident. We cannot allow ourselves to drive the car in the same way and direction. The question is whether we shall drive the same car. But, definitively, we have to repair the car and start thinking about driving to a different direction and with different purposes”.

xv Former Prime Minister **Lagumdzija** quoted Robert Kennedy’s affirmation that the new indexes should go beyond GDP because “GDP measures everything except that which makes life worthwhile”

xvi The current system, based on the US dollar and on the pegging of the Chinese yuan to the U.S. dollar, perpetuates the imbalance. If any country”, said **Quiroga**, “had the trade balance deficit and the financial problems of the US and had to issue the amounts of debt that America has had to issue, it would need to go before the Paris Club of international creditors”.

xvii “The IMF would have killed us if it had been us, developing countries, who had run those deficits”, President **García** mentioned half-jokingly.

xviii Drawing on what happened during the crisis, President **Quiroga** highlighted the need of coherence and consistency, not “changing the rules at the middle of the game”: “You can’t keep on changing the rules (...) If a former Chairman of a private bank in Latin America became Finance Minister and then, first saved a small bank, then let a medium bank crash, and then saved some bigger ones, he’d be accused of crony capitalism, he’d be shot and thrown into jail, but that is what’s happened in the US; and it is contagious...)

xix Such as those on minimum capital requirements or some “common sense” limits to leverage ratios

xx Both traditional micro- prudential and macro-prudential regulations should be strengthened. One of the main lessons from this crisis is the importance of sound macro-prudential regulation to keep systemic risk under control and mitigate the impact of contagion from the financial sector to the rest of the economy. On the micro-regulation side, there should be stricter rules on rules to prevent currency and maturity mismatches and to ensure that financial institutions are adequately capitalized.



xxi Too-big-to-fail or “systemically important financial institutions” are financial intermediaries with global dimension, or at least, with significant cross-border activity, engaged in some combination of commercial and investment banking whose failure poses a systemic risk or negative externality to the financial system as a whole, which in turn affects the real economy

xxii “The combination of a casino bank and a utility bank just doesn’t make sense. I think we need to go back and separate the two, so that people who deposit their money in what they consider to be utility banks should not be exposed to the risky activity of the casino banks”, said **Moyo**.

xxiii “As things normalize”, the argument went, “the search for a yield might lead the wealth holders to shun deposits at the “utility” banks and move to “casino”-banks when, on the contrary, in a crisis situation everyone should seek refuge in the utility-protected banking system; these movements might increase the instability of the banking system” Thus **Canuto** advocated pursuing an instruments-based rather than an institution-based approach, making sure that the risk profile is reflected in capital requirements in a dynamic fashion rather than making a distinction according to the type of institution.

xxiv “The nomenclature should not do away with the fact that if you are handling people’s money, you need a certain level of risk adjusted capital, whatever you want to call an institution”, in President **Quiroga’s** words.

xxv In the words of **Otaviano Canuto**: “Phenomena like the *black swans* that we saw are bound to happen again and one should be prepared”. **Nkosana Moyo** used the metaphor of earthquakes, tsunamis, and movements in tectonic plates; he made the point that, even if we could predict them, catastrophes will happen and markets will adjust to the new situations. Accidents are still going to happen and it might be better to concentrate on how to deal with those risks that we cannot avoid. In the words of **Prime Minister Kok**: “not even the most sophisticated and internationally coordinated systems of regulation and supervision will be able to prevent certain events happening in the future. Everywhere where risk is taken there is the possibility that something might happen that cannot be kept under control; this is intrinsically related to the functioning of the market.”

xxvi **Moyo** advanced this example to explain the concept of **balkanization**: “In the shipping industry, when you build a supertanker whilst you don’t expect accidents to happen, you nevertheless use an architecture that ensures that, if in fact an accident were to happen, the damage would be limited. That is referred to as “balkanization”, which means that the ship is constructed in such a way that is broken down into smaller tanks or departments so that, if some accident happens, you lose a small amount of the cargo, or if water ingresses then it doesn’t take over the whole ship and it sinks”.

xxvii Enrique **García**, President of the Andean Development Corporation, defended the assignment of clearly separated functions to the central bank and the other supervisory agencies. The central bank would have the competence over monetary and exchange rate policies and the setting of the general financial policy framework, while the actual follow-up and day-to-day supervision would be assigned to a different supervisory agency. Otaviano **Canuto** mentioned that when it comes to the supervision of systemic risk, the central bank will have to work in very close coordination with other supervisory agencies and that a too-sharp and a clear-cut regulatory division might make this necessary coordination more difficult.

xxviii In order to enhance independence and make sure that the boards play their role as the first line of control over the banking activities, there should be rigorous criteria for being a member of the board of a financial institution “You have in some boards in the financial sector, people who know nothing at all about management of a bank and they are the ones that will make the critical decisions”, some pointed out. It was also suggested that there should also be measures to avoid having the boards full with political appointees. These appointments may compromise the board’s independence and create incentives for corruption, as the remunerations that those “political” appointees perceive for their board membership may be much higher than their public or political salaries.

xxix “The G20 is better than the G8, but worse than the G 190”, was heard during the Club of Madrid’s General Assembly.

xxx President **Quiroga** said: “I think that what the IMF has done is fine, but those of us who have dealt with the IMF know that, 10 years ago the IMF was really the ABTMF (Argentina, Brazil, Turkey Monetary Fund). It is now the EE MF, the Eastern Europe Monetary Fund. And I think the Eastern European situation is going to absorb most of the resources that are being put for the IMF. We are going to be lacking resources for development, roads and infrastructure; social safety nets may not be available around Africa and Latin

America". Separately, some also argued for extending to the subnational level the scope of regulation and supervision in decentralized countries, such as Spain and Germany where there is a strong presence of regional banks.

xxxi "The fact of the matter –García said- is that we have to restore growth; growth in developing countries cannot remain at 4% or 5% but has to reach 7% or 8%". As the saving capacity in developing countries is structurally insufficient to cover their investment needs and as industrialized countries are also going to need funds to finance their current fiscal deficits of 10%-12% of their GDP, there is going to be great competition in the future for those scarce resources". In addition, at an international level, **John Kufuor**, member of the Club of Madrid and former President of Ghana, stressed the need to maintain the "safety nets for the poorer parts of the world so that poor countries are not caught off-guard by problems, such as this, that started in the industrialized countries and whose main sufferers may be end up being those who didn't contribute to making them". **Sanjay Peters**, Director of the Centre for Emerging Markets at ESADE Business School, called attention that we should not forget other "residual" effects of the crisis, such as the impact that growing poverty levels may act as powerful catalysts of global instability through the channels of large scale migration flows and through its impact on security issues.

# **An Institutionalized and Effective International Governance System**





# An Institutionalized and Effective International Governance System

By Andrés Rigo

## First Session

The discussion focused on the analysis of the large asymmetries between globalization and institutions, and the concrete efforts being made to solve them.

Mr. Buzek, president of the European Parliament, opened with the following points: first, the need for a network of global institutions; networks are better for smaller countries and give them a sense of participation in the decision-making process; second, the value of reinforcing regional integration; and third, the importance of increasing the role of parliaments in the global architecture, i.e., through pre-summit meetings of parliaments.

The expert on the panel, Mr. L. Martínez of the Brookings Institution, asked, what went wrong?, and explained that, like in the case of the Great Depression, it will take a long time before we have full answer. In the meantime, we need to understand the gaps in the current system and how they have developed.

**First gap:** the focus of the current system has been on the emerging markets, where crises have erupted in the past (e.g., the East Asian crisis), and not on where financial instability developed on this occasion. In particular, the United States refused to submit to a financial sector assessment program, an instrument devised after the East Asia crisis to monitor the financial policies of individual countries. **Second gap:** there is no ruthless-truth-teller. The International Monetary Fund (IMF) is supposed to have this role but fails to fulfill it in respect of the larger players. **Third gap:** domestic regulators are the first and last line of defense, but in the case of the insurance giant, AIG, \$500 billion fell outside regulatory supervision; similar problems are present throughout the system. **Fourth gap:** international regulators cannot keep up with the dynamism and sophistication of the private sector networks and as a result nobody can see the whole picture. **Fifth gap:** the regulatory system is pro-cyclical; when the times are good regulation is weakened, and vice versa.

Then Mr. Martínez addressed what is needed for the future: first, a grand bargain where the US would remain the indispensable nation, Europe would be guaranteed a measure of control, the major emerging nations would be ensured that participating in the system is less costly than staying on the sidelines, and poor countries would be guaranteed representation around the table; second, application of peer pressure to financial regulation and the management of global imbalances; and third, institutions which can see the whole picture.

The first discussant, Mr. Prodi, explained that there are three methods of building an international governance system: top-down, by agreement, and growing by example. He contrasted Kyoto and Copenhagen, where he noted the progress made in the world opinion in the time lapsed between the first and the second. He also referred to the European Union (EU) as an example of a super-nation that exported democracy. In this respect, he lamented that in recent times the EU seems to have evolved from a laboratory into a museum, weakening the

capacity of Europe to be at the forefront of reform of the international system. Mr. Prodi emphasized that the economic development of Africa, this will not happen unless there is first a strong political agreement among African states. This is surely one of the most crucial issues in the contemporary world to which any governance system must respond.

The second discussant, President Cardoso, noted that the financial crisis unveiled situations that already existed. It is not true that nobody saw the coming crisis; many economists pointed out the unsustainable deficits of the United States. In turn, the financial crisis has permitted us to see better the profound economic transformation that took place during the last decade. However, it is not clear whether China is ready to share global responsibilities. President Cardoso was impressed by how soon the crisis was declared to be over. The financial or banking crisis may be over but the rest of the economic crisis is still evident in the form of unemployment, possible inflation caused by the massive liquidity injected in the system, and the weakness of the dollar.

According to President Cardoso, the crisis has created disequilibrium. The United States cannot impose decisions without consultation, which is an opportunity to introduce changes. He supported the idea of a network of institutions rather than the creation of another hierarchic organization. The IT revolution makes it easier to think about the possibility of a more democratic world order and seems to be apposite to the shifting of power from one or two poles to a more dispersed form of power. He emphasized the need for leadership and the need for discussion, which can contribute new ideas because it is not clear yet what should be done. It is a process without decision yet. In fact, if there were one, it would mean that it had been imposed by a superpower, which has not occurred. Therefore, it is an opportune moment to think about and discuss new forms of governance.

### *Participants' comments*

There is an issue of political will – the will to create a governance system to tackle the list of global problems that no country can solve by itself. As stated by S. Hoffmann, “everybody knows what has to be done and everybody knows that what has to be done cannot be done.” The disproportionate weight of Europe in the international organizations may be an asset for Europe in the negotiation of international governance. There is a need for multi-state or multi-group leadership (D. Hidalgo).

For the financing of public goods, it is essential to move to an automatic system that is not dependent on the payments from rich donor countries (M. de la Rocha).

At the international state level, there is a trend towards diffusion of power and democratization but, at the national level, the credibility or legitimacy of governments depends on the approval of voters. If they do not approve, the situation has real consequences in international relations, witness Honduras or Afghanistan. There is a huge gap in the discussion of this dynamic democratization of global governance (T. Piccone).

It is not possible to ask China, Brazil, etc. to take action on climate change, currency matters, or financial markets unless they get, for instance, commensurable power in the IMF. A grand bargain has to take place. For this to happen, states have to

cede some of their sovereign rights. While most countries would recognize this, it is doubtful that the US Congress would (A. Jara).

The impotence of the African countries faced with the crisis may be seen as an opportunity to spur them to come together to participate in the global economy. In this respect, is there a hierarchy in terms of what needs to be done? Must certain things be in place to facilitate a higher degree of integration? For instance, unless democracy across areas exists, it becomes difficult to work together from an economic development point of view (M. Masire-Mwamba).

More generally, African countries had followed the rules and were nonetheless hit by the crisis because the richer countries did not follow the rules that they had set presumably for all to follow. Who should pay for the bad advice they have received?

Mr. Martínez had the following observations on the discussion:

First, we overestimate the extent of a shift in power. The real question is the extent to which a country may exercise its power independently. China has little room to use its power without affecting the system on which it is based.

Second, we overestimate the degree to which the system has to reflect the underlying balance of power, the so-called “stickiness” of institutions.

Third, countries such as China or Brazil do not have a sophisticated global vision of their own interests.

Finally, because the financial system is concentrated in a few countries and so too are carbon emissions, if those countries address these issues effectively, then there is less concern at the global level.

Mr. Prodi reflected on the problem presented by the short-term concerns of politicians in a democracy and how can then they tackle the long term issues. It is again a matter for strong leadership.

President Cardoso recalled that he had proposed that the UN adopt a declaration on interdependence in order to move the sovereign state towards a more cooperative order. Leadership does not need to be unified; one thing is to take leadership regarding the environment while another is to take it regarding the struggle against racism. He noted that Brazil has suddenly discovered that it is more powerful than it ever imagined and doubted whether Brazil is capable of understanding its new role in a new era: a seat at the Security Council (for which Brazil has been striving for) is a long-standing concern. Powerful states need to take a different approach to be helpful at the global level.

## **Second Session**

The first expert, A. Jara, explained that governance requires four elements:

First, leadership, the G-20 has filled a leadership vacuum during the crisis but it should not be institutionalized because of the need to respond flexibly depending on the challenge.

Second, legitimacy concerns, specifically the democratic deficit, call attention to the distance between the citizen and global governance. Given its composition, the G-20 lacks legitimacy.

Third, efficiency – the system needs to show results for the benefit of all citizens. This element will require some shared or transferred jurisdiction, of which the European model is an example.

Fourth, coherence – there are competing objectives and challenges that require compromise and communication among the international agencies.

Mr. Jara spoke of a triangle in which the G-20 provides political leadership, the specialized international agencies contribute their expertise, and the UN provides accountability. In addition, an ethical dimension is needed to build trust.

The second expert, Professor Kaul, observed that there is a multiplication of crises: financial, environmental, etc., and global governance needs to address them. She pointed out that international cooperation is stuck because of two crosscutting basic problems. First, we have no theory that allows us to analyze the policy loops that today's world order of openness would require. Second, we have the incumbents, which are the strong powers that benefit from a closed order. To escape this situation, Ms. Kaul made the following recommendations: first, we have to correct the notion that national interest is best pursued through unilateralism. Based on her studies, cooperation rather than competition with other states is the best strategy to increase and maximize benefits. Second, the state must respond to the global expectations, acting not as the classical Westphalian state but take into account the outside context. Third, we need to speak of responsible sovereignty; states have to be accountable for the activities that are undertaken within their jurisdiction that have an impact on the global public domain.

Professor Kaul proposed that the UN be used to make these recommendations operational. The UN has in effect put the finishing touches on the Westphalian state order. Because of that and its experience in recognizing states as sovereign and equal, the UN could take the role of reforming the concept of sovereignty. To this effect, a Leadership Council would be created based on a fully representational charter; its task would be to help make evident that we have stepped into a new world order. Ms. Kaul was optimistic because the hegemonic power was getting tired and ready to move into a world of greater multipolarity.

The discussant, President Vike-Freiberga, pointed out that we can build single risk mechanisms to prevent crises, maybe we can hope to have a double level of protection, but by the time you get hit by three different things it is exceedingly difficult to come out with an answer and predict it in advance.

The second discussant, President Uteem, commented that the UN had a poor record in matters of sovereignty and lamented how poor countries are the victims of financial or environmental crises but rich nations do not face up to their responsibility. In this respect, he referred to the staggering amounts used to salvage the banking systems as compared to the G-20 budgets for development aid.



### *Participants' comments*

Mr. Solbes considered a three-level model: political legitimacy at the UN level, a body in between that presents ideas, and a third level to ensure the need for consistency between the first two. Then he referred to the European experience in terms of shared responsibility and leadership. Some leading countries may need to be always engaged but they would not be able to impose any solutions on their own (i.e. France and Germany in Europe). He warned that we will not be able to advance if our ambition is to have one system to solve all the problems. We need to advance step by step in different organizations trying to find solutions to different problems.

Another participant argued that the Westphalian state is still needed. Strong states are needed to promote international cooperation. Issues of identity need to be addressed because the transit to globalization has produced anxiety in the citizens. Maybe Westphalian states are still needed to give identity to people. He expressed doubts regarding international cooperation and how it had failed in Africa. There is much work to be done to convince states that cooperation is good for them.

Still another commentator pointed out that we are moving to a multi-polar world of big states (US, China) and regional units (EU, African Union). What organization will stir such a world? The General Assembly may give legitimacy but it is not the right stirring body. The G-20 is not legitimate, but it is a symbol of what is needed for the future.

Also, we have to go beyond states and change perceptions at the public level through civil society, academia, and the business community in order to open political space which in turn will permit politicians to take risks and make the necessary concessions to find solutions.

Professor Kaul commented that sovereignty can be strengthened through the types of international cooperation that she had outlined. The logic of the world order has changed. Under the openness of the new system, sovereignty has to be dealt with differently from when borders were closed. The concept of responsible sovereignty does not suppose a generalized approach but a change of logic to be applied to particular institutions and issues. One has to go case-by-case but according to the new logic. We have already slipped out of the Westphalian state order. Because of openness and interdependence, policy makers today cannot assure us access to all the public goods that they pretend they want to give us. The type of cooperation advocated here makes the state strong. Where states try to do it alone, they lose opportunities. We have left the Westphalian state but we need strong intermediary states. One should also allow time for this transition to happen and not be disappointed. One should not forget that it has taken 400 years for the completion of the Westphalian state.

Final comments from the participants:

Where it is a matter of power distribution, it is prudent to go package by package so that no one goes home empty-handed.

The importance of the truth teller was emphasized and the need for formal, regular, responsible information analysis. When the agenda for international

cooperation is set, there is the need for impartial analysis in terms of what economists call distribution of costs, in particular their impact on specific economies and societies.

# Annexes





## Annexes

The Club of Madrid is grateful to:

- The **Regional Government of Catalunya** for its support in the organization of the European Roundtable
- The **United Nations Economic Commission for Latin America and the Caribbean** (ECLAC), the **Andean Corporation for Development** (CAF), the **Iberoamerican General Secretariat** (SEGIB) and **Brookings Institution** for their support in the organization of the Latin American Roundtable
- **Casa Árabe** for its support in the organization of the Arab World Roundtable
- **Casa África**, the **Africa Progress Panel** and the **African Development Bank**, for their support in the organization of the African Roundtable



## Final Declaration of the Annual Conference

### ‘The Political Dimensions of the World Economic Crisis’

We, Members of Club de Madrid, met in Madrid on November 12-13, 2009, to discuss ‘The political dimensions of the world economic crisis’ and agreed on the following:

*The financial and economic crisis experienced over the past two years has made manifest a much deeper and complex systemic crisis and a realignment of world forces that requires democratic leadership to move beyond the outdated and simplistic, but still present, dichotomies of East/West, Developed/Developing, Old World/New World to find new solutions.*

*The crisis has highlighted the need for a more effective balance between the state and the market.* Unregulated markets can generate large costs for citizens. The state must be more effective, more efficient, fiscally responsible, capable of empowering its citizens and promoting prosperous economies and policies that foster democratic societies. Better states, accountable to democratic institutions, engender better markets.

*We welcome the incipient recovery in most parts of the world but there should be no complacency. We cannot go back to business as usual.* Unemployment has risen and the quality of employment deteriorated. Protracted weakness in the job market may generate increasing social and ethnic tensions and protectionist trends, all of which may place democratic systems under stress.

*Addressing the social impact of the crisis should be front and center of economic recovery and macroeconomic policies.* Democratic polities must strengthen social protection systems where they exist, and gradually create them where they do not. Democratic dialogue, participation and representation helps to manage the social demands created or exacerbated by the crisis and to strengthen inclusive democratic institutions.

*All countries must be part of the solution.* Emerging economies have effectively facilitated a budding recovery. There is a persisting need, however, to maintain or increase levels of official development assistance to help low income countries to overcome the crisis and more readily develop the capacity to construct democracies that deliver.

*Addressing the crisis requires public accountability, effective financial regulatory frameworks and democratic checks-and-balances.* We support initiatives to promote effective and comprehensive financial regulations, within and across borders, covering institutions and financial instruments previously un- or under-regulated, and also counter-cyclical policies to generate cushions of capital, provisions, and liquidity during booms to increase the capacity of financial institutions to withstand subsequent crises. Central banks and regulators must meet the highest technical standards and operate under rules designed to avoid their co-option by financial interests. As public entities, they must be accountable to the democratic institutions responsible for setting their objectives and scope of action.

*The time has come for in-depth reform of the global financial architecture. The institutions entrusted with the regulation of the global economy have proved fragile and unable to adopt the measures needed to prevent financial speculation from contaminating all forms of financing. Their reform requires urgent attention.*

*The enhancement of democratic values requires strengthened multilateralism and the participation of all countries in decision making processes. This will require broader representation of developing countries in the international governance system. The G20 is addressing important current issues but should be seen as a transition to a more representative and legitimate architecture. Existing international organizations should not be seen as mere service providers of the G20. The new multilateralism also requires strong and well functioning regional institutions.*

*Democracies must deliver: Improve the well being of peoples, empower the capacities of everyone to participate in reconstructing the present and developing the future, avoid the nightmare of another global financial collapse, and recognize that democracy is an instrument to address the crisis as well as a key objective of its successful resolution.*



## Agenda of the Annual Conference

### Thursday, November 12 – Annual Conference (Part I)

10:30	Transfer of participants from the Palace Hotel to the Palacio Municipal de Congresos	
09:00 – 11:30	Registration. <b>NOTE:</b> Participants must be seated at the Sala Madrid by 11:30. After this time access to Sala Madrid will not be allowed till after the Welcoming Words.	
12:20 – 13:00	<b>Annual Conference Welcoming Words</b> <ul style="list-style-type: none"> <li>• Ricardo <b>Lagos</b>, Former President of Chile. President of the Club of Madrid</li> <li>• Alberto <b>Ruiz-Gallardón</b>, Alcalde de Madrid</li> <li>• Manuel <b>Chaves</b>, Third Vicepresident of the Spanish Government</li> <li>• Esperanza <b>Aguirre</b>, President of the Regional Government of Madrid</li> <li>• His Majesty <b>King Juan Carlos</b></li> </ul>	** Sala Madrid
13:00 – 13:45	Greeting of His Royal Majesties to all participants and cocktail	** Hall Sala Madrid
13:45	Transfer of participants to Sala Paris for the lunch	
13:45 – 15:00	Lunch	** Sala Paris

15:00 – 16:15

**Plenary Session I**

\*\* Sala Madrid

**The World Economic Crisis and the Beginning of a New Paradigm in Global Governance?**

**Facilitator:**

- Michael **Keating**, Director Africa Progress Panel

**Panellists**

- Ricardo **Lagos**, Former President of Chile. President of the Club of Madrid
- Mary **Robinson**, Former President of Ireland and Vice President of the Club of Madrid
- Antonio **Gutérres**, Former Prime Minister of Portugal and UN High Commissioner for Refugees. Member of the Club of Madrid
- Jenny Mary **Shipley**, Former Prime Minister of New Zealand. Member of the Club of Madrid.
- José Antonio **Ocampo**, Professor at Columbia University; Former Under-Secretary-General of the United Nations for Social and Economic Affairs

16:15 – 16:30

Coffee Break

16:30 – 19:00

**Working Groups Session I: Diagnosis**

**Purpose:** To identify the 5 main effects the economic crisis is having in each of the respective areas. Each session will be divided into two blocks, **national** and **international**, in order to address the issue from both perspectives.

## 1. 'Employment, Social Welfare, and Democratic Rights and Duties'

\*\* Sala Berlin

### Moderator:

- Vidar **Helgesen**, Secretary General, International IDEA

### Panellists:

- Alicia **Bárcena**, Executive Secretary, Economic Commission for Latin America and the Caribbean
- Eddy **Lee**, Economic Adviser, Institute of Labour Studies, International Labour Organization

### Discussants:

- Mary **Robinson**, Former President of Ireland. Vice-president Club of Madrid.
- Alejandro **Toledo**, Former President of Peru. Member of the Club of Madrid.

### Rapporteur:

- Richard **Simeon**, Professor of Political Science and Law, University of Toronto. Advisor to the Club of Madrid.

## 2. 'The Citizen, the State and the Market'

\*\* Sala Londres

### Moderator:

- Peter **Eigen**, Former Chairman and Founder, Transparency International

### Panellists:

- Víctor **Rico**, Secretary of Political Affairs, OAS
- Geraldine **Fraser-Moleketi**, Director of Democratic Governance Practice, Bureau for Development Policy (UNDP)

### Discussants:

- Percival N.J. **Patterson**, Former Prime Minister of Jamaica. Member of the Club of Madrid
- Kjell Magne **Bondevik**, Former Prime Minister of Norway. Member of the Club of Madrid

### Rapporteur:

- Bolívar **Lamounier**, Director of Augurium Consultores. Advisor to the Club of Madrid.

**3. 'The Market, Regulatory Frameworks, and Democratic Governability'**

\*\* Sala  
Amsterdam

**Moderator:**

- Joseph **Janning**, Senior Director of International Governance Program, Bertelsmann Foundation

**Panellists:**

- Javier **Santiso**, Director, OECD Development Center
- Nkosana **Moyo**, Vice president and Chief Operating Officer, African Development Officer

**Discussants:**

- Jorge **Quiroga**, Former President of Bolivia. Member of the Club of Madrid.
- Wim **Kok**, Former Prime Minister of the Netherlands. Member of the Club of Madrid.

**Rapporteur:**

- Lucinio **Muñoz**, Senior Advisor. Spanish Treasury. Ministry of Economy and Finance. Advisor to the Club of Madrid

**4. 'An Institutionalized and Effective International Governance System'**

\*\* Sala Roma

**Moderator:**

- José Antonio **Ocampo**, Professor, Columbia University; Former Under-Secretary-General of the UN for Social and Economic Affairs

**Panellists:**

- Enrique **Iglesias**, Secretary General, Iberoamerican General Secretariat
- Leonardo **Martínez Díaz**, Fellow and Deputy Director, Global Economy and Development Program, Brookings Institution

**Discussants:**

- Romano **Prodi**, Former Prime Minister of Italy. Member of the Club of Madrid.
- Vicente **Fox**, Former President of México. Member of the Club of Madrid

**Rapporteur:**

- Andrés **Rigo**, Former Deputy General Counsel of the World Bank. International Arbitrator. Advisor to the Club of Madrid

19:15	Transfer from the Palacio Municipal de Congresos to the Palace Hotel	
19:45	Transfer from the Palace Hotel to the Caixa Forum	
20:00 – 22:00	Exhibition of “Palladio” and Dinner	Caixa Forum
22:00	Transfer from the Caixa Forum to the Palace Hotel	

### **Friday, November 13 – Annual Conference (Part II)**

08:30	Transfer from Palace Hotel to the Palacio Municipal de Congresos	
09:00 – 10:30	<b>Parallel Special Sessions on Club of Madrid Initiatives:</b> <b>a) “Global Leadership for Climate Action”:</b> This Initiative seeks to mobilize political will for a comprehensive, effective and fair global post 2012 climate agreement. <b>Chair:</b> President Ricardo Lagos <b>Panellists:</b> <ul style="list-style-type: none"> <li>• Mohamed <b>El-Ashry</b>, Facilitator Global Leadership for Climate Action Initiative. Senior Fellow, UN Foundation. Former Chair and CEO, Global Environment Facility.</li> <li>• Michael <b>Zammit Cutajar</b>, Ambassador on Climate Change, Malta</li> <li>• Martin <b>Lees</b>, Secretary General. Club of Rome.</li> <li>• Teresa <b>Ribera Rodríguez</b>, Secretary of State for Climate Change. Spain.</li> <li>• Manuel <b>Marín</b>, President of Iberdrola Foundation.</li> </ul>	** Sala Londres

**b) “The Shared Societies Project”**

\*\* Sala Roma

is a global initiative that provides leaders with greater understanding of the benefits of social cohesion and the incentives and means to act to advance it.

**Chair:** Prime Minister Jennifer Shipley, Co-Chair of the project

**Discussant:** President Cassam

**Uteem**, Co-chair of the project

**Panellists:**

- Rolando **Luque**, Deputy Ombudsman for the prevention of social conflicts and governability, Ombudsman Office, Peru
- Clem **McCartney**, The Shared Societies Project Content Coordinator
- Sean C. **Carroll**, Director of Programs, Club de Madrid

10:30 – 12:30

**Working Groups Session II:  
Prescriptions**

**Purpose:** To focus on identifying 3 specific recommendations to tackle each of the 5 main repercussions of the crisis, previously identified in the first working group session, at the global level.

**1. ‘Employment, Social Welfare, and Democratic Rights and Duties’**

\*\* Sala Berlin

**Moderator:**

- Vidar **Helgesen**, Secretary General, International IDEA

**Panellists:**

- William **Lacy Swing**, Director General, International Organization of Migration
- Sharan **Burrow**, President, International Trade Union Confederation (ITUC)

**Discussants:**

- António **Guterres**, Former Prime Minister of Portugal. Member of the Club of Madrid.
- Chandrika **Kumaratunga**, Former President of Sri Lanka. Member of the Club of Madrid.

**Rapporteur:**

- Richard **Simeon**, Professor of Political Science and Law, University of Toronto. Advisor to the Club of Madrid.

## 2. 'The Citizen, the State and the Market'

\*\* Sala Londres

### Moderator:

- Peter **Eigen**, Former Chairman and Founder, Transparency International

### Panellists:

- Jerzy **Buzek**, President of the European Parliament
- Yun Han **Chu**, Research Fellow, Institute of Political Science, Academia Sinica

### Discussants:

- Kim **Campbell**, Former Prime Minister of Canada. Member of the Club of Madrid.
- Olusegun **Obasanjo**, Former President of Nigeria. Member of the Club of Madrid

### Rapporteur:

- Bolívar **Lamounier**, Director of Augurium Consultores. Advisor to the Club of Madrid.

## 3. 'The Market, Regulatory Frameworks, and Democratic Governability'

\*\* Sala Amsterdam

### Moderator:

- Joseph **Janning**, Senior Director of International Governance Program, Bertelsmann Foundation

### Panellists:

- Enrique **García**, President of the Andean Corporation for Development (CAF)
- Otaviano **Canuto**, Vice President for Poverty Reduction and Economic Management, World Bank

### Discussants:

- Zlatko **Lagumdzija**, Former Prime Minister of Bosnia Herzegovina. Member of the Club of Madrid
- John **Kufuor**, Former President of Ghana. Member of the Club of Madrid

### Rapporteur:

- Lucinio **Muñoz**, Senior Advisor. Spanish Treasury. Ministry of Economy and Finance. Advisor to the Club of Madrid.

#### 4. 'An Institutionalized and Effective International Governance System'

\*\* Sala Roma

##### Moderator:

- José Antonio **Ocampo**, Professor at Columbia University; Former Under-Secretary-General of the United Nations for Social and Economic Affairs

##### Panellists:

- Alejandro **Jara**, Deputy Director General, World Trade Organization
- Inge **Kaul**, Adjunct Professor on Global Policy Studies. Hertie School of Governance

##### Discussants:

- Vaira **Vike-Freiberga**, Former President of Latvia. Member of the Club of Madrid.
- Cassam **Uteem**, Former President of the Republic of Mauritius. Member of the Club of Madrid

##### Rapporteur:

- Andrés **Rigo**, Former Deputy General Counsel of the World Bank. International Arbitrator. Advisor to the Club of Madrid

12:30 – 12:45

Coffee break

\*\* Hall Sala Madrid

12:45 – 14:00

#### Plenary Session II: Report on Working Group Discussions

\*\* Sala Madrid

##### Moderator:

- José Antonio **Ocampo**, Professor at Columbia University; Former Under-Secretary-General of the United Nations for Social and Economic Affairs

##### General Rapporteur:

- Jorge **Domínguez**, Vice Provost for International Affairs, Harvard University. Advisor to the Club of Madrid

##### Rapporteurs from all Working Groups

14:00 – 15:30

Lunch

\*\* Sala Paris



15:30 – 17:00	<b>Plenary Session III: What is to be Done Next: Democratic Practice and Governance as Instruments to Address the World Economic Crisis</b>	** Sala Madrid
	<b>Facilitator:</b> <ul style="list-style-type: none"> <li>• Lord Mark <b>Malloch Brown</b>, Senior Advisor World Economic Forum</li> </ul> <b>Panellists:</b> <ul style="list-style-type: none"> <li>• Felipe <b>González Márquez</b>, Former President of the Government of Spain. Member of the Club of Madrid</li> <li>• Joaquim <b>Chissano</b>, Former President of Mozambique. Member of the Club of Madrid.</li> <li>• Fernando Henrique <b>Cardoso</b>, Former President of Brazil. Member of the Club of Madrid</li> <li>• Ricardo <b>Lagos</b>, Former President of Chile. President of the Club of Madrid</li> <li>• Wim <b>Kok</b>, Former Prime Minister of the Netherlands. Member of the Club of Madrid</li> </ul>	
17:00 – 17:30	<b>Closing Ceremony</b> <ul style="list-style-type: none"> <li>• Ricardo <b>Lagos</b>, Former President of Chile. President of the Club of Madrid</li> <li>• Vincenzo <b>Scotti</b>, Secretary of State for Foreign Affairs, Government of Italy</li> <li>• Miguel Ángel <b>Moratinos</b>, Minister of Foreign Affairs, Government of Spain</li> </ul>	** Sala Madrid
17:30	Transfer from venue to Hotel	
PM	Departure of participants and Club of Madrid Members	

## List of Participants

### Members of the Club of Madrid

Ricardo Lagos	Former President of Chile. President of the Club of Madrid
Valdis Birkavs	Former Prime Minister of Latvia
Kjell Magne Bondevik	Former Prime Minister of Norway
Kim Campbell	Former Prime Minister of Canada
Fernando Henrique Cardoso	Former President of Brazil
Joaquim Chissano	Former President of Mozambique
Philip Dimitrov	Former Prime Minister of Bulgaria
José María Figueres	Former President of Costa Rica
Vicente Fox	Former President of Mexico
Felipe González Márquez	Former President of Spain
Antonio Guterres	Former Prime Minister of Portugal
Osvaldo Hurtado	Former President of Ecuador
Wim Kok	Former Prime Minister of the Netherlands
John Kufuor	Former President of Ghana
Chandrika Kumaratunga	Former President of Sri Lanka
Zlatko Lagumdžija	Former Prime Minister of Bosnia Herzegovina
Antonio Mascarenhas Monteiro	Former President of Cape Verde
Rexhep Meidani	Former President of Albania
Festus Mogae	Former President of Botswana
Olusegun Obasanjo	Former President of Nigeria
Percival Patterson	Former Prime Minister of Jamaica
Romano Prodi	Former Prime Minister of Italy
Jorge Quiroga	Former President of Bolivia
Mary Robinson	Former President of Ireland.
Petre Roman	Vice-President of the Club of Madrid
Jennifer Shipley	Former Prime Minister of Romania
Alejandro Toledo	Former Prime Minister of New Zealand
Cassam Uteem	Former President of Peru
	Former President of the Republic of Mauritius
Vaira Vīķe-Freiberga	Former President of Latvia

### Institutional Members

Esperanza Aguirre	President, Regional Government of Madrid
Alberto Ruíz-Gallardón	Mayor of Madrid

### Honorary Members

Kofi Annan	Chairman, Kofi Annan Foundation and Former United Nations Secretary-General
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### Members of the Constituent Foundations

Diego Hidalgo	President, Fundación para las Relaciones Internacionales y el Diálogo Exterior (FRIDE)
Anthony Jones	Vice-President and Executive Director of the Gorbachev Foundation of North America
George Matthews	Chairman of the Gorbachev Foundation of North America
José Manuel Romero	Vice-President of FRIDE

### Advisors of the Club of Madrid

Jorge Domínguez	Antonio Madero Professor of Mexican and Latin American Politics and Economics. Vice Provost for International Affairs, Harvard University
Rut Diamint	Professor of Political Science, Universidad Torcuato Di Tella, Argentina
Grzegorz Ekiert	Professor of Government, Center for European Studies, Harvard University
Bolívar Lamounier	Director of Augurium Consultores
Alexander Likhotal	President & CEO of Green Cross International
Lucinio Muñoz	Senior Advisor. Spanish Treasury. Ministry of Economy and Finance
Ted Piccone	Senior Fellow and Deputy Director of the Foreign Policy Program, Brookings Institution
Andrés Rigo	Former Deputy General Counsel of the World Bank
Richard Simeon	Professor of Political Science and Law, University of Toronto

### Experts and Invitees

José Antonio Ocampo	Professor at Columbia University; Former Under-Secretary-General for the United Nations for Social and Economic Affairs; Academic Coordinator of the Programme on "The Political Dimensions of the World Economic Crisis"
Alicia Bárcena	Executive Secretary, Economic Commission for Latin America and the Caribbean (ECLAC)
Bernardo Bortolotti	Executive Director, Fondazione Eni Enrico Mattei
Sharan Burrow	President, International Trade Union Confederation (ITUC)
Jerzy Buzek	President, European Parliament
Otaviano Canuto	Vice President for Poverty Reduction and Economic Management, World Bank
Emilio Cassinello	Director General, CITpax

Manuel Cháves	Third Vice President of the Spanish Government
Taeyul Cho	Ambassador of Korea in Spain
Yun-Han Chu	Research Fellow, Institute of Political Sciences, Academia Sinica
Georges Couffignal	Director, Institut des Hautes Études pour l'Amérique Latine
Andie Davis	Communications Strategic Consultant
Terry Davis	Former Secretary General, Council of Europe
Ricardo Díez Hochleitner	Honorary President, Club of Rome
Linda Duffield	Chief Executive, Westminster Foundation for Democracy
Peter Eigen	Former Chairman and Founder, Transparency International
Mohamed El Ashry	Senior Fellow, UN Foundation
Gilda Farrell	Acting Head of Department, DG Social Cohesion, Development Division, Council of Europe
J. Christer Elfverson	Senior Diplomatic Advisor, Concordia 21
Javier Fernández-Lasquetty	Counsellor on Immigration and Cooperation, Community of Madrid
Geraldine Fraser-Moleketi	Director of the Democratic Governance Practice, Bureau for Development Policy, UNDP
Enrique García	President, Andean Development Corporation
Antonio García Ferrer	President, Fundación ACS
Sacha Goldman	Secretary General, Collegium International
Carlos González Shánel	Founder Member, Center for Analysis and Studies for Latin America, Respekt Institute
José Antonio Griñán Martínez	President of the Regional Government of Andalucía
Kai Grunauer-Brachetti	Philanthropic Services, UBS
Antonio Gutiérrez Vegara	President of the Commission for Economic and Financial Matters. Spanish Congress
Miguel Hakim	Secretary for Cooperation, Inter-American General Secretary
Vidar Helgesen	Secretary General, International IDEA
Silvia Hidalgo	Director, DARA
Enrique Iglesias	Secretary General, Ibero-American General Secretariat
Joseph Janning	Senior Director of the International Governance Programme, Bertelsmann Foundation
Alejandro Jara	Deputy Director General, WTO
Germán Jaramillo	Director-Representative in Spain, Andean Development Corporation
Inge Kaul	Adjunct Professor on Global Policy Studies, Hertie School of Governance, Berlin
Michael Keating	Director, Africa Progress Panel

Peter Kelly	Chairman of the Board of Directors, International Foundation for Electoral Systems (IFES)
Margaret Kilo	Fragile States Unit Head, African Development Bank
William Lacy Swing	General Director, International Organization for Migration
Roland Lappuke	Ambassador of Latvia to Spain
Eddy Lee	Economic Adviser, International Institute of Labour Studies, International Labour Organization
Martin Lees	Secretary General, Club of Rome
Jos Lemmers	Head of the Department for Democratic Participation, Council of Europe
José Luis Machinea	Former Executive Secretary General, ECLAC, and Professor at IELAT, University of Alcalá de Henares
Mark Malloch Brown	Senior Advisor, World Economic Forum
Percival Manglano	General Director, Cooperation for Development, Regional Government of Madrid
Cristina Manzano	Director, Foreign Policy
Mario Marconi	Head of Philanthropic Services, UBS
Manuel Marín	President, Iberdrola Foundation
Rodolfo Martín Villa	President, Sogecable
Leonardo Martínez Díaz	Fellow and Deputy Director, Global Economy and Development Program, The Brookings Institution.
Ricardo Martínez Vázquez	Director General, Casa Africa
Mmasekgoa Masire-Mwamba	Deputy Secretary General, Commonwealth Secretariat
Rafael Miranda Robredo	President, Foundation ENDESA
Andrea Monari	Resident Director General, Asia Development Bank European Representative Office
Isabel Mota	Trustee, Calouste Gulbenkian Foundation
José Manuel Morán	Associate Member, Club of Rome
Nkosana Moyo	Vice president and Chief Operating Officer, African Development Bank
Carlos Mulas Granados	General Director, Fundación IDEAS para el Progreso
Herman Mulder	Senior Advisor, UN Global Compact
Salvatore Nigro	Executive Director, EUROPEFE
Olivia Orozco	Coordinator, Socio-Economic Program, Casa Árabe - IEAM
Luis Padilla	Secretary General, Casa Africa
Sujala Pant	Governance Specialist, Bureau for Development Policy, UNDP
Carina Perelli	Executive Vice-President, International Foundation for Electoral Systems (IFES)
Sanjay Peters	Associate Professor of Economics, IESE Business School

Mario Pezzini	Deputy Director, Public Governance and Territorial Development, OECD
Germán Quintana	Secretary, Inter-American Development Bank
Teresa Ribera	Secretary of State for Climate Change, Government of Spain
Víctor Rico	Secretary for Political Affairs, Organization of American States (OAS)
Francisco Rojas Aravena	Secretary General, FLACSO
José Juan Ruiz Gómez	Director, Strategy and Analysis for Latin America, Grupo Santander
Simon Rye	Director of the Oslo Centre
Jesús Sainz	President, Promomadrid
Marion Salines	Economist, EU Institutions and For a Division, European Central Bank
Javier Santiso	Director of the Development Centre (OECD)
Jesús Sáenz	Director, Casa Asia
Vincenzo Scotti	Secretary of State of Foreign Affairs, Government of Italy
Narcís Serra	President, Centre for International Studies in Barcelona (CIDOB)
Edward Shapiro	President, Foundation of the Club of Madrid
Sarah Silver	Director, Slifka Foundation
Youba Sokona	Executive Secretary Sahara/Sahel Observatory
Javier Soria	Chief of the Area for Middle East, Spanish Ministry of External Affairs and Cooperation
Ingrith Srinath	Secretary General, CIVICUS
Gustavo Suárez Pertierra	President, Real Instituto El Cano
Bill Sweeney	President, International Foundation for Electoral Systems (IFES)
Laura Tedesco	Visiting Professor, Universidad Autónoma de Madrid
José Ignacio Torreblanca	Director, European Council on Foreign Affairs
Roel von Meijenfeldt	Executive Director, Netherlands Institute for Multiparty Democracy
Carlos Westendorp y Cabeza	Former Minister of Foreign Affairs of Spain
Richard Youngs	Director of the Democratization Programme (FRIDE)
Michael Zammit Cutajar	Ambassador on Climate Change, Malta

### **Club of Madrid Directors**

Fernando Perpiñá-Robert	Secretary General of the Club of Madrid
María Elena Agüero	Director of Special Projects and Institutional Relations
Sean Carroll	Programmes Director
Ricardo Hidalgo	Chief Financial Officer
Nicolas Rougy	Director of the Brussels Office

## **Background Document for the European Roundtable**

### **The Crisis and the Challenges for International Governance: A European Perspective<sup>4</sup>**

**By Jean Pisani-Ferry (Bruegel)**

It is meaningful that one of the very first decisions taken after the crisis erupted in full force in September 2008 was to reform international governance by creating the G20. This long overdue decision was in part accidental, but it was nevertheless indicative of the consensus within the international community that designing and implementing an appropriate response required creating a more legitimate and more effective body than the G7. The upcoming G20 meeting in London is expected to result in further reforms, this time of the international financial institutions.

The relationship between the financial crisis and international governance is not entirely straightforward. The crisis is certainly by now a global one but it has been at root a crisis of the US banking system that immediately contaminated the European banking system. It is only when the crisis took a turn for the worse in September 2009 that the rest of the world started being really affected by capital flow reversals and the collapse of world trade.

A few numbers may illustrate the point. According to the IMF, US banks have suffered 57% of the losses on US-originated securitised debt and European banks 39%, leaving only 14% for the rest of the world. More generally, North America and Europe jointly represent 70% of the global supply of financial assets and they probably account for an even larger share of financial regulation, which again would suggest that managing the financial crisis and even more preventing future ones could have essentially remained a transatlantic affair.

The need for a global economic venue where the leaders of the major industrialised, emerging and developing countries meet and discuss directions for international governance is in fact much more pronounced in other domains like food security (with Europe and North America jointly accounting for less than one-third of world cereal demand), energy and climate (with the same regions accounting for 40% only of CO<sub>2</sub> emissions), and trade (where, again, Europe and North America account for somewhat more than 40% of world total only).

It was nevertheless the financial crisis that triggered a change in global governance. The question is now whether the G20 will be able to deliver on the expectations it has created.

To discuss the consequences of the crisis for global governance the first section of this note addresses the regulatory agenda. Macroeconomic dimensions are taken up in section 2. Conclusions are offered in section 3.

4. This paper was prepared as an input document for the Club of Madrid's Roundtable on "The Political Dimensions of the World Economic Crisis: a European Perspective" held March 26, 2009 in Barcelona, Spain.

## 1. The regulatory agenda

It is widely recognised that the crisis in large part originates in the deficiency of financial regulation – knowing that “deficiency” can mean absence or insufficiency, but also inadequacy. Was this failure of governance primarily a national failure, or a failure of international cooperation to which stronger global governance can remedy?

Deficiencies were no doubt in many respects entirely national. To give only a few examples, the belief that regulators cannot know better than markets had little to do with external developments and the competition between public agencies that resulted in an excessively lax supervision of US banks was a purely internal deficiency. By the same token, the very uneven exposure to toxic assets of banks within Europe illustrates that it was in the power of national authorities to exercise strict oversight of their banking systems – as done with success in Spain. Failures of national authorities cannot be blindly ascribed to international deficiencies.

Weaknesses in international governance have however also contributed to regulatory and supervisory deficiencies. Three important channels have been:

- *Competition among regulators resulting in “regulatory shopping” by transnational players and as a consequence in a loosening of national regulations or a weakening of their effectiveness.* For example, the off-balance sheet conduits of some German banks were established in Dublin, which explains in part why they were neglected by supervisors. The same applies to the operation of weakly regulated and supervised Icelandic banks in the UK and elsewhere.
- *Disagreements among regulators resulting in weak global frameworks, excessive reliance on self-regulation or the subcontracting of important part of regulation to private organisations.* A key example here is the rulebook for international banking supervision issued by the Basel Committee for Banking Supervision. The painfully negotiated framework has been largely invalidated by the crisis because of its excessive reliance on ratings and the banks’ internal risk assessment models.
- *Resistance by national authorities to the transfer of significant responsibilities to supranational bodies, resulting in incoherent and/or vulnerable frameworks.* The key problem here has been the supervision of transnational financial institutions. Some global banks have grown too large to be supervised by any national authority and even more to be bailed out by any national treasury.

Despite its extensive legislative apparatus, the EU itself has not been immune from these problems. Especially the third one is acute as the number of pan-European banks has grown in recent years, but supervision remains essentially national and coordination among national agencies is of limited effectiveness. However there is no willingness to contemplate radical reforms. The recent Larosière report commissioned by the European Commission and endorsed by the European Council does not envisage centralising the supervision of pan-European banks and advocates instead closer cooperation between national authorities.

Crisis management since summer 2007 has confirmed that the tension between the globalisation of finance and the weakness of international governance is



a major problem in the current crisis. Cooperation between central banks in the provision of liquidity to distressed banks has been remarkably smooth but international cooperation in the resolution of banking crises has been less exemplary. Many problems have emerged, for example as regards the coordination of deposit guarantee schemes, but the most difficult one is no doubt the rescue of banks with significant cross-border operations. This raises major difficulties for small countries with large, internationalised banking systems, such as Austria or Ireland.

The issue is especially acute within Europe where it has only been given partial, ad-hoc solutions (for example when the Belgian-Dutch group Fortis was jointly bailed out by the two governments). The crux of the matter is that the taxpayer remains ultimately national and that for this reason governments reject the notion of a burden-sharing scheme that would commit them to contributing to the budgetary rescue of a non-national bank.

The upshot is that even in the EU, the tension between economic internationalisation and political accountability has not been resolved in a satisfactory way. As pointed out by the recent report of Lord Turner, chairman of the British Financial Services Authority, "The current arrangements [...] are not a sound basis for the future regulation and supervision of European cross-border retail banks. Sounder arrangements require either increased national powers, implying a less open single market, or a greater degree of European integration".

From this perspective the G20 agenda provides only a partial response. The European insistence on extending oversight to all financial institutions in all countries and on cracking down regulatory and tax heavens can be seen as a stepping stone towards a comprehensive regulatory architecture. The Europeans have learned from experience that it is only in exceptional circumstances that entrenched special interests of this sort can be overcome and they have every reason to push their agenda ahead. This should not hide, however, that tax and regulatory heavens are not the core of the issue. Rather, the fate of global financial regulation depends on the attitude of the main players – the US, the EU and its member states, Switzerland, Japan, and China.

So far, these players have not departed from their traditional stance. The G20 November declaration insisted that "regulation is first and foremost the responsibility of national regulators" and on regulatory reform it emphasised the role of the Financial Stability Forum, a club of regulators, rather than that of the International Monetary Fund, a structured institution equipped with decision-making powers. The Obama administration is certainly more sympathetic to global institutions than the previous one but Congress is unlikely to delegate significant regulatory powers to supranational bodies. It is therefore likely that cooperation will be intensified further and that regulation will be tightened but that the distribution of powers between national and international institutions should remain broadly intact.

What is uncertain is the attitude of private institutions. As Mervyn King, the governor of the Bank of England, said, banks have experienced that they are "global in life but national in death" and the perception that this is a reality is bound to influence their internationalisation strategy. At the time of writing it is unclear whether the trends towards the creation of global financial players will continue or be significantly tamed by the experience of the crisis.

### 2. The macroeconomic agenda

The macroeconomic roots of the crisis are less unanimously recognised than its regulatory roots, but a growing number of contributions has emphasised the role of global macroeconomic conditions in creating an environment auspicious to financial instability.

From the immediate aftermath of the Asian crisis up to the outbreak of the global crisis, the world economy has been characterised by an unusual but seemingly stable pattern of savings flows. Throughout a decade the poor countries, chiefly China, have been financing the rich ones, chiefly the US, whose savings deficit represented some 2% of world GDP. Instead of resulting in capital flows from capital-rich to capital-poor countries as expected, financial globalisation was letting capital flow in the opposite direction. In 2005 Fed governor (now president) Ben Bernanke famously spoke of a “global savings glut”.

Several, possibly complementary explanations have been offered to account for this surprising pattern. Emerging countries, especially China, have been accused of keeping their exchange rate artificially low in order to stimulate exports and run an external surplus. Following the traumatic experience of the 1997-1998 crisis, the accumulation of foreign exchange reserves by the same countries has been seen as a form of self-insurance that would avoid them recourse to the IMF if confronted with macroeconomic and financial shocks. Finally, it has been argued that households and companies in those countries had little trust in the value of domestic financial assets and that they had preference for US-made assets of reportedly better quality and safety.

Whatever the weight given to these explanations, the massive flow of foreign savings into the US was bound to impact interest rates, savings behaviour, and the market for financial assets. Indeed it contributed to keeping long-term interest rates low, thereby fuelling the real-estate boom, to lowering domestic savings, thereby feeding the consumption boom, and to increasing the demand for US-made safe assets, thereby contributing to leverage and the manufacturing of assets of dubious quality. It is these conditions that, combined with a lax regulatory environment, provided the perfect incubator for boom-and-bust.

This type of analysis leads to emphasise the lack of global macroeconomic surveillance and the role it could have played, had the world economy been equipped with effective global institutions. In particular, exchange rate surveillance should have prompted policy corrections in the presence of massive and lasting external surpluses and deficits; trust in the multilateral regime should have made self-insurance unnecessary; and, although less straightforward, alternative assets could have been offered to surplus countries. The world pattern would have been different and arguably less auspicious to complacency towards the risk of instability.

This suggests that the reform of the international financial institutions should have a role in creating conditions for future financial stability. This dimension of the global agenda was largely overlooked by the G20 meeting in November but its main tenets have since then emerged. Global financial institutions, especially the IMF, need:

- To warn against economic and financial developments that involve risks of instability and send signals to governments and supervisory institutions so that they can tighten oversight accordingly;

- To provide effective insurance against private capital flow reversals and for that they must be equipped with sufficient firepower. This implies increasing their resources to a level commensurate with potential needs in a context where crises are characterised by massive outflows;
- To exercise even-handed surveillance over the policies of the major countries and blocks and issue warnings when these policies contribute to global instability. This implies making the institutions legitimate through a more adequate representation and weight of the participating countries.

What this sketchy analysis suggests is that issues of governance and of effectiveness are very closely linked. Keynes used to say that the job of the IMF is “ruthless truth-telling” but the Fund today lacks effectiveness in dealing with global problems because it does not have the legitimacy that would allow it to tell the truth to China and the independence that would allow it to tell the truth to the US.

Ultimately, the reform of global financial institutions should be seen as a stepping stone towards a balanced international monetary system of the sort recently advocated by people’s Bank of China’s governor Zhou. It is crystal clear that a prerequisite for such a system is a bold institutional reform.

The recent reform of quota and voice at the IMF has evidently not been commensurate to these needs. It has not even been sufficient to create or recreate the needed ownership in the institution among emerging and developing countries. The G-20 has mandated that ministers prepare proposals to reform international financial institutions, including giving greater voice and representation to emerging and developing economies, and G20 ministers have agreed that it should be done by early 2011. This indispensable reform needs to go far beyond the incremental changes agreed upon in 2008. It implies in practical terms a reduction in the number of European votes and seats, possibly leading to a consolidation, and the renunciation to the U.S. veto power. Without such a reform the IMF will continue to be perceived as an instrument of yesterday’s powers and it will be unable to play the macroeconomic role it needs to play.

If there is a venue where such reforms need to be discussed, it is the G20 summit. The matter is not a technical, but a political one. The question put to the heads of state and government is whether they agree on a major redistribution of powers within the institution and at the same time on a strengthening of its role and effectiveness.

### 3. Conclusions

Back in November, global governance reform was the world leaders’ chosen response to the outbreak of the crisis. They now have to deliver and they are at risk of disappointing. This would be a very unwelcomed development, because it would signal a collective inability to act and could trigger retreat towards national, possibly nationalistic solutions. History teaches us that failed international conferences in times of deep crises are to be avoided.

The G20’s agenda so far has put emphasis on regulatory reform. There is no doubt room for sensible initiatives, some of which are remotely related

to crisis prevention and some of which could have more effectiveness. But there are limitations to what the G20 can do in this field. First, most of the issues to be solved are of the responsibility of the narrow group of countries with sophisticated financial systems. It is appropriate to involve emerging and developing countries in the discussion but their participation is unlikely to change the outcome significantly. Second, regulatory cooperation can be improved but there is little room for radical reform. Problems within the EU are an indication that the supervision of financial institutions remains a fundamentally national responsibility. Third, reforms are technical in nature and this adds to the risk of disappointing.

The reform of international financial institutions, first and foremost the International Monetary Fund, is a more promising avenue. If significant enough it could help contain developments conducive to instability. It could embody the transition to a US-dominated world economy to a more balanced, multilateral regime. And it is the condition for rebuilding trust in the system among emerging and developing countries and thereby for avoiding the kind of quasi-secessionist behaviour observed in recent years.

This is at core a very political issue where only heads of states and governments can take initiative. The G20 meeting in London offers a rare opportunity for launching a bold reform process. It belongs to the United States and to Europe to take the initiative, because their power and representation in the international financial institutions prevents the rest of the world from ownership in them.

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## Final Report of the European Roundtable<sup>5</sup>

### **‘The Political Dimensions of the World Economic Crisis: A European Perspective’<sup>6</sup>**

The political dimensions of the financial crisis are still being played out. Judging their impact requires much speculation for the present. But the outlines of the challenges are beginning to be detectable. As stated by Ricardo Lagos, President of the Club of Madrid *‘Politics is back’*. Politically, Europe is embroiled in the financial crisis at three different levels. A first concern is with the impact of the financial crisis on the politics of integration within Europe itself. As second issue relates to the way in which the crisis threatens to pull the European Union (EU) back from a broadly liberal policy in its external economic relations and its views on multilateralism. A third trend is towards a less cosmopolitan political dimension of European foreign policies.

On March 26, 2009, the Club of Madrid<sup>7</sup> launched its programme on ‘The Political Dimensions of the World Economic Crisis’ with a Roundtable focusing on the European perspective of this crisis. This event gathered Club of Madrid Members, all democratically elected former Heads of State or government, with high-level representatives of intergovernmental organisations, civil society and academia, to discuss the issues outlined above. The following report offers a summary of the key points and recommendations addressed during the meeting, exploring these three levels of linkage between the economic crisis and considerations of a more political nature.

*‘This is not just a crisis but a change in paradigm’*

**Diego Hidalgo,**

President, Fundación para las Relaciones Internacionales y el Diálogo Exterior (FRIDE) and Member of the Board of Directors of the Club of Madrid

5. This summary report was prepared by Richard Youngs, Coordinator of the Democratisation Program, of the *Fundación para las Relaciones Internacionales y el Diálogo Exterior* (FRIDE) and Agustina Briano, Junior Programme Officer at the Club of Madrid.

6. The Club of Madrid is grateful to the Regional Government of Catalunya for its support in the organization of this Roundtable discussion

7. The Club of Madrid promotes “Leadership for Democracy that Delivers”. It is an independent organization dedicated to strengthening democratic values and leadership around the world to meet political challenges at the local, national, regional and global level. Drawing on the unique experience and resources of its Members – more than 70 democratic former heads of state and government from 50 countries – and in partnership with organizations, governments and individuals that share its goals, the Club of Madrid addresses issues of global concern and provides peer to peer counsel, strategic support and technical advice to leaders and institutions working to further democratic development. The Club of Madrid constitutes the world’s largest forum of former Presidents and Prime Ministers and offers today’s leaders an unequalled body of knowledge and political leadership.

## Cracks in European solidarity

First, the crisis has impacted in a profoundly political sense on the dynamics of integration within Europe itself. Few days have gone by without Czech, French, and other ministers crossing swords in public. The spirit if not the letter of the single market has been torn asunder. State aid rules have been relaxed. France has offered soft loans to companies on condition they use local suppliers<sup>8</sup>. Competition rules in the financial sector have been suspended and consideration of advancing liberalisation in the services sector – which accounts for two thirds of economic activity in the European Union (EU) – is now off the agenda.<sup>9</sup>

The Commission has speeded up the delivery of structural funds to central and eastern Europe and made rules more flexible (dropping so-called ‘co-financing’ requirements). But requests for new money from these sources were refused. These new member states still feel embittered at how they have had to turn to the IMF in the absence of more generous EU assistance. Such support was belatedly increased at the April G20 summit. But, the core feeling of solidarity has been ruptured.

*‘My proposal is that all these countries (Members of the EU) that are to commit to an agreement with the IMF do so through the EU. That would be a guarantee. The anger of the population, this feeling that they are paying for broken china, could be very damaging for our democracies’.*

**Petre Roman,**

Former Prime Minister of Romania  
and Member of the Club of Madrid

*‘There is still a discrepancy between the degree of integration we have (at the EU) and the governance system...clearly the European system is not built to respond to a crisis...So in fact the problem so far has been solved by improvisation and leadership.’*

**Jean Pisani-Ferry,**

Director of the Brussels European and Global Economic Laboratory

Within the EU the crisis has unleashed a fundamental tension between the economic and political spheres. Rescue packages and broader stimulus measures have been introduced at the national level. The political impact is to have increased the pressure of accountability on governments to their national populations. Observing the EU’s difficulties in articulating a common response to the crisis, some have observed a re-nationalisation of economic policy-making. But at the same time it is recognised that effective solutions to the crisis require deeper coordination between governments. This tension requires European

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8. Financial Times, 5 February 2009, p. 9

9. Simon Tilford, How serious is the threat to the single market? CER Bulletin, 19 March 2009.

governments to recognise that 'more Europe' in the economic and financial spheres is not enough. Such measures cannot be divorced from the need to re-energise the EU's democratic legitimacy. The lesson of European integration is that economic divergence can easily spill over into political divergence. The crisis cannot be solved while parking the political dimensions of integration.

*'A system in which profits are private but losses are socialised cannot possibly be sustained politically.'*

**Vitor Gaspar,**  
Director General,  
Bureau of European Policy Advisers, European Commission

Intra-EU and broader international considerations have conditioned each other. Many of the most acute tensions have revolved around challenges within Europe. Member states have accused each other of adopting protectionist measures that undermine the single market. Hard-hit central and eastern European states lament the lack of support from their EU partners, especially Angela Merkel's refusal to assent to a common rescue plan for the region. At the same time, there has been a clear read-over to the EU's global agenda. Deepening divisions within Europe have nourished a return to beggar-thy-neighbour thinking within the EU's external relations too.

*'If we look at the situation in various countries we can see how they differ in their responses...nation-based policies do not mean failure and...coordinated ones do not mean success'.*

**Antonio de Lecea,**  
Director of International Economic and Financial Affairs,  
European Commission

Moreover, the crisis has intensified the debate over the borders of the EU. More solidarity is needed towards the new member states of central and Eastern Europe. But the EU must address the fact that the countries beyond its borders have been hit hard. This applies especially to Ukraine and the Balkans. The EU cannot solve its own problems if it abandons these fragile new democracies. A Crisis Response Package was formulated under the Pre-Accession Instrument. However, member states have become more reluctant to accept further enlargement just when the political costs of retracting from their promises to the Balkans and Turkey will be even higher. Angela Merkel has insisted that the crisis requires a 'time-out' on enlargement, after Croatian accession. In the middle of the crisis the EU has rolled out its new Eastern Partnership offering various areas of cooperation with six countries on its eastern periphery. But France and other states have refused to grant this partnership more significant amounts of money, insisting that two-thirds of overall Neighbourhood Policy money go to the Mediterranean. This looks like inflexible clientelism. The Partnership needs to be linked much more tightly to the means needed to combat the crisis in Ukraine and other eastern states.

*'We must recognise that in the face of this crisis the EU and its neighbours are in fact sailing in the same boat, a maybe 'Shengenzed' boat...We must think about South-East Europe and what would happen if we continue to widen the gap between the waiting room for the EU and the EU as such'.*

**Zlatko Lagumdzija,**

Former Prime Minister of Bosnia and Herzegovina  
and Member of the Club of Madrid

Furthermore, this issue is also related to the idea of a 'Social Europe' and the effects the crisis is having on unemployment, inequality and poverty, both inside and outside the EU borders. As part of its response to the crisis, the EU must not forget to keep its active population as close to the market and employment as possible in order to contain social unrest and increase competitive prospects for the future, once the economy starts to grow again. Inter-generational issues and social cohesion are an increasing concern as Europe experiences increasing social inequalities and the middle class begins to wither. These may be fertile ground for unexpected political consequences across the EU where we are already beginning to witness serious threats to and even the collapse of incumbent governments. It is vital for the governmental stimulus packages to envisage budgetary projections to protect the most vulnerable sectors of society and the social security safety nets.

*'If there is no money to create new jobs, if there is no money to create new business, there is no future at all'.*

**Valdis Birkavs,**

Former Prime Minister of Latvia and  
Member of the Club of Madrid

*'The effects of the crisis on Europe may widen the gap between and within states along poverty and welfare lines. This may not only jeopardise economic prospects but the very basic idea of a shared society in Europe. We may, in the end, resolve the economic crisis but also have a new social crisis.'*

**Zlatko Lagumdzija,**

Former Prime Minister of Bosnia and Herzegovina  
and Member of the Club of Madrid

### **Reshaping the global economy**

*'Global complexities and global problems can only be solved by global solutions. What we do at the European level should always be with a mindset of helping global structures.'*

**Wim Kok,**

Former Prime Minister of the Netherlands  
and Member of the Club of Madrid



Second, the financial crisis has deepened the illiberal drift in EU external economic policies. In general terms, the aftermath of the crisis has witnessed a massive decrease in cross-border financial exposure and contraction in international trade. A number of specific responses to the financial crisis have compounded the general tendency to protectionism. Since the outbreak of the crisis, European ministers have ritually promised that there will be no slide towards protectionism. They did so at the G20 summits in both November 2008 and April 2009. The more ardently they state this, the more they contemplate just such measures.

*'In a globalised economy, the State cannot simply be the saviour called upon in exceptional circumstances. States have an organizing purpose and a regulatory role to be exerted in normal times'*

**Lionel Jospin,**

Former Prime Minister of France and  
Member of the Club of Madrid

Of course, the financial crisis represents a major case of market failure. In the face of over-extended debt, markets clearly were not self-correcting. There is widespread agreement that tighter regulations are required in the financial sector. Sceptics insist that any further economic liberalisation would be akin to 'trying to cure a state of inebriation by having another whiskey'<sup>10</sup>. Prior to the crisis, economic policies were based on the West providing capital to emerging economies and supporting a liberal trading regime as a means of importing goods back into European markets. The whole geopolitical balance of this bargain has now shifted. The West is set to export less capital, while China's unparalleled liquidity will enhance its power. The 'liberal equation' has been undermined<sup>11</sup>.

And a defensive scepticism of markets has certainly pervaded European reactions to the crisis. The trend is towards 'protection lite' – or what some practitioners now refer to as new means of 'covert' or 'accidental' protectionism. The EU has not adopted out-and-out trade restrictions but a series of actions that militate against international interdependence. The EU reacted vigorously against the 'Buy America' provisions launched under the new Obama presidency, but several similar 'buy national' campaigns have been supported in Europe too.

Financial bail outs have gone hand in hand with governments exhorting banks to lend only to national markets. The retrenchment of private capital encouraged by European countries is set to hit emerging economies particularly hard, and in some cases has already done so. The new protectionism is in finance rather than trade<sup>12</sup>. Western governments' guarantees of deposits in their banks have had the perverse effect of dragging capital out of emerging economies into the developed world. Some also accuse the UK of letting the pound fall as a protectionist measure.

10. Robert Skidelsky, 'Where do we go from here?', Prospect, no. 145, January 2009

11. Roger Altman, 'The Great Crash 2008: A Geopolitical Setback for the West', Foreign Affairs, Jan-Fen 2009

12. George Soros, '.....should be the central concern', Financial Times, 23 March 2009, p.9

The French finance minister urges protectionism as ‘a necessary evil’.<sup>13</sup> Of the twenty governments signing up to G20 statements, solemnly rebutting protectionism, seventeen have adopted protectionist measures. EU populations now perceive open trade very much as a risk more than opportunity. The rise of the Linke party under Oscar Lafontaine in German polls is seen as the result of its highly protectionist platform. Much focus has centred on differences between member states on the right balance needed between more stimulus and more regulation – the UK pushing harder for more spending, France and Germany for more regulation. But these differences mask a common retreat from economic liberalism.

*‘The World Trade Organization should be empowered to monitor the application of policy measures in this crisis resolution, and to avoid again tariff barriers and other forms of market distortion and spill overs’.*

**Paola Subacchi,**

Research Director of the International Economics  
Department, Chatham House

Gordon Brown lectures the world on the dangers of protectionism; but, for one commentator, the prime minister’s own inward-looking policies render him ‘hypocrite-in-chief’<sup>14</sup>. In the US, Democrat free traders have refused to criticise the ‘Buy America’ initiative in part because they insist that European procurement rules are still far more restrictive<sup>15</sup>. It is notable that the supposedly well integrated transatlantic business class has not emerged as an influential brake on these trends. Middle Eastern, Russian and African interlocutors have all ironically suggested to diplomats that the European spree of bank nationalisations mirrors the statist route for which the EU has for so long admonished developing countries.

Member states such as Germany, France and Italy have introduced restrictions on Sovereign Wealth Funds – at the very least sitting uneasily with a Commission-led code of conduct offering access to SWFs where a minimal degree of transparency exists in such funds. A new German law restricts access of foreign buyers, in particular big Chinese and Middle Eastern SWFs. President Sarkozy has moved ahead with creating a French fund explicitly to fend off such foreign ‘predators’. The so-called Santiago principles agreed in October 2008 to open up east-to-west investment are now in doubt. Some member states have fought for more governmental control over IMF loans, wishing to move away from a focus on liberal reforms.

The EU has come to back some reforms to international financial institutions. European governments have backed G20 statements agreeing to bring forward a reweighing of IMF votes from 2013 to 2011. But in practice, they have contemplated change within a relatively limited range, resisting any commitment to far-reaching change in 2011. The EU has been able to hide

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13. Le Monde, 4 February 2009

14. Martin Wolf, ‘Why Davos man is waiting for Obama to save him’, Financial Times, 4 February 2009, p. 11.

15. Financial Times, 6 February 2009, p. 6

behind the US's long-standing reluctance to accept reduced power at the IMF. This has enabled European countries to maintain a studied ambivalence on the question of their own willingness to accept diminished sway. At the end of March 2009 a significant reform of IMF lending was agreed, involving a dilution of conditionality. With parts of Europe itself in need of emergency funding, for the first time most EU states sided with developing states in advocating such a weakening of structural conditions.

*'I fear Europeans are underestimating the magnitude of the crisis. The European Central bank is very cautious, even with the Eastern European Crisis. The Federal Reserve is very aggressive and very fearful, ready to face a problem anywhere. So I think the problem is that we have a different perception of what may happen to the world economy'*

**César Gaviria,**

Former President of Colombia  
and Member of the Club of Madrid

Options for broad coordination of macroeconomic policy at the global level have been resisted. The EU, and especially European Central Bank, have lagged behind in policy easing and the size of fiscal stimulus recommended by the IMF. The crisis has made policy-makers in key European financial institutions, if anything, more adverse to losing control of decisions and being dragged into policies they deem not to be in the immediate European interest. No European support has been forthcoming for a powerful Economic and Social Council at the United Nations. European states are now even more reluctant to give up their vetting of membership to the Basel Committee for Banking Supervision. A preference for informal groupings of the G7, G20 and Financial Stability Forum (a club of regulators) has taken precedence over a genuine multilateralisation.

The April 2009 G20 summit held in London a few days after the Club of Madrid Barcelona Roundtable was generally hailed as a success. The G20 agreed to triple funds to the IMF; \$75 billion of the increase is to come from EU governments. It also committed to boosting trade finance by \$250 billion and extending additional credit to poor countries. The Financial Stability Forum was broadened out into a Financial Stability Board that would incorporate developing countries in the G20. But genuinely rebalancing reform was off the agenda. The Spanish and Dutch governments have squeezed their way into a 'G20 plus', rendering Europe even more over-represented – to the openly expressed chagrin of emerging powers.

*'The Doha Development Round is low hanging fruit. We have the text, the divergences are not big, we still need the political decisions to be made. We do not need more technical time. We need political attention that has to come from the highest level.'*

**Alejandro Jara,**

Deputy Director General, World Trade Organization

In most European states the G20 summit was hailed as a victory over ‘Anglo-Saxon free market capitalism’. The regulatory route was given more emphasis than measures to stimulate spending and trade. The UK moved some way to accepting the need for heavier regulation, closing the gap in positions that had loomed in the run up to the summit. Trade was the glaring omission from the G20 – beyond another non-committal pledge to avoid protectionism. No concrete steps were taken towards restarting the Doha round. Positions in that round had already reached a lowest common denominator. Yet revisiting this and re-loading the trade dossier was declared off the agenda in London<sup>16</sup>.

As European countries look to the IMF for economic help this has geopolitical consequences. It requires the EU to have a far more proactive and coherent position on effective multilateralism. The EU has talked for a long time about the importance of the latter but still has not been willing to take the steps necessary to achieving it. Immediate ad hoc policies are necessary to deal with the worst of the crisis.

*‘Informal solutions are necessary but we should urge our leaders to keep in mind that whilst taking action at the short term, they should also work on the new structures for the long run because we cannot afford to wait till these new structures are in place.’*

**Wim Kok,**

Former Prime Minister of the Netherlands  
and Member of the Club of Madrid

But these must not divert attention from the structural changes that are needed in the international system. Crucially, reform of the financial institutions is not enough. This cannot be divorced from the need to reform the broad range of multilateral institutions that cover the political sphere as well.

*‘We need to have a ‘G’ that is legitimate in the context of an international institutional framework, not an ad hoc group of countries who selected themselves and selected who participates in the meetings. Europe should claim for institutional mechanisms to manage global governance’.*

**José Antonio Ocampo,**

Content Coordinator of the Club of Madrid programme on  
‘The Political Dimensions of the World Economic Crisis’  
and Director of the Program on Economic and Political Development  
at the School of International and Public Affairs, Columbia University

There is a long running debate over whether the EU is a generator of globalisation or a defence against it. The scales may be tipping towards the latter point of view. The crisis reveals serious market failures but the baby should not be

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16. Lucy Davis, ‘G20, where is the trade?’, European Voice, 1 April 2009, [www.europeanvoice.com](http://www.europeanvoice.com)

thrown out with the bathwater. At the same time, the crisis has revealed that this dichotomy – EU as a dimension of globalisation versus EU as bulwark against globalisation – is a false one. The policy change needed is to make sure that the EU contributes to a different type of globalisation, effectively linking the nation state, regional and global levels.

## Europe's geopolitical vision

Third, internal tensions and uncertainties over reform to the international financial institutions in turn pose acute challenges for the EU's more political, external role. More unity and effort is needed on other issues such as climate change, energy security, demographic trends and non-proliferation. The financial crisis must be understood as embedded in this broader set of international challenges, not separate from them. There are signs that the EU's commitments to climate change, security and human rights are suffering as a result of the crisis. This incipient trend must be reversed.

*'We should not look into the economic crisis alone because what we are experiencing today is the accumulation of four crises that are mutually feeding each other: the climate change crisis, the food and hunger crisis, the oil and energy crisis and the economic and financial crisis. We have to see all four as the framework of the current economic situation.'*

**Kjell Magne Bondevik,**

Former Prime Minister of Norway and  
Member of the Club of Madrid

The crisis risks leading to a preference for 'strong government' in a way that undermines democratic quality – both within and beyond Europe. Those of a 'realist' bent will ask, does the financial crisis not make the issue of democracy seem rather irrelevant? Can we really preach democracy's advantage as the West's economic systems come crumbling down? Are we not even more dependent on Chinese liquidity to kick start recovery? Can we talk democracy in Africa with cash-rich China poised to extend its influence there even further? Some experts argue that after the financial crisis the EU needs to stop trying to support democracy beyond Europe and simply safeguard it within its own member states<sup>17</sup>.

And indeed, as the international context has changed, the EU appears less willing to sacrifice engagement with autocratic regimes. European approaches to democracy rely heavily on the positive, modernisation scenario that as China, Russia and other non-democratic states extend their trade and investment links they will come to press for better governance to protect their own investment in third markets.

European governments and the Commission have become increasingly less minded to exert pressure for democratic reform. They increasingly eschew

17. Anatol Lieven, 'Europe has to guard democracy amid crisis', Financial Times, 10 December 2008

sanctions related to democracy and human rights issues. Many would say that the reluctance to use critical measures and sanctions is a good thing – not a sign of any lack of commitment to democracy and human rights but a correct recognition that such measures are often counter-productive. The problem is that neither has the EU engineered its positive engagement effectively to support liberal democratic values. The rewards and incentives the EU offers for democratic reform remain limited, in some cases increasingly so.

*'In Europe the casualty may be integration. In Eastern Europe it may be democracy. In the rest of the world the casualty may be failed states... and we might face an increasing number of time bombs. One should look at the European contribution outside the concerns of the G20, of course to the short-term resolution of the crisis, but also the longer term issues like development, poverty or the environment.'*

**Sadiq Al Mahdi,**

Former Prime Minister of Sudan and  
Member of the Club of Madrid

The Czech foreign minister laments that the EU is 'backtracking on democracy'. Germany increasingly prioritises its role as a 'coalition builder' rather than values-advocate in foreign affairs<sup>18</sup>. One UK minister welcomes the return of the US to 'good old fashioned policies of national interest'<sup>19</sup>. France and Spain remain generally unconvinced of the democracy agenda. In Italy, Silvio Berlusconi tilts towards Atlanticism, his rivals on the left towards Europeanism; neither side distinguishes itself in pro-democracy efforts. Diplomats from many member states argue that the financial crisis places more of a premium on political stability. Doubts have surfaced during 2009, as the Czech and Swedish presidencies have tried to galvanise support for a new European Consensus on democracy: many member states have reacted ambivalently, reluctant to firm up current policy instruments.

*'The crisis and the problem is economic but the solution remains primarily a political choice so we have to consider the whole matter from a political perspective.'*

**Hong Koo Lee,**

Former Prime Minister of Korea and  
Member of the Club of Madrid

But it would be wrong to conclude that the financial crisis renders open politics irrelevant, even harmful. Crisis often acts as the trigger for political breakthroughs. In the midst of a crisis the 'strong leader' might gain currency. But democracies offer the accountability and open deliberation that are necessary for stabilisation

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18. Hanns Maull, 'Germany and the Art of Coalition Building', in Erik Jones and Saskia van Genugten (eds.) *The Future of European Foreign Policy*, London, Routledge, 2009.

19. Lord Malloch Brown, BBC World, 30 March 2009.

over the longer term. Despite the crisis it remains the case that sustainable economic development is best built on democratic foundations. Obama's caution on democracy makes it more not less imperative that the EU show some determined and enlightened leadership in supporting global democracy.

*'More institutions are needed but they are no substitute to political leadership and courage.'*

**Antonio de Lecea,**

Director of International Economic and Financial Affairs,  
European Commission

Better understanding of the ways in which the crisis could undermine democratic quality, transparency and accountability must be reinforced. Nationalism and inequalities must be rebutted. The normative appeal of democracy must be enhanced; democracies must demonstrate they can manage the crisis in a more open and fair way than non-democratic regimes. An effective democracy must be built on a balanced and mutually reinforcing relationship between state, market and civil society. There is no trade off between effective management of the crisis and deepening democratic quality.

*'Democracy that delivers requires a mutually reinforcing balance between the state, the market and the individual. The fundamentalisms of the binomial system have failed. The crisis is a result of a world without rules'.*

**Ricardo Lagos,**

Former President of Chile and  
President of the Club of Madrid.

### Final Declaration

We, Members of Club of Madrid, met in Barcelona on March 26 to discuss the political dimensions of the world economic crisis from a European perspective. We agreed on the following diagnosis and recommended actions:

1. We recognize *that the mega-crisis that the world is experiencing is global and systemic in character*. It is the most devastating financial crisis since the Great Depression, generating the worst recession since the Second World War; a veritable collapse of international trade, and serious social consequences, as seen in the rise of unemployment and poverty. These economic and social implications are producing important political impacts, putting democratic systems under stress in many parts of the world.
2. In these circumstances, *public sector response must be strong and timely*. Underestimating the severity of the crisis could lead to the worst possible scenario, another “lost decade” in world development, with significant social and political effects. We therefore welcome the expansionary monetary policies being adopted by various industrialized countries but are concerned with the small stimulus packages being implemented by members of the European Union; the delay of the European Central Bank in adopting more aggressive policies, and the inadequacy which financial sector bailouts have demonstrated so far. The upcoming meeting of the G20 in London should not miss the opportunity to agree on strong and coordinated macroeconomic stimulus in industrialized countries.
3. *Facing the social costs of the crisis should be at the centre of all macroeconomic policy packages*. Social protection systems must be strengthened in those countries where they exist, and gradually created in those where they are not in place. Managing high levels of unemployment and underemployment will be their most challenging task. Social dialogue can be extremely useful in managing the social demands created by the crisis, simultaneously helping to strengthen our democracies.
4. *It is essential to correct the regulatory deficit*, the principal, individual cause of the current financial crisis. We hope the G20 will agree to promote comprehensive financial regulations, covering institutions (such as hedge funds) and activities (derivates) previously unregulated; to include counter-cyclical provisions in these regulations; to enact stronger supervision of systemically important institutions, including the use of colleges of supervisors to oversee financial institutions operating worldwide; and to foster strong consumer defense, reflected in the financial safety of assets and loans made available to unsophisticated agents. Financial bailouts are costly and have significant distributive effects. Transparency and accountability should therefore be rigorously applied.
5. *Emerging and developing countries must be part of the solution*. The sharp interruption of capital flows to developing countries is a major source of concern. Economies that were healthy just a year ago have come under severe strain. The G20 should therefore also agree on increased capitalization of the IMF and the major multilateral development banks. Developing countries are reluctant to use IMF resources due to the intrusive conditionalities of the past. A major review of these conditionalities is essential and positive steps are being taken in this direction.
6. *The decrease of international trade since the third quarter of 2008 is a major source of concern*. Nationalism is being reflected in strengthened



protectionism, often introduced in indirect ways. For example, rescue packages for the financial sector or some productive activities are creating subsidies that affect the competitive position of developing countries unable to match the financial support that industrial countries can provide. We therefore propose a total freeze on these protectionist trends and a special meeting of the WTO to create effective mechanisms to ensure this.

7. *A strengthened global architecture requires a special effort in institution building.* While G20 meetings have been a step forward, global governance cannot rely on informal mechanisms lacking representation from most countries of the world. The institutionalization of the G20 through the creation of a representative Global Economic Council, under the UN but with the support of the global financial institutions could be a solution. The latter, particularly the Bretton Woods institutions and existing regulatory bodies, should also be strengthened. This process could help address the issue of voice and representation of developing countries in international economic decision making. And, as the European history reflects, stronger regional institutions are an essential complement to world institutions in building a better global order.
8. *Beyond the need for an urgent response, we recognize that this is an institutional crisis of the global order.* The world cannot postpone creating an international financial architecture consistent with the deep interdependency of our globalized economy. The agenda should be broadened to include: the creation a truly global reserve currency, which could be based on the Special Drawing Rights of the IMF; the creation of institutional and effective mechanisms for macroeconomic policy coordination; the role of capital account regulations in the emerging system of financial regulation; the creation of a special court to mediate and eventually arbitrate disputes associated with over indebtedness at the international level; and enhanced international tax cooperation.

### **Abstract**

The financial crisis that hit the world in 2008 has become global and triggered the start of a worldwide economic recession. By the fourth quarter of 2009, most countries will have been in economic recession for nearly a year. Wealthy countries will have become less wealthy and the poor even poorer. National government and international financial institution attempts to cope with the financial crisis and other economic troubles will have inevitable political consequences and may put the procedures of constitutional democratic politics at risk, create conditions for heightened social unrest and possible violence, and deepen the inequality and injustice in which many continue to live. Financial and macroeconomic troubles cannot justify the deferral of equally crucial challenges being faced by humanity today, ranging from poverty to global warming, from human rights to peace building, all key to sustaining democracy, good governance and development.

Above and beyond the urgency to design and implement policies and measures to address this mega-crisis in the short-term, a recurrent theme appears in all discussions – the need to look ahead and welcome the crisis as an opportunity to address much deeper, medium and long-term concerns, at multiple levels. The design and adoption of a new, more effective international financial architecture is seen as a vital step in preventing future meltdowns and attaining international financial stability, as well as a more credible, truly multilateral and democratic governance structure in the international financial institutions.

But concerns are not limited to financial institutions. The governance structure of nearly all international organizations and of the various global ‘groupings’ is also being questioned. Can this crisis become the opportunity to effectively address this issue? To rethink entrenched ways of doing things and to promote reforms that strengthen democracy? A post-crisis, multiple level strategy and approach will be essential both in structural and leadership terms. Will this strategy be underpinned by existing structures and groupings or will new or renewed ones emerge? Defining and agreeing on how, when and what in a course of correction of this magnitude will need leadership and experience, sagacity and audacity. Other important issues such as those highlighted above – climate change, poverty alleviation, good governance – must not be left by the wayside in the necessarily bold and foreseeable process of change and reform that lies ahead.

The current crisis is extremely complex. It affects various countries and regions differently depending on their level of development, location and inclusion in the global economic networks, among others. Dealing with it will require different solutions and strategies for each region and each group of countries. This is why the proposed work program is based on regional round-tables in preparation for a global discussion in our Annual Conference 2009. Participants are convened not to discuss the specificities of particular financial or economic measures. As politicians and experts in policy and decision-making, participants are encouraged to focus their attention and analysis on the policies being adopted by governments and multilateral institutions to meet the challenges posed by the economic crisis, as they bear on the imperative of strengthening and sustaining democratic values, democratic leadership and the quality of politics and policies.

## Programme

*Thursday, 26th March*

- 13:30 – 14:00      *Welcoming words: (Sala Tàpies)*  
**Ricardo Lagos**, President, Club of Madrid. Former President of Chile.  
**José Antonio Ocampo**, Programme Academic Coordinator. Professor at Columbia University. Former Under Secretary General of the United Nations for Social and Economic Affairs  
**José Montilla i Aguilera**, President of the Autonomous Government of Catalunya
- 16:00 – 20:00      **Roundtable** 'The Political Dimensions of the World Economic Crisis – A European Perspective' (*Sala de Música*)  
**Block 1: The Situation within Europe: the National and Supranational**  
**Block 2: Europe's New Role in the International Arena**  
*Moderator: Philip Stephens*, Associate Editor and Senior Commentator, Financial Times  
*Welcoming Words: Hon. Antoni Castells*, Minister of Economy of the Autonomous Government of Catalunya  
*Speaker: Jean Pisani-Ferry*, Director of the Brussels European and Global Economic Laboratory, Member of the European Commission's Group of Economic Policy Analysis  
*Rapporteur: Richard Youngs*, Coordinator of the Democratisation Program, *Fundación para las Relaciones Internacionales y el Diálogo Exterior* (FRIDE).  
 Cocktail offered by the Hon. Josep Lluís Carod-Rovira, Vice President of the Autonomous Government of Catalunya (*Biblioteca*)
- 20:00 – 21:30

## Participants list

### Members of the Club of Madrid

Ricardo Lagos	Former President of Chile. President, Club of Madrid
Sadiq Al Mahdi	Former Prime Minister of Sudan
Valdis Birkavs	Former Prime Minister of Latvia
Kjell Magne Bondevik	Former Prime Minister of Norway
Joaquim A. Chissano	Former President of Mozambique
Cesar Gaviria	Former President of Colombia
Lionel Jospin	Former Prime Minister of France
Wim Kok	Former Prime Minister of the Netherlands
Zlatko Lagumdžija	Former Prime Minister of Bosnia and Herzegovina
Hong Koo Lee	Former Prime Minister of Korea
Petre Roman	Former Prime Minister of Romania
Diego Hidalgo	President, Fundación para las Relaciones Internacionales y el Diálogo Exterior (FRIDE)
Anthony Jones	Vice President and Executive Director, Gorbachev Foundation for North America (GFNA)
Fernando Perpiñá-Robert	Secretary General, Club of Madrid

### Experts and Invitees

Bjørn Klouman Bekken	Higher Executive Officer, The Royal Norwegian Ministry of Foreign Affairs
Federiga Bindi	Visiting Fellow, Brookings Foundation and Advisor on Global Governance to the Italian Minister of Foreign Affairs
Antoni Castells	Finance and Economy Counsellor, Regional Government of Catalunya
Senén Florensa Palau	General Director, Institut Europeu de la Mediterrània (IEMed)
Antonio de Lecea	Director of International Economic and Financial Affairs, European Commission
Carlos Gasòliba	President of the Spanish Committee, European League for Economic Co-operation
Vitor Gaspar	Director General, Bureau of European Policy Advisers, European Commission
Alejandro Jara	Deputy Director General, World Trade Organization
Carlos Losada Marrodán	Associate Professor of the Department of Business Policy, ESADE
Leiv Lunde	Senior Advisor on the Global Economy to the Minister of Foreign Affairs, Government of Norway

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José Antonio Ocampo	Academic Coordinator of Club of Madrid Program on the International Financial Crisis. Professor of Professional Practice in International and Public Affairs and Director of the Program in Economic and Political Development at the School of International and Public Affairs, Columbia University
Alfredo Pastor	Professor of Economics, IESE Business School
Mario Pezzini	OECD Deputy Director, Public Governance and Territorial Development
Jean Pisani-Ferry	Director of the Brussels European and Global Economic Laboratory, Member of the European Commission's Group of Economic Policy Analysis (GEPA) and of the French Prime Minister's Council of Economic Analysis
Narcis Serra	President, Center for International Relations and Development Studies (CIDOB)
Philip Stephens	Associate Editor and Senior Commentator, The Financial Times
Paola Subacchi	Research Director of the International Economics Program, Chatham House
Philippe Egger	International Labour Organization
Carlos Westendorp y Cabeza	Principal Advisor to the EU's High-Level Reflection Group on the Future of Europe
Richard Youngs	Coordinator of the Democratisation Program, FRIDE
Juan Zaldueño	Lead Economist, Office of the Chief Economist, Europe and Central Asia Region, World Bank

## **Background Document for the Latin American Roundtable**

### **‘The Impact of the Global Economic Crisis on Latin America’<sup>20</sup>**

**By José Antonio Ocampo\***

From 2003 to 2007, Latin America experienced an exceptional economic boom thanks to an unusual combination of world financial prosperity, sustained growth of international trade, extraordinary raw material prices and high capital inflows from emigrant workers. This boom was the most significant in over thirty years, specifically since the region’s economic growth between the 1960s and early 1970s. It was a widespread process and indeed benefited small and medium-sized economies more than the region’s two largest ones. In contrast with the situation since the debt crisis (and earlier in some cases), its social impact was also highly positive. Unemployment and poverty were considerably reduced, employment grew dynamically and was of a better quality and inequality was diminished in a large number of countries.

The region was not significantly affected by the first part of the international financial crisis which started in August 2007 in the United States with the subprime mortgage fiasco. Foreign financing was reduced and became more irregular. Furthermore, capital inflow growth from migrants started to decelerate as a result of fewer employment opportunities abroad, especially in the US construction sector. Rising raw material prices, however, sustained the boom in several countries throughout the first half of 2008. When this trend changed halfway through the year, therefore, it signalled the end of positive growth. The world crisis, enhanced by the collapse of the Lehman Brothers investment bank in the US in mid-September dramatically increased this trend.

#### **1. Economic impact**

The economic impact of the world crisis, which took some time to be acknowledged, was enormous. The forecasts of all multilateral agencies (World Bank, ECLAC, IMF and UN) announce that the region’s GDP will be falling by 1.5% (IMF) to 2.2% (the most recent estimate from the World Bank), with ECLAC and the UN predicting intermediate figures (falls of 1.7% and 1.9%, respectively).

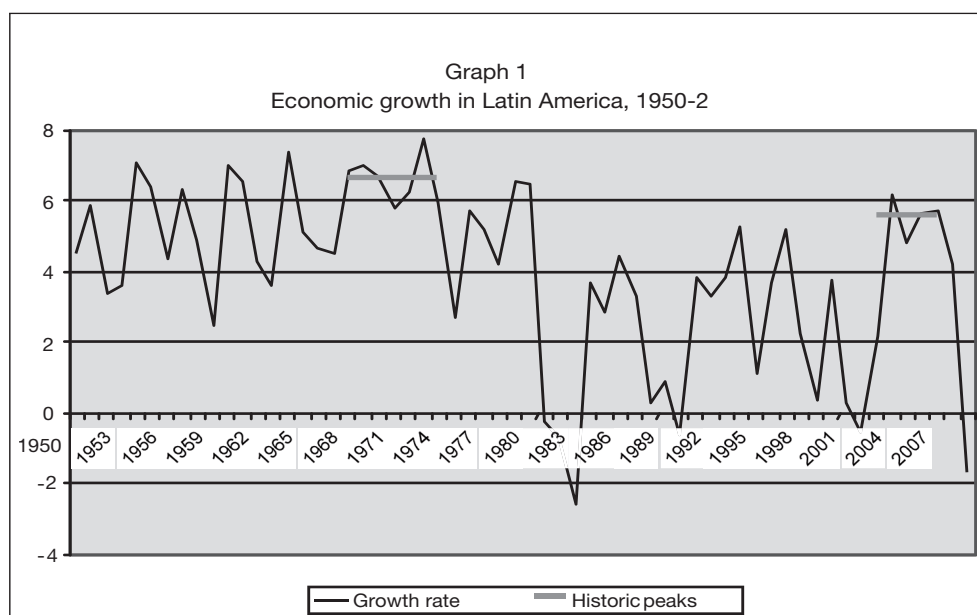
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20. This document was prepared as an input document for the Club of Madrid’s Roundtable on “The Political Dimensions of the World Economic Crisis: a Latin American Perspective” held July 13th, 2009 in Santiago de Chile.

\* Professor and co-President of the Initiative for Policy Dialogue at Columbia University. Member of the Commission of Experts of the UN General Assembly on Reforms of the International Monetary and Financial System. Former Under-Secretary General of the United Nations for Economic and Social Affairs and Executive Secretary of the Economic Commission for Latin America and the Caribbean, and former Minister of Finance of Colombia.

Some private organisations have made even more pessimistic forecasts. Furthermore, the crisis is widespread. Mexico is the most affected economy, but most of the region's countries will see their economic activity reduced.

From a historical perspective, this recession is worse than those of 1990 and 2002 and, according to the most pessimistic forecasts, could be worse than the post-war period in 1983, although possibly shorter in length (see Graph 1). The forecasts also show that what is lost in 2009 will only just be recovered in 2010, and the per capital GDP will not return to 2008 levels until 2012. In other words, this crisis will set development back by four years. It is not so bad as the “half a decade lost” in 1998-2003 and certainly better than the “wasted decade” of the 1980s. Some scenarios are, however, more pessimistic.



Source:  
ECLAC

The way this crisis has spread shows significant differences with the past, and some surprises. Notwithstanding some negative forecasts, the reduction in capital inflow from migrants has been relatively moderate (5.2% and 6.7% in the last quarter of 2008 and the first of 2009 relative to the same periods a year earlier).

The financial channels have also been weaker than was initially expected. In contrast with the three previous episodes (the debt crisis, the Mexican crisis of 1994-1995 and the financial crisis affecting emerging economies that first arose in Asia in 1997), none of the region's countries has now seen a collapse of its internal financial system. Risk margins, and consequently the cost of foreign financing, started to increase in mid-2008 and exploded with the world financial collapse in September, but peaked towards the end of October and has since been considerably reduced. In recent weeks, it was around 9%, some two percentage points higher than during the boom, but much lower than the typical rate found from mid-1998 to mid-2003, during the financial crisis affecting emerging economies. The availability of foreign

financing fell drastically in mid-2008 and dried up altogether in September, but has been gradually improving since the beginning of 2009. In the critical weeks of the financial debacle, there were important losses on the derivative markets, especially in Brazil and Mexico, which brought pressure to bear on international reserves. However, they were only marginally reduced and remain at very high levels. Finally, although the stock markets collapsed in mid-2008, they remained at higher levels than in other regions and participated in the world stock market boom of April and May 2009.

From a historic perspective, although the financial sectors of industrialised countries were at the eye of the storm, in strictly financial terms, this has been a much worse crisis for Latin America than the debt crisis and the financial crisis affecting emerging economies. This is due to both external and internal factors. In external terms, the fact that the crisis arose in the industrialised world generated an active response from the economic authorities, which was not found in the past in crises arising in the developing world (except for the Mexican crisis of 1994-1995). The internal reasons are associated to the fact that Latin American economies are macroeconomically stronger, as discussed in the following section.

In commercial terms, the current crisis is much more profound. The collapse in world trade is unprecedented since World War II and is even more severe than the situation at the start of the Great Depression in the 1930s. In the first quarter of 2009, the value of world trade was 31% less than in the same quarter of 2008, because of both the drop in raw material prices and the heavy drop in the world demand for manufactured goods. Although basic product prices partially recovered in the second quarter of 2009, a similar trend is not yet clear for manufactured goods, as shown in the 24% reduction in Chinese exports in April and May relative to the same months of 2008. Both the IMF and the UN are expecting a 11% reduction in world trade volumes in 2009, and no growth, or at best a very partial recovery, in 2010.

Latin America has formed part of this process. Its exports fell by 26% in the first quarter of the year, relative to the same period in 2008. As the magnitude of the current recession found in the region cannot be explained by the financial crisis, the present situation could better be described as a commercial crisis. In other words, although the region has reduced its financial vulnerability, its commercial vulnerability is much greater than in the past.

This means that, unlike the situation in Mexico after the 1994-1995 crisis or in Latin America as a whole after the 1998-2002 emerging economy crisis, the possibility of overcoming the recession thanks to export growth is limited. From a broader perspective, this presents policy-makers with important questions concerning the development strategy that, for a quarter of a century, has been emphasising the importance of economies forming part of world trade and investment trends. This issue is revisited in the last section of this document.

## **2. The response to the crisis**

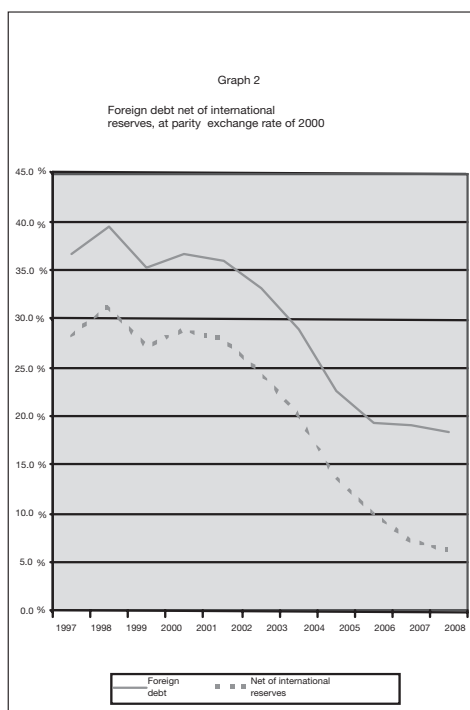
It was generally agreed in the last few months that anti-cyclical macroeconomic policies were required in response to the crisis, on both a regional and global scale. It was also recognised that developing countries have more limited



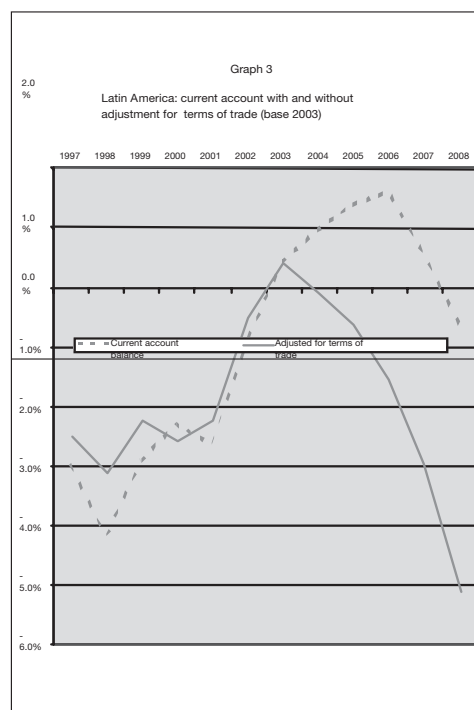
possibilities in this respect, basically because financial and trade flows have pro-cyclical effects on such economies. The different multilateral banks have therefore been active supporters of such policies, including the World Bank, the IADB, the ADC and the CABEL. The IMF has received unprecedented resources and substantially innovated its financing strategy, particularly with the creation of the Flexible Credit Line in March, which has already been used by Colombia and Mexico. The Federal Reserve also created lines of credit, through currency swaps, for the central banks of Brazil and Mexico, and China has provided Argentina with similar resources.

Furthermore, Latin America has wider margins than in the past for adopting anti-cyclical macroeconomic policies. The most important change can be found in the monetary and currency exchange field. The sudden interest rate increases characteristic of previous crises, often due to attempts to prevent depreciation of national currencies, have been avoided. On this occasion, central banks have been able to lower interest rates, provide the financial system with resources (reducing bank swaps, among others) and, in most large countries, they have let the exchange rate depreciate (with some intervention to prevent an uncontrolled adjustment process). The countries with development banks have also used them to support credit reactivation.

The basic reasons enabling this action to be taken were two factors which have hindered the transmission of the crisis through financial channels: the heavy reduction in governmental foreign debt and high levels of international reserves. As shown on Graph 2, in 2008, foreign debt net of international reserves, was equivalent to 6% of the GDP, compared to nearly 30% prior to the previous crisis. This was due to several factors. The first is the development of domestic bond markets, which have become a dynamic source of public financing in many countries. The second is the decision of most central banks to absorb excess foreign financing by accumulating international reserves, as shown by the fact that the two periods of abundant foreign financing (from mid-2006 to mid-2007 and the first half of 2008) also saw heavy accumulation of reserves. The third was the current account surplus. With a few exceptions (Argentina, Bolivia and Venezuela), however, this was not the most important source of accumulation of reserves. Indeed, the region's slight current account surplus during the recent boom is practically entirely explained by the improvement in terms of trade, as if the current account is estimated with the terms of trade prior to the boom, the decline was considerable during the period of prosperity (Graph 3).



Source: Author's calculations based on ECLAC statistics. For Chile, this includes resources from sovereign funds



Source: Author's estimated from ECLAC data

In the tax field, there have been multiple announcements of anti-cyclical policies, but there is not much margin. The basic reason is that, although fiscal deficits remained at moderate levels and public debt levels are more favourable in nearly all countries than prior to the previous crisis (the most significant exceptions are Argentina, Colombia, Uruguay and, marginally, Brazil), these results are not due to spending austerity during the previous boom but to exceptional public income levels. Public expenditure grew faster than long-term economic growth and, in this respect, was pro-cyclical, with some exceptions, the most important of which is Chile, but also El Salvador and Guatemala. It will not be easy, therefore, to maintain these rates of public expenditure growth during the crisis. However, with acceptable growth rates, expenditure could play a stabilising role and programmes could be launched to relieve part of the impact of this crisis on low income sectors. Indeed, such programmes have been instated in several countries.

## 3. The political implications

The political implications of this crisis will first be found in a decline in social indicators. The information provided in the June report on employment published jointly by ECLAC and ILO, shows a fall in the employment rate, a considerable drop in the formal employment growth rate (social security contributors) and an increase in unemployment in the first quarter of 2009 relative to the same

period in 2008. However, the impact is still modest and compatible with modest growth in employment, albeit with some important exceptions. The situation in Mexico is a cause for concern, as the country could be facing one of the most severe labour crises in the last few decades (among other things, due to the radical change in migratory conditions in the US), and the same applies to Colombia, where the unemployment rate has increased to one of the highest in the region. With regards to poverty, the UN has projected an increase of 3.6 million people living in extreme poverty in Latin America; this effect is also modest and susceptible to focalised policies. The impact on employment and poverty will increase, however, if the crisis lasts for long. Consistent with these as yet modest effects, there appear to have been no important political mobilisations associated to the crisis to date.

More significant is the switch to more active ideas of the role of the State, as part of a worldwide process. In Latin America, however, this was occurring before the crisis, as seen in several regimens clearly identified as leftist (with different variants), although there is also more pragmatism concerning the role of the State in central and right-wing governments. One interesting aspect is the renewed attention paid to the role of the domestic market and development banks. Brazil is a pioneer in both these issues. Anti-cyclical packages refer precisely to how to activate domestic demand in an unfavourable economic situation. Development banks would be the most important way in which to renew interest in industrial policy (or productive development policy in general), but so far this process is only showing strength in Brazil.

The most interesting question for the future refers to what will drive the region's economic growth. After more than a quarter of a century promoting a strategy based on insertion in international trade and investment currents, the collapse of world trade has generated major questions, which will become increasingly evident if international trade takes some time to recover, which is more than likely. If this happens, countries or regions with important domestic markets will be better off, as they were during the Great Depression in the 30s. Like then, this may be forced by the facts rather than by ideas, which in general continue to be open.

There are obviously other alternatives. It appears that China will be a driving force in Asia, something that the countries closer to the US and Europe, such as Latin American countries, do not have. It will be important to do more business with China, but it will depend on the ability to close the huge commercial divide with the Asian giant and diversify exports to that destination, as for Latin America they still depend on a series of basic products (soy, copper, oil and iron mineral).

The "domestic" market of Latin America is its regional market. This is particularly true for the smallest economies. Regional political differences, as shown in the Andean Community crisis and weakness in other processes, have become a major obstacle. But there are also economic factors at stake. As in the previous crises, the reduction in intra-regional trade is enhancing the crisis, and exchange rate policy differences continue to be an important drawback preventing further integration (due to dollarization, the only adjustment option for Ecuador is to limit trade, and this affects its regional partners).

Nonetheless, some initiatives appear to be progressing, especially those related to energy integration. There are also intra-regional payment proposals, including an initiative by Argentina and Brazil aimed at enabling payment in their own

currencies (a mechanism which could spread to all ALADI Reciprocal Payment and Credit Agreement members) and the ALBA Sucre arrangement. But political differences are also in play here. For instance, the Sucre initiative could be adopted through ALADI (Latin American Integration Association), possibly with the collaboration of the Latin American Reserve Fund (FLAR), but the agents involved appear to prefer ALBA for political reasons. The region has the best regional financial cooperation mechanisms in the developing world (ADC, CABEL, the Reserve Fund and the ALADI payment convention), which could be enormously strengthened by the crisis. In this respect, the most important incomplete task is to transform the FLAR into a true Latin American Reserve Fund, as its name implies.

Regional cooperation, therefore, needs an important political effort to make use of the opportunities provided by this situation to foster regional integration efforts. But this necessarily requires the region's countries to overcome their political differences.

The relative absence of Latin America from major debates concerning international financial reform is also significant, as is that of the rest of the developing world in generation (with the possible exception of China). Regional members of the G20 are in an excellent position to construct an agenda which, while representing a consensus among themselves, is capable of mobilising a truly regional proposal.

## **Final Report of the Latin American Roundtable<sup>21</sup>**

### **‘The Political Dimensions of the World Economic Crisis: A Latin American Perspective’<sup>22</sup>**

**By Ted Piccone**

The global economic crisis has touched every region of the world to varying degrees but its impact on the countries of Latin America and the Caribbean has been especially discouraging. After two decades of economic malaise, debt overload, fiscal crises and hyperinflation, the region was enjoying a robust six-year period of economic growth – a “bonanza” – that was beginning to have tangible results in terms of poverty reduction and a growing middle class. Now, just one year into the global recession, the countries of the region are suffering major setbacks in economic growth, employment, remittances and exports, with expectations of significant backsliding in poverty reduction, fiscal stability and social investments. These developments, combined with elements of autocratic populism in some countries, rising public insecurity and the risks of climate change, present major challenges for democratic leadership at the national, regional and global levels.

On 13 July, 2009, the Club of Madrid, under its program on “The Political Dimensions of the World Economic Crisis,” gathered at the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) in Santiago, Chile for an in-depth discussion with top experts on the regional aspects of the global recession. Present at the all-day roundtable were eight Members of the Club of Madrid, all democratic former heads of state or government, along with high-level representatives from intergovernmental organizations, academic institutions and civil society to analyze the economic situation and the political implications that flow from it. This report offers a summary of the key points and recommendations that were raised at the meeting as input to the Club of Madrid’s annual conference on the topic in November, 2009.

#### **The End of the Bonanza... and the Start of a New Paradigm?**

After six years of strong economic growth and encouraging poverty reduction, the global recession has put the region’s economy in reverse, with a likely contraction of two percent in 2009, unemployment rising to nine percent, remittances declining, tourism collapsing and exports falling. Despite the gloomy prognosis, however, there is cause for optimism that the region will be able to turn the corner and return slowly to a positive growth trajectory in 2010. As a result of painful economic measures taken by newly democratic

21. Meeting Rapporteur and author of the Final Report: Theodore J. Piccone, Senior Fellow and Deputy Director for Foreign Policy, The Brookings Institution.

22. The Club de Madrid is grateful to the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), the Iberoamerican General Secretariat (SEGIB) and the Andean Corporation for Development (CAF) for their support in the organization of this Roundtable Discussion.

governments in the wake of the debt crisis of the 1980s, fiscal balance sheets generally are in better shape now than in previous periods of economic decline. Inflation remains relatively low, credit is available and counter-cyclical policies are cushioning the macroeconomic blow. Initial predictions of dire consequences for the region have proven exaggerated. Remittances, for example, have not fallen as dramatically as feared, loss of reserves has been minimal, and central banks have been able to keep interest rates low, all in contrast with the worse scenarios of the past.

Unlike previous home-grown economic crises in the countries of the region, the global recession of 2008-09 was generated outside the region, principally in the United States. The bonanza itself had also been caused by external factors. Growing financing was coupled with rapid increase in consumption in the United States. China's rise as an economic powerhouse drove demand for Latin America's natural resources to unprecedented and perhaps unsustainable levels. Rapid world growth and booming financial and commodity markets also led to a mutual dependency between China and the United States in which all parties, including Latin America, benefited before all were hurt by the collapse of the financial system.

*"The perfect marriage between China and the United states seemed marvelous but the foundations were unsustainable."*

**Jorge Quiroga,**

Former President of Bolivia, Member of the Club of Madrid

On the positive side, the generally safe macroeconomic approach of the region may have broken the myth of Latin America as a "box of bad surprises." [Frei p. 19] In addition, the period of bonanza delivered benefits to everyone – consumers, businesses and governments – through lower interest rates and longer terms of borrowing. As opposed to past 'boom and bust' episodes in which public institutions took too many risks, this time around it was the private sector that pumped up the unsustainable debt balloon.

This latest experience with the downside of globalization has added further weight to the view that the dominant neoliberal model of the 1990s is not only politically dead, but also economically spent. The gospel of broad market deregulation and smaller government has proven to be a recipe for financial disaster as banks took on more and more risk without proper controls. The now-defamed "Washington Consensus" created unrealistic expectations of linear growth; it also relied excessively on economic rather than political solutions to society's problems. Moreover, the abrupt reversal in the region's fortunes on the heels of a boom period has sharpened levels of societal frustration which could lead to tensions and conflict. As a result of the crisis, political and economic conditions are ripe for a paradigm shift toward a better balance between a stronger state, an efficient but regulated market, and an educated and active citizenry.

While it is difficult to generalize across such a diverse group of countries, there are a number of lessons the region has learned from previous downturns. For example, some countries prepared themselves better than others to cope with

possible crises even though within countries some sectors are better positioned than others to take advantage of the enhanced trade and technological innovation that globalization offers. Second, pro-cyclical policies, including an increase in protectionist measures, have been shown to backfire, while counter-cyclical policies are proving to be a stabilizing factor. Third, social discontent is more likely to emerge in economic crises, making the normal functioning of democratic institutions more difficult and raising the importance of expanding social safety nets.

While states can take steps to incorporate these lessons in their response to the current economic crisis, developments at the global level are making it even more difficult to organize a coherent approach. For one thing, Latin America is less relevant on the international stage than it was 30-40 years ago. Compared to other regions, per capita income has declined. The region's share of exports as a percentage of the global total has dropped from 14 to 7%. Second, the traditional, export – led development model, based on a supposedly comparative advantage and high concentrations of commodity exports persists, particularly in South America, making the region more vulnerable to external shocks. Other regions with higher rates of productivity, savings and investment in education and infrastructure are pulling ahead. In addition, the region remains plagued by the highest levels of inequality and public insecurity in the world. To overcome these disadvantages, Latin American economies need to transition over the long term to more competitive, balanced models of quality economic growth based on macroeconomic stability, microeconomic efficiency, equity and environmental equilibrium.

In light of these circumstances, there is a clear need not only for stronger but for more responsible states, ones which are fiscally sound capable of protecting their citizens, delivering social services, promoting social cohesion and protecting the environment while empowering entrepreneurs, and regulating the market while giving private initiative the needed space. Such responsible states are also needed to respond to the impending crisis of climate change, the growing challenges of migration and the persistent menace of drug trafficking and organized crime.

*“There are no rescue packages if we climb above two degrees Celsius of global warming (...) There is no step back.”*

**Ricardo Lagos,**

Former President of Chile, President of the Club of Madrid

Unfortunately, governments in the region have grown weaker and more fragile with a wholly inadequate tax structure to support the aspirations of citizens for a strong state that can deliver public goods within a framework of democratic stability.

*“We want to have states like Denmark without paying high taxes”*

**José Miguel Insulza,**

Secretary General of the Organization of American States

To make matters worse, the growing competition for scarce financial resources on the global stage will make it more difficult for Latin American countries to borrow on preferential terms. For example, if the United States' fiscal deficit continues to grow, it will increasingly compete with Latin America for external financing. In the face of such competition, those states with the best policies and recognized respect for rule of law are more likely to succeed, making it virtually impossible for today's Latin America to secure the resources needed to reach adequate levels of growth.

Given such limited resources, states and society must make some fundamental decisions: to what extent should we raise taxes and redistribute income rather than borrow from the future to accelerate development in the present? To what extent can corporations self-regulate their behavior by, for example, acting in a more socially responsible manner towards and with the communities in which they operate? Must the state intervene more directly in commercial affairs, even if it means slower economic growth?

Latin America could learn from Asia in this regard. Asian states, including China, have pursued smart policies of political economy featuring higher rates of savings and investments in education and public goods. Latin America must do the same, increasing its levels of public and private investments and savings and improving the quality of education if it is to grow economically.

*"Everyone says that we have better education but if you check Latin America's performance in international rankings of education we can see this is just not so"*

*"UNASUR not only excludes Mexico, it weakens the OAS"*

**César Gaviria,**

Former President of Colombia, Member of the Club of Madrid

The impact of a major decline in foreign trade raises some particularly challenging questions for Latin America's export-led development model. Will the region turn again to a more internally driven market model, not merely at the national level but the regional level as well? The current blow to global trade should, in theory, be the moment for accelerating regional integration. Instead, regional integration is in crisis, in large measure because of internal political divisions in the region. Tensions, for example, have grown between Colombia and Ecuador, Peru and Bolivia, Venezuela and Colombia, Peru and Chile, Uruguay and Argentina, and so on. Brazil's initiative to create the Union of South American States (UNASUR), which excludes Mexico, and the potential inclusion of Venezuela instead of Mexico in Mercosur, are sowing discord as well. The great diversity of the region – with populations ranging in size from 300 million to only 50,000 and wide disparities in wealth, resources and power – makes it even more difficult to achieve consensus on common interests.

The diversity of the region is also seen in the way different states are handling the economic crisis. Some have built strong fiscal positions, with low public sector debts that provide some room for counter-cyclical policies. Others, however, spent heavily during the boom years and have little room for maneuver. Still others remain heavily dependent on the U.S. economy, and have been hit hard by the



crisis in the world's major economy crisis. Some others have been diversifying into Asia and, particularly, China, and have been able to expand exports into those markets. Despite these variations, a general consensus seems to exist around such themes as open economies, sustainable fiscal policies, control of inflation, and anti-poverty programs. This may be insufficient, however, to regain the momentum of the 1990s toward regional integration.

*"Today we are further apart than ever with no coordination in economic infrastructure or energy matters"*

**Eduardo Frei Ruiz Tagle**

Former President of Chile, Member of the Club of Madrid

Mexico in particular faces a number of daunting challenges. With the arrival of democracy in the 1990s, Mexico was able to reduce its external debt, double its reserves, cut inflation and interest rates and reduce poverty. However, its heavy dependence on the U.S. economy (90 percent of its trade is with the U.S.), particularly in the energy and auto sectors, disproportionately affected the country when the U.S. economy hit bottom in 2009. The North American Free Trade Agreement (NAFTA) is dormant. A politically contentious and immature debate on fiscal policy (Mexico's fiscal income is one of the lowest per capita in the region) prevented any significant reform during the period of bonanza even though the government is dangerously dependent on oil as its main source of income. A confluence of negative forces – the economic crisis, the H1N1 virus, a surge in drug-related crime and violence – has exacerbated these structural problems. The way out demands strong democratic leadership, with the courage and wisdom to focus not just on economic efficiency but on human development and gender equity if it is to escape its current path of turmoil.

*"Democracy has brought us a period of growth but it must be nourished and protected because surprises are always around the corner"*

**Vicente Fox,**

Former President of Mexico, Member of the Club of Madrid

## **Impact of Economic Crisis on Democratic Development**

While Latin America's economies are, in general, better prepared to cope with the economic crisis than in the 1980s, the average citizen is not. The new middle class is highly vulnerable with few guarantees of social security. Because the bonanza period was short-lived, savings rates and home ownership remain low. Chances of a quick recovery that will directly benefit vulnerable households are also low. Based on the experience of prior periods of contraction, it can take twice as long to recover levels of social progress as it does to recover economic growth. Similarly, productivity recovers more quickly after a crisis than does employment. On the bright side, however, some states have made important progress in establishing large social safety net programs (e.g., Bolsa Familia in Brazil, Oportunidades in Mexico). Nonetheless, the beneficiaries of public

policies in Latin America remain segmented – education and health services are not the same for all, impeding social mobility. And tax policies, compared to other regions of the world, fail to redistribute income and wealth.

In the meantime, political polarization and social tensions are likely to grow, endangering the region's advances in democratic and fiscal stability.

*“The economic growth needed to reduce poverty will not happen in the next 4-5 years and social problems will be aggravated as a result”*

**Rebeca Grynsman,**

Regional Director for Latin America and the Caribbean,  
United Nations Development Programme

The timing of the economic downturn is particularly sensitive given the impending heavy schedule of elections throughout the region, contests that will present voters with a choice between democratic reformism and autocratic populism. Now that it is no longer as easy for autocrats to write checks, as they did in the not so distant past, tendencies toward “Cesarismo” – the substitution of republican institutions with monocratic leaders – are more pronounced and more dangerous. This phenomenon is distinctly Latin American – the classic concept of representation is substituted by a president above the constitution and the law; the parliament is replaced by direct dialogue between the president and the masses; and the tools of the state are used to serve the president, without intermediaries.

*“Our Latin America still has formidable deficits of democratic culture”*

**Julio María Sanguinetti**

Former President of Uruguay,  
Member of the Club of Madrid

There is a powerful demand for internal consensus on key societal issues beyond what can be achieved through elections. Building such consensus, however, is proving difficult in the face of weak and immature democratic institutions and flaws in the implementation of the rule of law. There are some notable examples of persistent state weakness due to politicization and corruption. Argentina's troubling experience of manipulating official economic statistics and its impact on bond holders is a recent case in point. The tendency to maneuver constitutions and elections to stay in power, promoted both by sitting presidents, political parties and special interest groups that benefit from privileged access to power, is particularly worrisome.

*“It is vile towards democracy for a constitution to be modified in benefit of a sitting president”*

**Julio María Sanguinetti**

Former President of Uruguay,  
Member of the Club of Madrid

This risks undermining the public's faith in the constitution as the highest law of the land. Meanwhile, just as parliaments held sway in the 19<sup>th</sup> century, and the executive in the 20<sup>th</sup> century, judicial authorities are emerging as decisive political actors. The consequence of turning to the courts to resolve political problems – the 'judicialization' of politics – is the inevitable politicization of the judiciary. Without sufficient legal guarantees and a truly independent judiciary, it will remain difficult to attract investors.

Another critical factor to explain Latin America's weak democratic institutions is its deficit of citizenship, i.e., the overreliance on leaders to resolve our problems combined with low levels of civic education and critical thinking.

The critical question, then, is what kind of state is necessary to ensure appropriate interventions in the economy, promote social welfare and protect democracy and the rule of law? What kind of leaders will emerge to guide the state through these turbulent waters? Which institutions are capable of mediating the growing conflicts of ideology, redistribution of resources and demands for greater public participation?

To move in a new direction, leaders need to marry the political with the social, meaning they must harness political change to legitimate social demands. A new, much more ambitious political agenda needs to respond to the big challenges – corruption, violence, child labor, extreme poverty – and give them the importance they deserve. Instead, the region is sliding back toward "caudillismo" as an escape from weak democratic institutions and leaders. A strong leader is particularly appealing to the poor and vulnerable, facing the abyss of chaos everyday and needing some order and stability in their lives.

*"State resources benefit the politically powerful and do not help the poor."*

**César Gaviria**  
**Former President of Colombia, Member of the Club of Madrid**

Tackling the very high levels of insecurity and drug trafficking prevalent in the region – the highest in the world – must be a top priority for democratic states. The potential collaboration among Mexican cartels, Colombian narco-guerrillas, Central American gangs and Andean cocaleros could overwhelm weak states and pose a grave risk to our democracies. A proper and more efficient use of resources can help achieve this, as shown by the progress made in Colombia through improvements in the public security forces and judicial system. Mexico can and will likewise get the drugs and crime situation under control. But no amount of effort by Latin American states will solve these twin scourges as long as the United States continues to criminalize drug consumption, which has utterly failed to slow down demand for Latin America's illicit drug products. Treating addiction as a public health problem and reducing the harm associated with drug consumption is proving to be a better approach, as demonstrated in Europe. Legalization of small quantities should also be considered. Latin America should move in these directions given the strong evidence against the effectiveness of punitive approaches. Throwing young people in jail for consuming small quantities of drugs will condemn them to delinquency as adults. Local demand and supply markets must be controlled through prevention and education through public-private partnerships.

The political crisis in Honduras has forced the region's governments to face some tough questions regarding the quality of democracy in some states as well as the capacity of the inter-American institutional architecture to respond to democratic backsliding. In the Honduran case, the political elite felt so threatened by the risk of a Chavez-style constitutional reform process that it violated the very constitution it aimed to protect by ejecting the democratically elected president from the country. On the other hand, it appears certain that President Zelaya also made many mistakes, including his attempt to order the military to carry out the popular referendum despite a judicial order against it. The role of the military in facilitating the coup reminds us of the autocratic tendencies still present in Latin America, even though trends of democratization – free and fair elections, continuity and alternation of elected governments, independent media and active civil society – appear predominant. Nonetheless, the Organization of American States (OAS), despite its Inter-American Democratic Charter, appeared unable to deter or mediate the conflict, leading several experts to call for its strengthening as a diplomatic tool for defusing conflict. While the Honduran crisis showed the strong regional consensus against coups deposing presidents, other branches of the state (judiciary, legislature) cannot call upon the OAS to intervene when their powers are usurped. It also has no clear guidelines regarding attempts to change the democratic rules of the game in mid-stream, a phenomenon which many felt was a threat to democratic stability in the region. Re-opening the Democratic Charter under the current fractured relations in the hemisphere, however, could be more trouble than its worth and would likely fail.

### **Latin America's Role in Reforming Global Governance**

The global economic crisis has catalyzed the growing debate surrounding the quality and fairness of the current architecture of global governance and of the institutions created over the last sixty years to manage insecurity and deter conflicts. Latin America's past experience with such institutions, both at the regional and global levels, has informed this debate and moved it toward favouring proposals to diffuse power and increase resources.

The initial effort by central banks to coordinate responses to the crisis was largely productive. The Group of 20's decision to increase resources to the International Monetary Fund so that developing countries could sustain counter-cyclical policies was particularly important. The May 2009 announcement by the World Bank, the IDB and the CAF to co-finance \$100 billion dollars for this purpose over two years is a concrete example of positive collaboration in support of the countries of the region in the face of the crisis. On the other hand, the capital replenishment of the Inter-American Development Bank is urgent and must be quickly resolved. The critical task of reforming bank regulations in a way that does not create distortions between the United States and other countries also remains incomplete. Also pending is the job of reforming the international monetary system, including the question of whether the U.S. dollar should retain its role as the reserve currency, a system some felt was unstable and unfair. International policies concerning debt relief and regulation of capital flows – factors that played a major role in generating previous crises – should also be added to the unfinished agenda.

*"If the United States did not own the dollar, it would have to be in the Paris Club"*

**Jorge Quiroga,**

Former President of Bolivia,  
Member of the Club of Madrid

Better control of credit risk agencies should also be considered, as well as completing the Doha Round of the trade negotiations and approval of free trade agreements, starting with Washington's long-awaited assent to the accords with Colombia and Panama.

*"How do we eliminate a certain ideological dogmatism and strengthen realistic pragmatism in solving the region's problems?"*

**Enrique García,**

President, Andean Corporation for Development

One important political issue that continues to challenge the international community with increasing intensity is, simply put, how to organize itself in the 21<sup>st</sup> century era of globalization.

*"A new geometry is being constructed in which the future is not just shared but negotiated and we (Latin America) have to be at that negotiating table"*

**Alicia Bárcena,**

Executive Secretary, Economic Commission  
for Latin America and the Caribbean

The ad hoc institutionalization currently underway, in which the G-8 has expanded to include a more diverse set of large economies (including Mexico, Argentina and Brazil) under the banner of the G-20, is a positive development but some felt a more fundamental restructuring is desirable. This would include placing a reformed IMF, with a more balanced share of votes among its members, at the center of macro-economic policy coordination. Ideally, the international financial institutions should play a catalytic role in mitigating risks, a more creative role in adapting to diverse national circumstances and a conservative role in how they manage resources. The role of the UN on international economic matters should also be on the agenda.

Latin America's leaders, especially those of the three countries that are part of the G-20, have a special role to play in insisting that such issues get on the international agenda.

*"Mexico, Brazil and Argentina have a responsibility to play a key leadership role in advancing Latin America's perspectives at the G-20."*

**Ricardo Lagos,**

Former President of Chile,  
President of the Club of Madrid

In this regard, the recent encyclical of Pope Benedict XVI reminds us of the historic opportunity our political leaders have today to re-order the international agenda toward the common good and toward the full realization of human development for all the world's citizens, especially the poor.

At the regional level, however, Latin America's institutional architecture in the financial arena is in good shape. It has one of the most comprehensive set of financial institutions, including the Inter-American Development Bank, the Corporación Andina de Fomento (CAF), the Central American Bank for Economic Integration (CEBEI), the Latin American Reserve Fund (FLAR), and the Treaty for Payments and Reciprocal Credits of the Latin American Integration Association (ALADI). Countries of the region should steer all efforts to build upon and strengthen these institutions to adapt to and facilitate greater regional integration, but should not create new ones.

*"We should strengthen the existing regional financial architecture instead of creating parallel institutions"*

**José Antonio Ocampo,**

Academic Coordinator, Club of Madrid Program  
on the Political Dimensions of the World Economic Crisis.  
Professor of Professional Practice in International and Public Affairs and  
Director of the Program in Economic and Political Development  
at the School of International and Public Affairs, Columbia University.

## Final Declaration

We, Members of Club of Madrid, met at the Economic Commission for Latin America and the Caribbean (ECLAC) in Santiago de Chile to discuss the political dimensions of the world economic crisis from a Latin American perspective, agreed on the following issues:

1. The international crisis has strongly affected Latin America. We are particularly concerned with the social and the likely political consequences arising from this crisis.
2. The crisis threatens to severely undermine six consecutive years of growth, improvements in human development and political stability, which many countries in the region have attained with great sacrifice. The resulting loss of confidence in the governments' capacity to regain economic growth with equity could result in more polarized electoral processes which could in turn weaken democracy and contribute to the re-emergence of authoritarian tendencies.
3. The crisis brings new political challenges to democratic leadership in the region. If adequate measures are not adopted, it could endanger the political and social progress achieved during the last decades, generating conditions conducive to violent social outbreaks and the exacerbation of the injustice which millions of people in the region still face.
4. Overcoming the crisis will be more difficult as result of the growth and intensification of drug consumption and drug trafficking and organized crime in the region. These phenomena respect no frontiers and challenge both the quality of democracy and the rule of law, as well as intergovernmental cooperation in security matters.
5. The origins of the crisis have made manifest the dangers of market fundamentalism. We underscore the need for a strong and active State, fiscally responsible, capable of protecting its citizens and of promoting prosperous economies and public policies that guarantee social cohesion. The region needs more active and higher quality States without ignoring the value of the market.
6. The adoption of anti-cyclical macroeconomic policies is crucial. We celebrate the reduction of interest rates by the central banks of the region, the fiscal packages adopted by the governments, and the renewed focus on intra-regional trade.
7. Latin America has the best network of regional financial institutions – IADB, ADC, CABEL, LARF and the Agreement on Payments and Reciprocal Credits of LAIA<sup>23</sup>. We draw attention to initiatives aimed at a better use and further deepening of these mechanisms to improve intra-regional payments, which exclude the need to create parallel institutions for this purpose.
8. We emphasize the need to improve international support for anti-cyclical policies and to reactivate credit to developing countries. In this regard, the effective use of multilateral development banks and their replenishment, if needed, as well as the simplification and modernization of conditionalities associated with multilateral lending will be essential. We welcome the

<sup>23</sup> IADB: Inter-American Development Bank; ADC: Andean Development Corporation; CABEL: Central American Bank for Economic Integration; LARF: Latin American Reserve Fund; LAIA: Latin American Integration Association

increase in IMF resources, including the creation of a New Flexible Credit, the renewed and increased allocation of Special Drawing Rights and the reform of other IMF programs.

9. We call for the improved voice and participation of developing countries in multilateral financial institutions.
10. We highlight measures aimed at combating the effects of the crisis on the poor and most vulnerable. Experience indicates that recovering social indicators is twice as costly as regaining economic performance. It is therefore necessary to develop more ambitious social protection systems, based on the principles of universality and solidarity, including measures to maintain and create new jobs.
11. The contraction of international trade has resulted in a 26% decrease in Latin American exports during the first quarter of 2009. We condemn the reappearance of protectionism in its various forms. We urge the rapid and equitable conclusion of the Doha Round and call attention to the need to deepen our own processes of regional trade and economic integration, overcoming the political tensions that have weakened them in recent years and taking into account that in crisis only multilateral responses can be efficient.
12. The presence of three Latin American countries in the G20 provides us with a unique opportunity to influence the design of the new institutional architecture which surely must result from the crisis. Convergence of views will be imperative and, in that sense, we highlight the need to present a coordinated regional agenda before the G20 meeting in Pittsburgh in September. This consensus must include issues repeatedly raised by developing countries, such as: the reforming the reserve system; correcting global payments imbalances; regulating capital flows; creating an adequate institutional mechanism to resolve the problems of excessive over-indebtedness; and a greater representation of developing countries in international financial institutions.



## Abstract

The financial crisis that was originated in the United States in the middle of 2007 has since September 2008 become a global systemic economic crisis. The current strong worldwide recession now threatens to become a profound social crisis with repercussions for all States. This crisis is however affecting countries and regions differently, depending on their level of development and degree of insertion in the world economy. Since there is a strong interdependence between the industrialized economies – where the crisis started – and the emergent and developing economies – which Latin America is part of – there is no doubt the crisis will have a deep impact in this latter region.

The socio-economic and political changes resulting from this crisis may be very profound. After six years of economic prosperity, with an average regional growth of 5.6% – grounded in the financial peak, a dramatic increase in commodity prices and high levels of remittances sent by workers – the region is now witnessing a major break in its expanding cycle.

The crisis threatens to severely undermine these years of growth, stability and improvements in human development, which many countries in the region have experienced in the last few years. The subsequent lost in confidence in governments being able to restore the socio-economic stability will further be reflected in a new electoral cycle in which one will have to choose between democratic reformism and autocratic populism.

As a result of this crisis, new political challenges, particularly for democratic leadership in the region, will arise. If one does not adopt the adequate measures to confront them soon enough, the crisis may put at serious risk the democratic advancements booked in the last decades, as well as foment conditions of social outbreak with possible violence, and ultimately worsen the conditions of injustice in which millions of people are living in that part of the world.

In this context, the various governments of Latin America and the Caribbean, together with the relevant international organizations, must adopt the necessary measures to address the economic crisis, as well as the other critical issues affecting the region, such as poverty, global warming, the realization of human rights and peace-building, whose management will be crucial in strengthening democratic values, good governance and human development.

In addition to an effort to design and adopt a new international and regional financial architecture which would help us conceive a more democratic and transparent world order capable of responding to the political challenges of the 21<sup>st</sup> century, one will also need to set off reflexion and decision-making processes that will specifically tackle the challenges democratic leadership is facing. In this context, various members of the Club of Madrid, together with prominent experts and senior policy-makers will be gathering at this roundtable to discuss the political dimensions of this crisis from a Latin American perspective, and to formulate recommendations that will help address the political issues resulting from the crisis.

The results that will come out of both this roundtable and the other ones organized in Africa, Asia and the Middle East will ultimately constitute the

building blocks of the Club of Madrid Annual Conference (12-13 November 2009, Madrid) in which participants will then be designing a global political perspective on the current economic crisis.

## Programme

*Monday, 13th July*

- 09:30 – 18:00      **Roundtable:** “*The Political Dimensions of the World Economic Crisis: a Latin-American Perspective*”  
*Moderator:* **Héctor Aguilar Camín**, historian and political analyst, Mexico  
*Rapporteurs:* **Ted Piccone**, Advisor of the Club of Madrid and Senior Fellow and Deputy Director for Foreign Policy, Brookings Institution; and **Ernesto Ottone**, Advisor of the Club of Madrid and Professor of Globalization and Democracy, University Diego Portales.
- 09:30      **Welcoming words (Room: Raúl Prebisch)**  
**Ricardo Lagos**, President of the Club of Madrid. Former President of Chile.  
**Alicia Bárcena**, Executive Secretary of the Economic Commission for Latin America (ECLAC)  
**José Antonio Ocampo**, Professor and co-Chair of the Initiative for the Political Dialogue at Columbia University. Member of the UN General Assembly Commission of Experts on International Monetary and Financial Reform.
- Block 1: The effects of the crisis in the region: an inside perspective  
*Speakers:*  
**José Miguel Insulza**, Secretary General of the Organization of American States, OAS  
**Jorge Quiroga**, Former President of Bolivia. Member of the Club of Madrid  
**Eduardo Frei Ruiz-Tagle**, Senator of the Republic of Chile and Former President of Chile
- 12:00      **Block 2: Latin America in a World in Crisis**  
*Speakers:*  
**Enrique García**, President of the Andean Development Corporation (CAF)  
**César Gaviria**, Former President of Colombia. Member of the Club of Madrid
- 15:00      **Block 3: Latin America - Crisis, Politics and Leadership**  
*Speakers:*  
**Julio María Sanguinetti**, Former President of Uruguay. Member of the Club of Madrid  
**Patricio Aylwin**, Former President of Chile. Member of the Club of Madrid  
**Vicente Fox**, Former President of Mexico. Member of the Club of Madrid
- 16:30 – 18:00      **Conclusions**

## **PARTICIPANTS LIST**

### **Members of the Club of Madrid**

Patricio Aylwin	Former President of Chile
Vicente Fox	Former President of Mexico
Eduardo Frei Ruiz-Tagle	Former President of Chile
César Gaviria	Former President of Colombia
Lionel Jospin	Former Prime Minister of France
Ricardo Lagos	Former President of Chile. President, Club of Madrid
Jorge Quiroga	Former President of Bolivia
Julio María Sanguinetti	Former President of Uruguay

### **Advisors to the Club of Madrid**

Rut Diamint	Professor of Political Sciences, University Torcuato Di Tella
Ernesto Ottone	Director of the Globalization and Democracy Programme of the Diego Portales University, Chile
Ted Piccone	Senior Fellow and Deputy Director, Programme of Foreign Policy, Brookings Institution

### **Experts and Invitees**

María Elena Agüero	Director of Institutional Relations and Special Projects, Club of Madrid
Héctor Aguilar Camín	Political Analyst
Alicia Bárcena	Executive Secretary, ECLAC
Edgardo Boeninger	Former Minister of State of Chile
Fernando Calderón	Sociologist and Permanent Advisor, UNDP
Georges Couffignal	Director, Institute of Latin American High Studies
Enrique García	President, Andean Development Corporation
Rebeca Grynspan	Regional Director of the UN Development Programme's Latin American and Caribbean Bureau
José Miguel Insulza	Secretary General, Organization of American States
José Antonio Ocampo	Academic Coordinator of Club of Madrid Program on the International Financial Crisis. Professor of Professional Practice in International and Public Affairs and Director of the Program in Economic and Political Development at the School of International and Public Affairs, Columbia University
Francisco Rojas Aravena	Secretary General, Latin American Faculty of Social Sciences

# **Final Report of the Arab World Roundtable**

## **‘Impact of the Global Economic Crisis in Arab Countries: A First Assessment’<sup>i</sup>**

**Olivia Orozco, Socioeconomic and Business  
Programme Coordinator at Casa Árabe**

**Javier Lesaca, Researcher of the Socioeconomic  
Observatory at Casa Árabe**

### **INTRODUCTION**

As in other parts of the planet, the Arab world is being affected by the global economic crisis. However, the effects and the degree of its impact are being diverse depending on each country and sector.

The Arab world is not a homogenous reality; on the contrary, the economic, political, geographic, social, demographic and cultural features of each country make it a highly diverse, heterogeneous and complex region. The multi-faceted nature of the way in which the crisis is affecting the region puts into evidence this complexity.

The initial impact of the international crash of the stock markets, which began in September 2008, was partly felt in certain Arab countries, and to different degrees depending on their openness and involvement in international financial markets. However, the fall in global demand which consolidated in 2009 is having important repercussions in certain countries and sectors. Not only has this downturn been transmitted through the collapse of international finance, with its constraints in investments and credit, but also through the drop in the price of hydrocarbons and the reduction of exchanges at a global level, especially concerning exports, tourism and remittances. The International Monetary Fund (IMF), in its latest report of October 2009, indicated that three main channels by which the crisis was transmitted to the region were “the reduction of remittances, foreign investment and exports”<sup>24</sup>.

The region is being affected by the crisis on different fronts, to different extents and in different ways, revealing important structural and developmental problems yet to be resolved. The main problem is still the extreme dependence on hydrocarbon exports and fluctuations in international markets, as a result of the still scarce industrialization and economic diversification in the majority of these countries. The fundamental challenges posed in this sense are, on the one hand, the creation of a competitive productive system and, on the other, the reform and improvement of the education system that would allow these societies to join the new global knowledge and would create employment for their large youth population.

<sup>i</sup> Final Document presented to the Club of Madrid Annual Conference, November 12, 13, 2009  
24. *Regional Economic Outlook: Middle East and Central Asia*. IMF. October 2009. Page 1

### The region in a relatively positive position

Following six years of unprecedented economic growth, coined ‘the third oil boom’<sup>25</sup>, the region has collectively tackled the current downturn from a relatively advantageous position in terms of accumulated assets and resources. Despite consecutive reductions in the area’s growth forecasts, the growth indicators continue to be higher than most regions on the planet. According to estimations from the Economist Intelligence Unit, in 2010 economies in Arab countries will be growing at 4%, almost double the world average<sup>26</sup>. These coincide with those presented by the IMF in their latest report on the region at the beginning of October 2009<sup>27</sup>.

### Diverse effects in different countries

The starting points of Arab countries are very diverse. For some the fall of hydrocarbon and food prices has meant a certain level of respite – to a certain extent moderating the so-called “Crisis of the three Fs”, *Food, Fuel & Finance*, which experienced its most critical period in the middle of 2008 – for others it means a drastic reduction in estimated revenue. Furthermore, the global economic downturn has surprised those in the middle of running ambitious economic investment and diversification plans conceived during the boom. Other countries, however, are facing the crisis following a prolonged period of reform and structural adjustment, as well as economic and commercial liberalization, during which significant reductions in social protection and limits to the State intervention in the economy had to be carried out.

The impact and consequences of the crisis in each of these countries will depend on both the social and economic structures and the specific strategies and development plans implemented during the previous period of economic growth.

Greater exposure to financial markets in the U.S. and United Kingdom as well as higher levels of speculative real estate investment have produced large budgetary cutbacks in Gulf countries. The drop in oil prices has seriously affected exporting countries such as Algeria, Saudi Arabia and Yemen, and the reduction of workers’ remittances abroad, exports and tourism has put countries like Egypt, Morocco and Jordan in a difficult social and financial position, due to significantly increasing unemployment levels, particularly among young people, and reducing vital sources of revenue for households. In contrast, in countries like Qatar, the number one global exporter of liquefied natural gas, the effects of the crisis have gone undetected. In others, such as Emirates, which habitually has an annual GDP growth of close to 15%, the economy has come to a standstill, even registering negative growth. The scarce demographic pressure and liquidity accumulated over the boom years has meant that the downturn has not significantly lowered citizens’ standard of living, although this is not the case in immigrant populations from

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25. Ali AlKuware, (2009) “The third oil boom. Preliminary reading of its causes and magnitude: the setting of the Gulf Cooperation Council (GCC)”, *Contemporary Arab Affairs*, 2:2, 304 – 318.

26. *Economist Intelligence Unit. Middle East and North Africa. Regional overview.* September 2009

27. IMF. *Regional Economic Outlook: Middle East and Central Asia.* October 2009. Page 1.

neighbouring countries, particularly Asian. Nevertheless, other oil-exporting countries with higher populations, scarce levels of economic industrialization and diversification and less foreign investment face a series of challenges worsened by the crisis. These include growth in unemployment and poverty rates and discrimination of certain sections of the population, all of which can become sources of social instability.

The cut of revenues, either due to the fall in oil incomes or from lower exports, remittances or tourism revenues, will bring about important limits to current development processes as well as substantial social and political challenges and uncertainties. Therefore, the crisis is testing out the development policies and strategies, introduced by the States, and their stability and strength, both on a national and regional level.

The aim of this document is to provide a tool with objective data and information that helps to understand the multiple characteristics and perspectives by which the international crisis manifests itself in the Arab world. It is a starting point for carrying out a more in-depth analysis of its repercussions on the region. Likewise, it shows the main ideas and dimensions of the social and political challenges that this crisis poses to the Arab countries, as it was discussed by the experts and Club of Madrid' Members, during the roundtable "*The Political Dimensions of the World Economic Crisis: an Arab World Perspective*" organized by Casa Árabe and the Club of Madrid on October 28<sup>th</sup>, 2009 in Madrid.

## **I. The Impact of the financial crisis and the convergence of diverse crises in Arab countries**

The early years of the 21<sup>st</sup> century witnessed a third oil 'boom', between 2002 and 2008, and were specially positive for the income of the for Arab oil-exporting countries, particularly, for those in the Gulf. Oil and gas prices reached historic figures and their liquidity and reserves practically increased exponentially during those years. The economies of these countries grew at rates of consistently over 6%, in real terms, and were even close to 10% in some Gulf countries; as a result, the per capita income practically doubled.

As in other similar time periods, joint economic expansion spread to other countries in the region. The rise in liquidity allowed exporting countries to tackle diverse industrialization, diversification and infrastructure projects, generating a significant demand for employment and an increase in economic activity, which benefited neighboring countries. Consequently, non-oil exporting Arab countries also experienced strong growth in their GDP and per capita incomes, as recognized in the latest Arab Human Development Report 2009<sup>28</sup>.

28. "Producer countries gained most in that narrative, amassing untold wealth, but non-oil Arab countries also benefited substantially from oil-related services, worker remittances, intraregional investment flows, regional tourism receipts, and aid." UNDP, Arab Human Development Report 2009: *Challenges to economic security*. Page 109.

### *1.1. The first impact of the financial crisis: sovereign wealth funds, stock markets and banking systems*

The first symptoms of a financial crisis appeared in the United States during the last quarter of 2007 with the outbreak of the subprime mortgage crisis, which quickly spread across the European financial system, primarily in Britain. At first it did not appear to be a cause for alarm in the Arab world; both the World Bank and the IMF emphasized that Arab financial systems had “little exposure” to global finance and, consequently, to those toxic assets which triggered the credit and banking crisis in the United States.

Nonetheless, a number of sovereign wealth funds from Gulf countries, which had stored a large part of the liquidity accumulated in these countries during the boom years, came to the rescue, along with other Asian funds, to recapitalize some of the U.S. banks and financial institutions affected by the subprime mortgage crisis. It is calculated that between 2007 and 2008 sovereign wealth funds invested over 100 billion dollars in the United States and Europe. The Kuwait Investment Authority (KIA) and the Abu Dhabi Investment Authority, with the Singapore GIC and the Saudi prince al-Waleed Bin Talal, put up 14.5 billion dollars to rescue Citigroup, while Kuwait also supplied funds to save Merrill Lynch. In February and June, Qatar also invested in Barclays and Credit Suisse, who then declared themselves bankrupt in September 2008, inflicting significant losses on the sovereign funds that had intended to secure them a few months earlier.

At first, the exposure to markets and risk assets were difficult to gauge due to the opacity of the funds. The British newspaper *The Observer* estimated that the sovereign wealth funds in the Gulf and Asia would register losses of least 4 billion dollars by the end of 2008.<sup>29</sup> According to the latest data released by the *Economist Intelligence Unit* (EIU), some funds such as those from Abu Dhabi ended up losing around 27% of the invested capital.

#### Changes in the funds’ investment strategies

The crash suffered by a large part of these funds during the financial crisis has caused investment strategies to be redefined. On the one hand, some funds are opting for more conservative strategies, such as SAMA, the Saudi Sovereign Wealth Fund Institute, whereas on the other, they are changing the nature and destination of their investments. Those traditionally focused on financial markets in Europe and the U.S. are turning their attentions towards other markets – in Arab countries and emerging ones, as well as towards direct investments. One example of this strategy change, announced on January 10<sup>th</sup> 2009 by the Abu Dhabi Investment Company, was to create four investment funds in the Middle East and North Africa. More precisely, the Emirate investment funds proposed the creation of stock funds in the Gulf Cooperation Council, an investment fund in the United Arab Emirates, a third for the whole of the area covering the Middle East and North Africa, and a fourth in developing North African countries. The President of the company’s Board of Directors indicated that it is “the ideal moment” for the Middle East and North of Africa to become the destination for the investment of these funds.<sup>30</sup>

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29. Olivia Orozco, Casa Árabe Economic and Business Bulletin “Crisis and sovereignty”, N°9, Dec 08–Jan 09

30. Casa Árabe Economic and Business Bulletin. N°13. August 2009, Page 11.



This consolidated a trend which started in the last years of economic expansion, when the sovereign wealth funds started to play a more important role in intraregional development funds.

### Repercussions for stock markets and the Arab financial system

The huge losses recorded by both sovereign wealth funds and private Arab capital in financial markets in the United Kingdom and the United States meant that the *stock market crash* in September 2008 affected the majority of the Middle Eastern stock markets. After the insolvency of Lehman Brothers was announced, on September 15<sup>th</sup> 2008, the Saudi Arabian stock market fell by 6.5%, Doha 7%, Kuwait 3% and Abu Dabi 4.35%<sup>31</sup>. Certain markets, such as Kuwait, had to close for a number of days to avoid outbreaks of panic.

Over the last year, falls in these Gulf stock markets have followed a parallel path to those in Europe and North America and are strongly linked. From May 2008 to January 2009 practically all the Arab market values noted how indices slumped by 50%.

In contrast, some Arab stock markets were relatively unaffected by these fluctuations, as those in Morocco, Lebanon and Jordan, with accumulated falls from January 2008 to March 2009 of between 13 and 28%, respectively. The behaviour of Tunisia's stock market was particularly noteworthy, with an accumulated growth in this period of 18%<sup>32</sup>.

### The spread of the crisis to the banking system and credit availability

The impact of these losses, the fall in investments and the ensuing lack of liquidity all had important consequences for the Gulf banks. In the Emirates, as in other countries, the central banks had to intervene to guarantee credit and deposits. As a result, from September 2008 to February 2009 cases of payment defaults multiplied; in particular, they tripled in Bahrain and doubled in Abu Dabi, according to IMF data.

As in Europe and the U.S., various factors coincided at the same time in the banking crisis – on the one hand, large excesses in credit concessions over a period of economic expansion, particularly in the real estate industry, together with, on the other, the investments' strong preference for secondary markets. As the IMF remarked, when the value of these assets and company profits plummeted both the general financial risk and the payment defaults increased, weakening the banks' balance sheet<sup>33</sup>.

### *1.2. The end of the third oil boom: the fall in oil prices*

Oil prices started to fall in the summer of 2008. However, from September to December that year the price dropped from 100 to 40 dollars per barrel, recovering slightly after February 2009, but following a much more moderate trend from then on.

31. Ibid., Page 11.

32. IMF. *Regional Economic Outlook. Middle East and Central Asia. May 2009.* Page 14.

33. Ibid. Page 6.

Arab countries make up 65% of the world's oil reserves and 45% of the gas reserves. The export of these products generates 50% of the GDP and 80% of its revenues<sup>34</sup>. Therefore, the fall in oil prices has particularly affected exporting countries – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates (UAE), Algeria, Iraq, Libya, Sudan and Yemen – and has halted the high growth taxes maintained in previous years.

As a result of the decline, both in exports and the price of oil, the Central Bank of Yemen announced its revenues from oil exports dropped around 75% last June. Likewise, the magazine *24-7* noted in July that the combination of low prices and the decline in production could mean a revenue drop of oil exports in the UAE of around 43% in 2009<sup>35</sup>.

### *1.3. The fall of investments and the bursting of the real estate bubble*

Another issue emanating from the international crisis and affecting Arab countries is the fall of direct foreign investment.

The crisis faced by European and American companies has slowed down recent investments being carried out in Arab countries. According to the World Bank, in its report of October 2009, the global flow of direct foreign investment in MENA countries could “drop notably in 2009”. The report indicates a recovery in 2010, though still below those levels prior to the current crisis<sup>36</sup>.

This has particularly affected the real estate market in many Gulf and North African countries. On September 17<sup>th</sup> 2009, the Kuwaiti newspaper, *Al-Qabas*, published that the crisis had made 675 real estate projects to be cancelled in Gulf countries, with 75% in Emirates, mainly in Dubai<sup>37</sup>. Real estate speculation had been among the highest in recent years in Dubai – with construction and the real estate industry representing 25% of the GDP – and, consequently, it has also suffered one of the worst falls in house prices.

On the other hand, the IMF estimates that foreign investment in non-oil exporting Arab countries will go down by around 11 billion dollars between 2008 and 2009, attributing the fall to credit and financing constraints, and the lack of domestic liquidity<sup>38</sup>.

In North Africa the real estate and construction industry have also suffered the consequences of the recession. One example is Morocco, where the industry has grown significantly in recent years thanks to large investments from both European companies and Gulf investment funds.<sup>39</sup> According to the newspaper *Al-Yarida al-Ula*, foreign investment in Morocco went down by 6% in 2009<sup>40</sup>.

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34. Ibid. Page 5.

35. “The crisis in Arab countries. Monitoring.” *Casa Árabe Economy and Business Bulletin*. Nº13, page 10.

36. World Bank. 2009 *MENAEconomic Developments and Prospects*. October 2009. Page 30.

37. *Al-Qabas*. September 17th 2009.

38. IMF. *Regional Economic Outlook. Middle East and Central Asia*. May 2009. Page 19.

39. In particular, the Reuters agency estimates that in recent years Gulf investors have invested close to 30 billion dollars in the Moroccan real estate and construction industries. “Industry trends and developments. Construction 2009”. *Business Monitor* 2009. March 11th 2009.

40. *Al-Yarida Al-Ula*. August 11th 2009.

The sharp downturn of growth in Gulf countries has had a negative effect on intraregional investment which many investment funds and companies were developing in North Africa.

Besides Morocco, Algeria is also another country affected by the fall in Arab investments. The Emirate company Emaar, one of the largest construction companies in the Gulf, announced in June that it was ceasing its activity and closing its office in Algeria, where it was involved with projects worth 20 billion dollars<sup>41</sup>. According to the newspaper *Al-Hayat*, the same company had lost 351 billion dollars in just three months at the start of 2009<sup>42</sup>.

#### *1.4. The drop in remittances and tourism*

Together with the drop in foreign investment, certain Arab countries have also suffered severe economic setbacks due to the decrease of immigrant remittances, among non-oil exporting countries, and a decrease in the number of tourists. The last issue has had repercussions in all Arab countries, but also particularly in the non-exporting ones who rely heavily on this source of revenue.

#### **Significant drop in remittances**

The drop in remittances is mainly due to those thousands of immigrants that had to leave those employments in emerging sectors either in Europe or the Gulf. According to the World Bank, it is precisely Arab countries which will suffer this drop the most, ahead of other countries in Latin America, Asia or Sub-Saharan Africa.

Egypt is the fifth highest country in the world to receive remittances from foreign workers, although the economic dependence on these revenues is greater in countries such as Senegal, Morocco, Jordan, Lebanon and Yemen, where they represent a higher percentage of their GDP.

In the case of Morocco, as with Tunisia, almost 80% of remittances come from workers in European countries; whereas in Egypt, like Jordan and Lebanon, the majority of them (over 50%, and 60% in Jordan) work in Gulf countries. Therefore, Egypt, Jordan and Lebanon are suffering indirectly, though in equal measure, the consequences of the economic standstill in oil-exporting countries<sup>43</sup>.

In June, the newspaper *Al-Bayan* reported that, according to a report by the Egyptian Economic Observatory, Egyptian workers' remittances abroad fell by 15%, while the number of these workers returning to the Gulf increased by 7,000 in March 2009<sup>44</sup>.

In Jordan, the Central Bank announced in June that remittances of Jordanians working abroad fell by 3% for the second month in a row. As in Egypt, the

41. Reuters, July 4th 2009.

42. *Al-Hayat*, July 31, 2009.

43. For instance, on September 25th the newspaper *Al-Quds al-Arabi* reported that 17,000 foreign workers abandoned Kuwait in the first half of 2009 as a direct result of the economic crisis. *Al-Quds al-Arabi*, September 25th 2009. Page 14.

44. *Al-Bayan*, 22 June, 2009.

remittances are one of the fundamental sources of revenue and exceed the total of foreign aid the country receives. According to the newspaper *Al-Dustur*, this fall is due to many Jordanians losing their employments abroad, particularly in Arab countries<sup>45</sup>.

Tourism drops by 18% in the Middle East while maintains its growth in North Africa

In terms of tourism, using the figures from the first quarter of the year, the report carried out by the World Tourism Organisation in June 2009 emphasizes that tourism in the Middle East globally dropped the most at the beginning of 2009 – in total, Middle Eastern countries received 18% less tourists. The report published by the Central Bank of Egypt on June 17<sup>th</sup> affirmed that revenues from tourism decreased by 17.3% in the first quarter of 2008. In contrast, in North African countries tourism did not decrease, in fact it increased by 6%<sup>46</sup>.

### *1.5. The decline of exports*

Finally, the collapse of the international markets following the economic crisis has given rise to a serious decline in exports to countries from the region. The economic standstill and the drop in demand from markets in Europe, the United States and Asia – the leading markets for exporting manufactured products and oil in Arab countries – has brought about an additional economic reversal for economies in the Middle East and North Africa. In some cases, exports to countries in the European Union constitutes almost 80% of the total exports (80% for Tunisia and 78 and 76% for Libya and Morocco respectively)<sup>47</sup>. The latest data provided by *The Economist* in September 2009 demonstrated a general deterioration in current account balance sheets, which were slightly steeper in the Gulf, though they generally maintain positive balances. In particular, oil exporting countries in the Arab world have gone from having a positive balance sheet of 348 billion dollars in 2008 to 62.1 billion in 2009. This is primarily explained in terms of the exports exceeding a trillion dollars in 2008 and coming to a standstill at 685 billion in 2009.

Although Morocco's official sources maintain a stance of economic optimism, there is still concern about the combined drop in exports, tourism and remittance revenue. A report from the Royal Institute for Strategic Studies details how, during the first quarter in 2009, Moroccan exports fell by 5%, direct foreign investment by 36%, remittances by 11% and revenue from tourism by around 14%<sup>48</sup>.

## **II. Unemployment among young people: The main social challenge of the crisis**

The economic crisis in the Arab world has not affected everyone in the same way. In fact, the macro-economic figures do not reflect the real impact the

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45. *Al-Dustur*, 6 June 2009.

46. *World Tourism Barometer 2009*. United Nations World Trade Organization.

47. European Commission. *European Neighbourhood Policy: Economic Review of EU Neighbouring Countries*. August 2008.

48. Royal Institute for Strategic Studies. *Le Maroc face a la crise financiere et economique mondiale*.

recession has had on the citizens of Arab countries. A 10% drop in the growth of the United Arab Emirate's GDP has not been translated into a lower standard of living or less social peace for Emirate citizens; however, a reduction of 0.1% in the growth of the Algerian economy could pose significant social challenges. The World Bank has warned about this situation and the risk various Arab countries run of the economic crisis becoming a social crisis.

*Per capita incomes: disparate starting points and demographic pressure*

As outlined in the introduction, not all Arab countries started off from the same position when coming up against the crisis. The per capita incomes allow an estimation of citizen's general living standards, though they do not guarantee a fair distribution or balance of wealth. In some GCC countries we can see how the per capita incomes are found at the same level, or even higher, than member countries from the OECD. Therefore, although the financial crisis has significantly reduced the level of reserves, liquidity accumulated during the years of economic expansion, levels of infrastructures and capital, as well as little demographic pressure has allowed them to face the recession with a position of relative confidence. However, from Qatar to Yemen, countries that have respectively the highest and lowest income per capita in the region, the position of each country is very diverse. In this sense, the countries with high level incomes (Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates) are the least likely to suffer political or social tensions, while those with low incomes are potentially more at risk to show social uprisings or political instability, in particular in Sudan, Yemen, and Mauritania. In between these two extremes are those countries with medium-high incomes like Libya, Lebanon and Oman, and those with medium-low incomes like Algeria, Djibouti, Egypt, Jordan, Morocco, Syria and Tunisia.

*The challenge of unemployment*

Unemployment rates, especially among young people, represent one of the main short and long term challenges for many Arab economies. According to the Arab Human Development Report, youth unemployment "disproportionately" affects Arab countries, with the unemployment average rate among young people reaching around 30%. It is particularly alarming in countries such as Algeria, which reveals a youth unemployment rate of 45%. Although slightly less alarming, the figures are also worrying in other places such as Saudi Arabia or Egypt, which reveal a youth unemployment rate of 25%, but that as Algeria, have higher percentages of population under 15, which could mean an increase in future youth unemployment rates<sup>49</sup>.

In this way, in June 2009, the newspaper *Al-Bayan* revealed that unemployment rates in Egypt could soar in 2010, an analysis shared by the Union Of Egyptian Workers Abroad, which believes the impact of the crisis on Egyptian labour will be fully felt next year<sup>50</sup>.

49. UNDP. *Arab Human Development Report 2009. Challenges to economic security*. Page 109.

50. *Impact of the Global Financial Crisis on Egyptian Workers, Fifth Report*. Center for Trade Union and Workers Services (Egypt), July 2009

Hence, one of the greatest challenges a large number of Arab countries face is unemployment and the need to create jobs for an increasing youth population. This socioeconomic situation becomes even more complex in those countries without revenues from hydrocarbon exports and with strong demographic pressure. Before long they will have to create jobs for a predominantly young population. Morocco and Egypt are possibly the clearest example of this situation, with unemployment and illiteracy particularly posing serious problems for the poorest sections of the population, which are, along with immigrants in the Gulf, those that will be most affected by the adjustment of the crisis and the fall in employment and remittances.

Other oil-exporting countries, such as Algeria and Sudan, with medium and low revenues and high levels of young population, will also have to face similar challenges.

Another challenge linked to the rise in unemployment is the possible increase of poverty. According to the *Arab Human Development Report 2009*, Arab countries, compared with other developing countries with similar levels of income and human development, should obtain higher results in poverty indicators<sup>51</sup>.

The economic crisis and the resulting public deficit has put development and public investment plans, industrialization processes, social policies and public employment at risk. The rise in unemployment is probably the most likely way the economic crisis will become a social one, particularly in those countries with a lower income per capita and lower human development conditions.

### **III. Public development plans and perspectives regarding the crisis**

After the impact of these consecutive crises, the economic and fiscal situation of the Arab countries has been significantly debilitated. Nevertheless, it can be generally said that, as in other countries, public investments in infrastructures, services and energy have taken over for the drop in private investment, especially foreign investment, and not just in the petroleum exporting countries. The projects for highway expansion, ports, railways, power networks, etc. are being maintained and increased in Morocco, Algeria, Saudi Arabia and other Gulf countries. Even though these investments will produce pressure on the public deficits, especially in the exporting countries that had anticipated having higher revenues, given the price situation in the oil market, it is expected that the accumulated reserves avoid having to turn to exterior debt. Algeria, which had managed to eliminate its exterior debt, enters once again into a position of budgetary deficit (4 percent of the GDP according to *The Economist*, although the Business Monitor International (BMI) predicted the largest budgetary deficit of the last 15 years, 10 percent of the GDP). In turn, according to the Economist Intelligence Unit (EIU), the only ones to avoid a deficit will be Kuwait, Qatar and Oman, while the BMI estimated in February that Qatar and the UAE would be the only countries in the Gulf that would not return to deficit situations.

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51. UNDP. *Arab Human Development Report 2009. Challenges to economic security*. Page 115.

*Signs of recovery, reviewing development models and some lessons from the crisis*

Certain institutions, such as the IMF in its last report of October 2009, dared to confirm certain recovery of the economy. In the case of the Middle East, this recuperation will take place thanks to “the recovery of financial conditions in the region and a rise in asset prices (especially oil)<sup>52</sup>”. The International Monetary Fund has indicated that the outlook for the Middle East in the past few weeks has improved “thanks to the stabilization of the global economy along with the resurgence in oil prices”. They do, however, warn that the situation is still “complicated” and add that the main danger of these faint signs of recovery could be that they are neither real nor sustained and continue to depend on possible future slumps in oil prices.

The World Bank is equally cautious. In a report made also public on October, it indicated that if MENA countries wish to uphold this economic recovery for the long term, they must take advantage of the current crisis to face imminent challenges in institutions and infrastructures that have hampered growth over decades.

A simply quick glance at the evolution of the GDP in Arab countries over the past 20 years allows to verify the high-level of dependency their economies have on the evolution of oil prices – a succession of peak and troughs in a sharp curve that reflect the volatility of a non-diverse, highly dependent economy controlled by factors out of its control.

The World Bank also added that in the years prior to the crisis the growth of Middle Eastern countries was “respectable, not staggering” compared with other developing regions. This growth is identical to the 90s, and even less than the 80s. It is estimated that the MENA region requires 300 billion in investments over the coming years to cover the current need for infrastructures, which is especially high in the countries of the Gulf Cooperation Council (GCC), despite the current efforts already implemented. It is calculated that between 1998 and 2007 GCC countries invested close to 20% of the GDP in infrastructures, significantly lower than the 39% invested in China or the 30% in South Korea.

Certain countries in the Gulf have already recognised this obstacle and have set up measures to resolve it. In 2009, Saudi Arabia has increased public spending in infrastructures by 36%, reaching 60 billion dollars in the process, and its medium term development plan includes 400 billion dollars worth of investment in infrastructures over the next five years. Qatar and Bahrain have also announced ambitious investment plans and Dubai, despite the high impact of the crisis, looks well set for recovery.

Without these necessary infrastructures, bureaucratic improvements and industrialization and diversification processes, the current signs of economic recovery, which have been observed in Arab countries during the last few months, could pass in history as another new shoot or pick up on the graph's curve instead of constituting a positive and sustainable growth trend over time, characteristic of an emerging economy.

<sup>52</sup>. *Regional Economic Outlook: Middle East and Central Asia*. IMF. October 2009.

In the current context, strengthening the reforms and development plans set up in the years of boom is more urgent than ever in order to curtail the dependency Arab countries suffer on the fluctuation of oil prices and international markets. Greater diversification and industrialization would be the key for creating more sustainable economies capable of generating more employment in the medium term.

### **IV. The political dimensions of the crisis: policies and measures for regional development**

Even though the region's socio-political aspects are extremely diverse, the experts and the members of the Club of Madrid, meeting at the Casa Árabe in the round table discussions organized in October, listed a series of priorities that should be worked out from the political sphere, at a national, regional and also international level, in order to promote more sustainable development models and to recover a stable line of short-term economic growth in the region. These priorities and measures are focused on three areas in particular: development and governance strategies, regional integration and international cooperation.

#### *4.1. Development and Governance Strategies at a national level*

Although the economic prosperity of this last expansive period was positive, the total growth of the region was not sufficiently important in relation to its potential and to the growth experienced in other emerging countries. Moreover, the way in which the drop in oil prices and of international trade was transmitted to the Arab countries proved the strong dependence that Arab economies have on the fluctuations of oil prices, as well as on the evolution of foreign markets.

It is necessary to implement new economic policies and new development strategies in order to recover from the crisis and to guarantee a sustainable and prosperous future in the region in the medium and long terms. To do this, it is necessary to confront an entire series of reforms and improvements in economic policies and governance in the following aspects:

#### **1. Education and employment**

Unemployment (especially among young people) is probably one of the greatest challenges in the political and economic agenda of the present Arab leaders. The deterioration of the real economy and the consistent increase in unemployment, as well as the decrease in the quality of life for the citizens can generate situations of social reaction and protests in some States, especially in those weaker governments such as Palestine, Iraq, Yemen or Sudan. The creation of better and greater work opportunities is also an important challenge in more stable countries such as Algeria, Morocco or Saudi Arabia, where demographic growth puts heavy pressure on the working population, with a growing and prepared youth. In view of this situation, it is necessary to carry out economic and educational reforms designed to promote diversification and develop the industrial, services and knowledge sectors, which are needed in order to generate a productive and competitive economy, capable of creating at least 100 million new jobs during the next decade.



## 2. State intervention in the economy and liberalization programs

During the last decade, the majority of the Arab countries have promoted processes of economic liberalization and structural programs designed to open their economies and adapt them to the global and free market model. However, the present financial and economic crisis has shown some failures in the self-regulated market system and has given some protagonism back to the State. In this way, the present economic crisis has deteriorated these liberalization processes, as well as the open economic policies undertaken by the Arab countries. The crisis must not be used as an excuse to return to interventionist processes, or to paralyze economic policies aimed at diversifying the economy and opening markets. However, the States must implement measures that guarantee greater social coverage for the least favoured sectors of the population, especially after the crisis. Its role must be especially active in the creation of a clear and transparent legal and regulating framework that guarantees the correct functioning of the markets.

## 3. Economic diversification, industrialization and knowledge society

The present economic crisis has revealed the existence of various structural problems in the Arab economies. The extreme dependence on oil revenue, as well as the lack of economic diversification is presented as one of the greatest challenges for the oil-exporting countries. Other structural problems are those related with the insufficient work performed in promoting a knowledge society.

A key point, in this sense, is for the revenue generated by the oil exports to be invested in generating a growth process for the real economy, so that this growth is reflected in the creation of job opportunities, especially among young people.

It is “essential” to improve the education of future generations in Arab countries, encourage research, as well as increase innovation and the use of new technologies. Promoting knowledge society is the best way to develop the great human capital that exists in the region. In this regard, the Arab countries must improve the quality of their education systems, as well as develop and strengthen knowledge and research in emerging sectors such as renewable energies.

## 4. Democracy and development through small governance projects

Even though the present economic crisis signifies a time of transformation in the Arab countries, most of the experts pointed out that the economic situation will produce few changes in the present government systems. In relation to the democratization processes in the region, the experts stated that the situation of an economic crisis may cause an increase in demand for transparency and control, especially regarding the management of Sovereign Funds. However, this increase in demand for transparency does not seem to be turning into an increase in tension and social contestation against the present governments, or altering the status quo in the region.

Nevertheless, small changes in governance at a national level can influence greater development of the region's democratization processes. These small projects could entail initiatives that promote transparency and good governing practices, and fight corruption. As Professor Tarik Yousef, Dean of the Dubai School of Government, stated the best way to encourage change in governance and favour future democratization processes in the Arab region is to promote these small projects of government reform (Small Governance Projects). On a small scale, these projects can be focussed on aspects such as promoting transparency, governance, rule of law, or small changes in institutional management. In the medium term, these small projects can generate a great impact on the improvement of the governing systems. Europe could be an interesting partner in this sense when it comes to offering support, assistance and cooperation in the development of these small governance projects.

### 5. Predictability, transparency and planning in the economic policies

In order to transmit security and stability to investors and commercial partners and thus attract long-term international investment projects, it is necessary for both plans and economic policies to be developed through a predictable and transparent process. Each country in the region should design its own economic plans to be implemented and announced in an open and transparent manner. This point was especially stressed by the former Prime Minister of Spain and member of the Club de Madrid, Felipe González, who emphasized that the more foreseeable, transparent, and planned the processes for design and implementation of economic policies are, the more investment and economic growth opportunities create.

### *4.2. Integration and economic cooperation at a regional level*

It is necessary to improve and reconsider the current political and economic relations of the Arab countries at a regional level and encourage greater political-economic cooperation among these countries. Abdeslam Baraka, former Moroccan ambassador in Spain and ex-Minister of Relations with the Parliament, stressed in his intervention that the Arab countries “need to develop a true neighbourhood policy, whether it be among the Arab States themselves or between the latter and their natural geographic environment, accompanied by a sincere desire for dialogue and cooperation and for resolving conflicts due to anachronistic frontiers inherited from the colonial period”. Felipe González also pointed out the strategic importance of regional cooperation. According to the former Spanish Prime Minister, the Sovereign Funds of the States of the Gulf Cooperation Council (GCC) should look towards the countries of northern Africa and focus their investments in that area. In this regard, Tarik Yousef did not seem excessively optimistic and stated that even though the countries in the CCG are promoting various pan-Arab business projects, the countries of the Maghreb are basically being left out of this dynamic mainly because economic interests are turning towards the East, towards China and India. On the other hand, he noted that, unlike the region of the Gulf, the countries of the Maghreb are becoming with time less homogeneous and less cohesive.

Greater political and economic cooperation among Arab countries is necessary in order to manage more efficiently the region's natural resources and coordinate their economic policies. In this respect, with the exception of the integration process being started among States of the Gulf Cooperation Council, in the rest of Arab countries these policies are still a chimera. Inter-Arab trade represents just 5 percent of the

total of commercial exchanges carried out in the Arab world. Besides, the inter-Arab tourism hardly represented a 10 percent in the whole region. In this respect, various experts showed their pessimism due to various factors:

### 1. Economic interest is turning towards the East

As Tarik Yousef stated, the economic weight of countries such as India or China interferes with the integration and inter-Arab economic cooperation processes. The global economy is turning towards the East, which causes the States of the GCC also to look toward these markets with more interest than to northern Africa. The countries in the Gulf want to take advantage of, in this sense, their economic potential as platforms between Europe and Asia, incrementing their regional economic power, in contrast with other Arab countries that until now had a greater economic weight.

### 2. Sovereign Funds: new actors in regional development

During the last decade, Arab Sovereign Funds have accumulated a large part of the liquidity coming from oil exports. As previously stated, a large part of this liquidity, instead of being reinvested in regional and local development projects, has been traditionally deposited in foreign funds that have suffered great losses in the present financial crisis. As a result, Arab Sovereign Funds should reconsider their investment strategies and focus on creating an increase of the real economy in the Arab region. This change in policy could turn them into prominent actors of regional economic development.

### 3. A pragmatic and open regionalism designed around energy

Taking into account the difficulties of a regional integration process in the Arab world, the European integration process can be taken as an example in order to develop regional cooperation with a pragmatic nature. A common and specific interest in the region, that could define this type of cooperation or regionalism, can be the management, consumption and distribution of energy. Also, given the present context and the points previously stated regarding the existence of different close or peripheral actors, any integration process in the region must maintain an open attitude in order to take into account other actors such as Turkey, Europe or southern Asia.

### *4.3. The role of the Arab region in the international sphere*

Currently, the Arab world lacks a single voice on the international scene. The lack of a common voice to speak with legitimacy on behalf of Arab countries entails an important handicap when defending the needs and interests of the Arab region in international institutions. Arab countries should urgently name a representative to represent them in organizations such as the G20 or other forums where important economic decisions are made for the region at an international level. Two aspects may contribute to advancing in this direction:

#### 1. Greater cooperation and integration with Europe and emerging countries

Greater political and economic cooperation among them, as well as a deeper relationship with other regions, such as Europe and emerging countries, would

help the Arab countries to gain greater influence in the international decision-making centres.

The almost perfect complementarities between Europe and Arab countries were an aspect especially emphasized by Felipe González. The Arab world and Europe are two complementary regions, destined to understand each other and to cooperate. In this sense, Europe needs to commit more to the Arab region and encourage a sustainable and lasting development in the long term. The former Moroccan Ambassador to Spain, Abdeslam Baraka, stressed the importance of “implementing the needed dynamics so that the peoples of the Mediterranean build up a new relationship based on mutual respect and on its projection towards the future”. The Arab countries, on their side, must improve their policies and their relationship with other international markets, in addition to Europe, with developing and emerging regions, such as China, India, Brazil or Turkey.

### 2. Oil: an international policy tool

Even though the decrease in oil prices was one of the main causes that generated the crisis in the Arab countries, in recent months the price of oil has gone back up until reaching once again \$70 a barrel. Most of the forecasts consider that during 2010 the price of oil will continue to rise, which will contribute to allowing the exporting Arab countries to return to a central position in the international sphere. This position should be used to develop an active role in the definition of a more sustainable model and stable global development.

On the contrary, the recovery of prices should not be an excuse for disregarding and not facing the main economic challenges in the region, and not working to reduce their dependency on these products, as well as trying to mitigate the effects of climate change and guarantee food security.

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## Final Declaration

The Experts gathered by Casa Árabe and the Club of Madrid at the Roundtable on “*The Political Dimensions of the World Economic Crisis: an Arab World Perspective*”, held in Madrid on October 28, 2009 agreed the following:

1. The Arab world is not a homogeneous reality. Similarly, the economic crisis affecting the region has also had different effects depending on the characteristics of each country.
2. The oil-exporting countries were the ones who suffered the most the consequences of the crisis, due to the descend of oil prices and the exposure of its financial products in international markets, but also are the ones that have the best prospects for recovery, mainly due to the increase in oil prices in recent months, which is expected to persist over the medium term, and to the growth dynamics that have been introduced since the major infrastructure and development projects were launched.
3. Meanwhile, importing countries were affected by the fall in global demand through decreases in remittances, foreign investment, tourism and exports. Although the decline in oil prices and food gave some temporary respite to their trade balances, they may experience greater difficulties in the future, especially until demand and growth recover in certain markets from which they are heavily dependent.
4. An increase in unemployment and the deterioration of the real economy and quality of life of citizens could generate discontent and social protest in some states, especially those with fragile governments, as in Palestine, Iraq and Sudan.
5. Reforms must be deepened to promote economic development, with a special emphasis on the real economy in order to create 100 million jobs in the next decade for a growing youth population.
6. Among the proposed measures, the promotion of political and economic cooperation between the Arab countries in order to facilitate them to gain influence in international economic decisions and to manage in a more rational and efficient way the natural resources of the region, is highlighted. In this sense, the difficulties and challenges that exist, so that these projects of cooperation and integration are successful in the short and medium term, were also recognized. Likewise, there was advocacy for a review of the relations between Europe and the Arab world with the aim of identifying economic complementarities between the two regions which are manifold.
7. Arab sovereign funds, which for years have absorbed the economic boom caused by high oil prices, are reconsidering, after losses realized on investments in financial institutions, their investment strategy. The above mentioned funds can play an important role in promoting investment and development projects which promote real economic growth in Arab countries instead of simply investing in international financial institutions.
8. It is essential to improve the education of future generations of Arab countries. It is convenient to promote research and improve the quality of education in Arab countries to maximize the vast human capital of the Arab countries and allow its full integration into the knowledge society.
9. To attract foreign investment it is imperative that both the governments and the Arab economic institutions achieve a greater predictability, transparency and planning in their economic policy.

10. The current economic crisis has cast doubt on the credibility of the liberalization and economic openness processes in many Arab countries. It is important, however, in this sense, not to return to interventionist patterns but to qualify and resize the Arab state role and dimension in the economy according to the situation of each country. In some cases there is still bloated state apparatus, which should be streamlined, while in others, an effort should be made to ensure the social coverage networks to cushion the effect of the crisis in certain vulnerable sectors of the population. The role of government in all cases must be active in creating a clear a transparent legal and regulatory framework for the proper functioning of the markets.
11. Regarding possible processes of democratization in the region, the crisis could lead to greater demand for transparency and democracy, but it seems unlikely that the economic slowdown may strongly erode the legitimacy of Arab governance systems.

## Abstract

Like other parts of the world, the Arab region is being affected by the current global crisis. Its effects and impacts have been, however, diverse depending on countries and sectors. After more than six years of unprecedented economic growth during what has been called the “third oil boom”, the region faces the current deceleration from a relatively advantageous position in terms of assets and resources. The crisis comes as well after a period of important structural reforms and adjustments in certain countries and in the midst of ambitious investment and diversification programs in others.

One of the key features that the crisis highlights is the social, political, and economic complexity and plurality of the Arab world. The effect of global demand slowing down, first felt in the drastic decrease in oil prices and, then, in other areas of the economy, like exports, tourism, remittances, etc., depends on both the economic structure of each country and the strategies of development implemented during the period of boom.

A bigger exposure to financial markets in the United States or UK, and a high level of speculative investments in real estate operations have produced severe cuts in the budget of Gulf countries; low prices in oil and gas have seriously affected exporting countries like Algeria, Saudi Arabia or Yemen; the reduction of remittances and tourism are seriously affecting Egypt, Morocco or Jordan, increasing the already high levels of unemployment, especially among the young. While some Gulf economies like Qatar are suffering practically no negative consequences of the recession, others like the Emirates, used to an annual GDP increase of 15%, will have to adjust to a cut of 11% in their rhythm of growth. Still, the low demographic pressure and liquidity gained during the period of boom have permitted the quality of life of citizens in Emirates to be scarcely affected by the crisis. In contrast, other oil-exporting countries with larger demographic pressures, low levels of industrialization, economic diversification, and foreign investment, will have to face higher unemployment rates and risks of social unrest. On the other hand, in spite of the important losses suffered during last September financial crisis, Sovereign Funds in the Gulf have become a key source of liquidity and attractive investment partners both outside and inside the Arab region.

Hence, the crisis is challenging in a variety of forms the strength and stability of economic policies and state development strategies, both at the national and regional level. Responses and ways out will have to adapt to each circumstance and development plans revised. Some forums have defended that strengthening cooperation and economic integration at the regional level would be the way to mitigate its impact and limit dependency and vulnerability from oil and global markets. This opens also new questions for the role to be played by the region at the international sphere.

The Roundtable, organized in collaboration between Casa Árabe and Club de Madrid, will gather a unique group of Club of Madrid Members and high level political leaders and experts to analyze and debate the impacts, challenges and opportunities that the current global crisis presents in the Arab region. After offering a quick snapshot of the main effects of the crisis in the region, participants will discuss possible development models for Arab countries in light of the crisis and the new place for the Arab region in the International scene.

## Programme

*Wednesday, October 28*

10:15 – 10:45

### **Welcoming words (Salón de Embajadores)**

Gema **Martín Muñoz**, Director General, Casa Árabe  
Fernando **Perpiña-Robert**, Secretary General, Club of Madrid

10:45 – 12:00

### **Block 1: The effects of the global crisis in the region: an internal look**

**Objective:** to give a quick snapshot of the effects of the crisis in the region in terms of: remittances, exports, tourism, foreign direct investment, the housing sector and the oil industry. The possible political implications of deteriorating social conditions in some countries would be a key aspect for discussion.

*Moderator:* Rafael **Conde de Saro**, Director General of International Economic Relations, Spanish Foreign Affairs Ministry

*Experts:*

Sofiane **Khatib**, Associated director, Middle East, World Economic Forum

Justin **Alexander**, Editor/Economist, Middle East, Economist Intelligent Unit

*Discussant:* Felipe **González**, Former Prime Minister of Spain. Member of the Club of Madrid

*Rapporteur:* Fatiha **Talahite**, Researcher of the National Centre for Scientific Research (CNRS), Université Paris 13

12:30 – 14:00

### **Block 2: Revising the role of the State in development models**

**Objective:** to revise the role of the State in enhancing new strategies and key sectors of growth, and promoting economic and social development through its investment and developing programmes. A special attention will be placed in the strengthening of human capital and economic diversification.

*Moderator:* Juan **Badosa**, President of CESCE (Spanish Company of Credit Insurance for Exportation)

*Experts:*

Abdeslam **Baraka**, Former Minister of Parliamentary Relations of the Government of Morocco and Former Ambassador to Spain

Ghassan **Finianos**, Professor of Arab Philosophy, University of Damascus; Director of Terre des Hommes-Syria

*Discussant:* Abdulkareem **El-Eryani**, Former Prime Minister of Yemen. Member of the Club of Madrid

*Rapporteur:* Gonzalo **Escribano**, Applied Economy Professor, UNED (Spanish Distance University)



15:30 – 17:00

**Block 3: The Arab Region in a World in Crisis**

**Objective:** to analyse possibilities for promoting economic integration and cooperation at the regional level and discuss which role could and should played the Arab region in designing a new global architecture in a transformed global governance system.

*Moderator:* Gema **Martín Muñoz**, Director General, Casa Árabe

*Experts:*

Tarik **Yousef**, Dean of the Dubai School of Government and Co-Director of the Middle East Initiative, Brookings Institution.

Francis **Ghilès**, Senior Researcher CIDOB Foundation

*Discussant:* Abdulkareem **El-Eryani**, Former Prime Minister of Yemen. Member of the Club of Madrid

*Rapporteur:* Olivia **Orozco**, Socioeconomic and Business Program Coordinator, Casa Árabe

17:00 – 18:30

**Conclusions**

*Moderator:* José Antonio **Ocampo**, Professor and co-chairman of the Initiative for Policy Dialogue at the University of Columbia, former Ministry of Public Finance of Colombia

*Rapporteur Block 1:* Fatiha **Talahite**

*Rapporteur Block 2:* Gonzalo **Escribano**

*Rapporteur Block 3:* Olivia **Orozco**

19:30 – 21:00

**TRIBUNA CASA ÁRABE (Auditorium)**

**Objective:** Key messages and recommendations will be shared in a session open to the public.

*Moderator:* Gema Martín **Muñoz**

*Participants:*

José Antonio **Ocampo**

Tarik **Yousef**

## Participants list

María Elena Agüero	Director of Institutional Relations and Special Projects, Club de Madrid
Justin Alexander	Editor/Economist, Middle East, Economist Intelligence Unit
María Dolores Algora Weber	Professor, Department of History, Faculty of Humanity and Communication, Universidad San Pablo-CEU
Haizam Amirah-Fernández	Lead Researcher, Mediterranean and Arab World, Real Instituto Elcano
Celia de Anca	Director, Center for Gender and Diversity in Global Management IE Business School
Abdulrab Awad	Ambassador of Yemen
Ibrahim Awad	Director Program of International Migrations, International Labours Organization
Juan Badosa	President, CESCE
Abdeslam Baraka	Former Minister of Parliamentary Relations and former Ambassador of Marrakech in Spain
Naziha Baraka	Minister in charge of Social Affairs, Embassy of Marrakech in Spain
Manuel Bonmatí Portillo	Confederal Secretary of International Policy, Unión General de Trabajadores (UGT)
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Ramón Enciso Bergé	Coordinator-Group Spanish Committee Averroes
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Ghassan Finianos	Professor Domaine Arts-Lettres-Langues, Department of Eastern Studies (Árab - Hebreu) University Michel de Montaigne; Director of Terre des Hommes-Syria
José Carlos García Fajardo	Profesor, Universidad Complutense
Francis Ghilès	Researcher, CIDOB

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Tarik Yousef	Dean, Dubai School of Government

## **Background Document for the African Roundtable**

### **‘The Political Dimensions of the World Economic Crisis: an African Perspective’<sup>53</sup>**

**Africa Progress Panel**

A year ago, African leaders and their partners were becoming increasingly concerned about the impact of the food and fuel crises and of climate change on the continent's people. These concerns persist, but they have been overshadowed by yet another, potentially more perilous threat. The global economic downturn has hit Africa particularly hard, not only through the direct effects of decreases in trade, foreign direct investment, remittances and aid levels, but also as a result of the response measures put together by the developed world. These have not only encouraged capital flight to the perceived safety of the West, but have also failed to address the specific situation and needs of the world's poorest countries and peoples. While many developed countries, including France, Germany and Japan, are already back on the road to recovery, African countries are facing the risk of a prolonged downturn if African leaders and their international partners fail to act.

The main responsibility to do so certainly rests with the continent's political leaders. They face the challenge of articulating and asserting Africa's needs and agenda on the global stage, drawing upon the values and standards enshrined in the Constitutive Act of the African Union and other landmark agreements as the basis for partnership and support from both the Global South and OECD countries. They cannot, however, do it alone. At a time when other financial flows are dropping, donor countries have an even greater responsibility to honour their international aid commitments and to ensure that global deals, whether on trade, climate change, intellectual property rights, illicit drugs, crime or migration are supportive of Africa's development needs.

#### **Setting the context**

Africa's story remains one of uneven but remarkable progress punctuated by setbacks and chronic problems. On the one hand, over the past decade many countries on the continent have been able to achieve real progress, whether in terms of economic growth and private sector development, primary education, women's rights or the fight against poverty and disease. On the other hand, there are still too many countries with authoritarian and corrupt leaders, too many contested election results and major problems persist such as the wars in Darfur, the Democratic Republic of Congo and Somalia, the surge of piracy off the horn of Africa, and recurring coups. The positive, longer-term trends towards less conflict, more democracy and greater development are nonetheless clear.

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53. This paper was prepared by the Africa Progress Panel Secretariat as an input document for the Club of Madrid's Africa Roundtable Consultation, held 3 November 2009, in Accra, Ghana.

These trends, however, are increasingly threatened by current dynamics. The financial crisis and the ensuing economic downturn have greatly compounded the policy challenges already facing the region as they begin to erode progress, reduce per capita growth and cause severe budgetary problems. With the World Bank warning that 43 out of Africa's 53 states are highly exposed and vulnerable to the effects of the crisis, the continent faces the real danger of malignant decoupling, derailment and abandonment. Efforts to achieve the Millennium Development Goals will be affected, success stories like the "Botswana boom" may have to be rewritten, and conflict resolution is becoming more complicated. The ability of African countries to support basic services like education and healthcare will be heavily impaired. The human, social and political consequences could be enormous.

Combined with the challenges of climate change, wide-spread poverty and economic marginalization, the global economic crisis now threatens Africa's development prospects and its peoples' lives. There is, however, also a positive aspect. The crisis could serve as a wake-up call for both Africans and their international partners. It may drive home the imperative of economic prudence and good governance to Africa's leaders and encourage them to use the resources of their countries more effectively and speed up the process of regional and continental integration. It may also encourage partners to recognize and make use of the continent's enormous potential and the vast scope for investment in its real economy. As such, it presents an opportunity to address some of the blockages that have been constraining Africa's growth and development for decades thus allowing the continent to contribute to global recovery.

### **The impact of the global economic crisis**

When the global meltdown was viewed as primarily financial, many thought that Africa might be spared. But this failed to recognize what globalization means, and how the world's economies, countries and fortunes are interconnected. Africa is now on the front line. Its countries are already experiencing reduced trade and economic activity, withdrawal of investors and an acute scarcity of credit. Tourist bookings are evaporating and vital infrastructure projects are being postponed or cancelled altogether. Financial inflows are dropping, including levels of remittances and possibly international assistance as the budgets of partners and the Diaspora shrink and capital flees from the economic periphery to perceived safety in the West. In nearly all African countries, job losses are mounting, job creation is slowing and the number of working poor is increasing dramatically.

The forecasts paint an increasingly gloomy picture. As a result of the crisis, the IMF has reduced its growth forecast for Sub-Saharan Africa from 5.5 percent in 2008 to about 1 percent in 2009. It also forecasts that a continued decline in economic activity could result in more than 53 million people being added to those living on less than \$2 a day. At its recent meeting in Istanbul, the World Bank estimated that by the end of this year, the countries of sub-Saharan Africa will have lost expected incomes of at least \$50 billion and the Institute of International Finance predicts an 82 percent decline of net capital flows to developing countries, from \$929 billion to \$165 billion, with Africa's share of this drop expected to be particularly severe. UNCTAD predicts that as a result of the anticipated poor performance of African economies, job creation will weaken, pushing unemployment rates higher and forcing more workers into the already large informal economy.

These are more than mere statistics. Every percentage fall in growth means a reduction in budget allocations for public services and reduced household incomes, with immediate social impacts – for example on nutrition levels, infant mortality and school attendance. Every person pushed back into poverty means another step away from achieving the Millennium Development Goals. Hard won gains in poverty alleviation, health, education and food security are now at risk of being reversed. At the same time, the recent riots in South Africa have shown that the risk for social unrest grows as governments become increasingly unable to maintain basic public services.

Naturally, the impact of the crisis, its symptoms and the ability to cope vary widely across the continent, its countries, regions and groups of populations. While the contraction in the volume of global trade, the dramatic shift in commodity prices and the drop in financial inflows have strong effects across most of Africa, some countries are hit harder than others. A country's degree of vulnerability thereby relates to its dependence on export revenues and degree of integration into world trade, its dependence on external financial flows and transfers, and its capacity to react, which in turn depends on the overall quality of governance and leadership, availability of external reserves, external debt and ability to adopt fiscal stimulus measures.

As with the impact of climate change, the most vulnerable countries are those both least responsible for the economic crisis and least able to withstand its effects. What is true for countries is also true for people. Many Africans were hit hard in 2008 by rising food and fuel prices. The economic crisis has now made the poorest of them even more vulnerable to sudden shocks, reduced the opportunities available to them, and frustrated their hopes. Their frustration could turn latent political divergences into acute strife and political contests into civil wars as parties fight for total power or access to resources.

Several African governments have already undertaken measures to minimize the impact of the crisis which range from setting up special monitoring units, providing fiscal stimulus packages, revising budget expenditures, targeting assistance on key sectors and strengthening the regulation of the banking sector and markets to expansionary monetary policy and foreign exchange controls to protect the exchange rate. The continent's Ministers of Finance and Central Bank Governors have held several meetings in order to discuss the impact of the crisis and articulate possible solutions for African countries. Their scope for an independent monetary and fiscal policy response is severely limited because of persistent inflationary pressures, strained budgets, deteriorating external balances, the continuing effect of the surge in food and energy prices in 2008, and downward pressures on their exchange rates.

Whatever response measures African countries have put together, they have been overshadowed by unprecedented activism at the global stage ranging from the UN Commission of Experts on Reforms of the International Monetary and Financial System to the G20's gigantic \$1.1 trillion stimulus plan. While there have been occasional references to low income countries in summit documents and policy proposals, politicians in developed countries are understandably preoccupied with the protection of their own economies. As a result, the legitimate concerns of low income countries (LICs) in general, and Africa in particular, have not featured prominently in the international rescue efforts. Even though the IMF and the World Bank have begun to disperse some

of the additional money that has been earmarked for them in the G20 decisions, most of it comes in the form of loans rather than grants and little has actually been used to mitigate the impact of the crisis on the poor.

This renewed marginalization of Africa marks a notable change from the last five years in which the continent has increasingly taken centre-stage at international policy gatherings like G8 summits. The consensus on the need for Africa's development which had been fostered at such meetings, whether at Gleneagles or Monterrey, now seems to have fallen victim to the second-round effects of the economic crisis. While media coverage, and indeed the communiqué, of this year's G8 summit in L'Aquila may suggest otherwise, developmental issues have lost much of their earlier prominence. Italy and Ireland have already reduced their ODA budgets and several other countries, including Germany, have indicated that statutory limits on national debt levels and domestic pressures will force them to follow suit once the worst of the crisis is over. This places growing pressure on African leaders to adapt their strategies for recovery and reprioritize their developmental needs accordingly as well as increase their efforts to use their countries' resources more effectively.

## **The drivers of change**

Despite its enormous impact on the continent, the global economic crisis is far from the only driver of change in Africa. Its effects must be seen within the context of other crises such as the continuing lack of food and fuel security as well as important trends such as demographic shifts, changing climatic conditions, the spread of digital technologies, the increasing engagement of emerging economies such as China, Brazil and India, the growth of an entrepreneurial middle class and the increasing empowerment of women. Together these drivers provide the background against which the state of the continent, the impact of the global economic crisis and the respective responsibilities of African leaders and their international partners must be assessed.

### *Demographics*

Often ignored within Africa itself, demographic trends are having a serious and undeniable impact on the economic, social and political development of the continent. While far from the only such trend of interest (others being rapid changes in the relative balance of religions, ethnicities and gender as well as accelerating urbanization), Africa's high rates of population growth are of particular concern. The continent's population has doubled over the last 28 years, and has quadrupled over the past 55 years. Such growth rates are by far exceeding national, regional and continental absorptive capacities in terms of basic needs such as food and water, labor, shelter, sanitation, infrastructure, public health and environmental sustainability. It is, however, not only the growth of Africa's population, but also its swiftly changing structure that is having an enormous impact on the continent's developmental outlook. Particularly the increasingly high percentage of young people (more than 40 percent of Africans are below 15 years of age) holds both, great risks and chances for Africa's states. If governments fail to articulate and act on strategies to provide sufficient education, employment opportunities and security to their populations, the resulting discontent is bound to overwhelm fragile societies and increase the risk of social tensions and political instability. If, on the other hand, the potential of this youth is harnessed and used productively,

as was the case in South East Asia during its economic boom, it may prove the bedrock of growth and development.

### *Climate Change*

The evidence is clear. Climate change is a reality that is already affecting the lives of millions of Africans by reducing agricultural production and food security, increasing water stress, facilitating the spread of diseases, increasing the risk of droughts, flooding and mass migration, as well as by eroding coastal habitats and valuable agricultural space through rising sea levels. This reality is threatening to overwhelm fragile communities and push millions of Africans even deeper into poverty as it jeopardizes countries' ability to generate sustained economic growth, create employment and achieve targets based on the Millennium Development Goals. With the Copenhagen Climate Change Summit (COP15) only weeks away, time is running out for African leaders to push their common position and negotiation strategy in order to ensure that a fair deal is reached that takes into account their special needs and circumstances with respect to financing, technology development and transfer, as well as technical support required for climate change mitigation and adaptation. The world's response to climate change will determine to what extent African governments can tap into new financing sources and access improved technologies, including the Clean Development Mechanism (CDM), planned mechanisms for sector approaches as well as new climate change adaptation funds. It will also determine the level of private sector investment in the continent's vast potential for energy production from renewable sources. Almost all Sub-Saharan countries have sufficient renewable resources, exploitable with current technologies, to satisfy many times their current energy demand. With the right long-term strategies and incentives, Africa could become a model of low-carbon growth and development.

### *The Spread of Technologies*

The spread of technologies like the internet and mobile telephony is having a profound impact on the African continent. Not least due to the leapfrogging of traditional fixed-line telecommunications networks, the uptake of mobile telecommunications is proceeding at a breathtaking speed. Mobile phone penetration for example, has risen from 2 percent in 2000 to over 30 percent by 2008 and is expected to increase to over 50 percent by 2012, meaning that there will be more than 500 million subscribers. Whether by connecting people with each other or rural areas to the world, by spreading knowledge, improving health care delivery or by providing a basis for small businesses, the new technologies have changed the way Africa's people interact and its economies function. Farmers are increasingly using cell phone-based trading platforms for their agricultural products and in markets where transferring cash is expensive and exchange rates are volatile, prepaid minutes have become a form of currency. With the spread of new technologies bound to continue unabated, African leaders need to apply the developmental lessons learned by India and China who once were, and to a certain extent still are in a similar position with respect to the spread, regulation and targeted application of new technologies.

### *The Increasing Engagement of Emerging Economies*

The importance of emerging economies like Brazil, China, Middle Eastern countries and India to Africa's development is growing by the day. As some



of the continent's largest trading partners and sources of investment, they have been instrumental in boosting growth rates and spurring much needed infrastructure improvements in Africa for many years. Over the last years, their involvement has evolved from energy security to encompass a much broader agenda of cooperation, including the sharing of developmental experiences and the outsourcing of agricultural production to previously uncultivated lands in Africa. However, there is a real danger that many of the deals struck come at the expense of large segments of Africa's population.

### *The Growth of an Entrepreneurial Middle Class*

A particularly promising development across the African continent is the emergence of an entrepreneurial middle class that is increasingly driving economic growth. In some countries, such as Botswana, Rwanda and South Africa, this middle class has been growing by double-digits per year for some time now and has led to fundamental shifts in economic and developmental dynamics. Middle class entrepreneurs provide innovation, help create jobs and foster the diversification of domestic and regional markets. However, in many other countries on the continent structural factors and bad governance are holding back the growth of this crucial segment of the population.

### *Women Empowerment*

The empowerment of Africa's women has been progressing at pace over the last fifty years including some genuinely historic developments over the last half decade. The adoption by the African Union of the Solemn Declaration on Gender Equality in Africa in 2004, for example, has given a new prominence to the issue of women's rights. This has been reflected in new national laws on everything from tackling violence against women to equal pay. The election of Ellen Johnson Sirleaf as President of Liberia one year later has also been a clear sign of how Africa is changing and a remarkable step for women across the entire continent. The fact, too, that Rwanda's parliament was the first in the world in which women took over half the seats (56 percent including the speaker) is a source of pride. In many African countries, women are now driving economic growth and social progress. But as women everywhere on the continent know, this is not the full picture. Significant gender gaps persist in education, health, employment, wages and political participation. For every headline success, there are many more cases of women who find their talents and aspirations blocked by formal and informal barriers. In the race to harness the energy and skills of women, Africa – for reasons of history and culture – is in danger of being left behind.

## **The implications for African leaders and their partners**

Africa's challenges seem as daunting as its opportunities appear enticing. Given the disparate nature and structure of the continent's 53 countries and their economies there is no single policy panacea – one size certainly does not fit all – to enable them to weather the storm, preserve the powerful momentum of recent years and use their potential to contribute to global recovery. There is, however, a broad consensus on the need for a combination of accountability, resources and leadership that will help African leaders to make the most out of their circumstances and allow for the optimal support of the international community.

### *Accountability*

The crisis has clearly shown the need for accountability and effective governance systems at all political levels. At the national level, African countries must consolidate the trend towards improved political governance, including by tackling the key cross-cutting issues emerging from the UNECA Africa Governance Report and the African Peer Review Mechanism (APRM) process. Leaders must strive to improve the quality of elections, promote broad-based participation in the development process and strengthen institutional checks and balances to increase the accountability of the executive branch. At the same time, efforts should be redoubled to combat the spread of corruption. Underlying all of the above is the importance of making governance systems more accessible and responsive to the continent's rapidly increasing young population.

At the regional level, Africa needs to find cooperative ways to overcome the structural challenge of small market size. Sub-Sahara's total economy is equivalent to that of metropolitan Chicago, but spread over a vast area and fragmented into 48 separate countries. It will be important to accelerate three processes: The first is the rationalization of currently overlapping agreements; second is deepening the process of integration within sub-regions; and third is improving the process of coordination across the different sub-regions. While African governments and the African Union need to lead these processes, it is also important that the policies of development partners, for instance in trade and investment, incentivize their efforts. Unfortunately, there is a real danger that the fractured nature of political leadership at the continental level may prevent the harmonization of regional integration efforts.

At the global level, the financial crisis has triggered a re-examination of a range of wider systemic issues such as the effectiveness of international institutional arrangements for policy dialogue, coordination and action. Africa's leaders should make good use of this opportunity to push for a new multilateralism which anchors the continent more firmly in international decision-making processes and institutions, including the Bretton Woods Institutions and the United Nations. They have a strong case to argue. It is clear that Africa is profoundly affected by wider global developments such as climate change and the economic crisis. It is also clear that, as a continent of nearly a billion people, it is hugely under-represented in virtually all international fora that deal with such challenges. Unfortunately, where Africa does have adequate representation, it often lacks negotiation capacity; this also needs to be rectified.

### *Resources*

At the same time, the current crisis will not be overcome by institutional reform alone. Faced with enormous funding shortfalls, African countries also need increased access to alternative resources. These include several categories, namely, emergency aid, support to sustain basic social services and economic activity, and development assistance to fund long-term growth-multipliers like infrastructure and agriculture. They should be accompanied by systemic changes to biased trade rules, bloated subsidy regimes, and other forms of market distortion currently restraining Africa's economic potential.

The private sector certainly also has an important role in mobilizing additional resources for Africa. For this reason, international institutions and the governments

of source countries need to provide specific development-orientated financial tools such as lending facilities and risk guarantees in order to increase the incentives for private sector investment in the continent. African countries need to make every effort to attract private capital for the funding of vital development projects in the infrastructure and agriculture sector; regulatory and pricing reform, as well as monitoring mechanisms to prevent corruption will need to be ramped up to achieve this goal.

### *Leadership*

Many of the measures outlined above – particularly those regarding institutional reform, climate change and economic responses to the crisis – require difficult decisions and compromises, some even substantial sacrifices, from Africa's leaders and their international partners. Both must resist rising domestic pressures, maintain macroeconomic as well as fiscal prudence, and heed the mutual commitments they have entered into as part of the Monterrey Consensus. The economic and political effects of the current crisis put growing pressure on both sides to reconsider their commitments. In donor countries, development aid risks being de-prioritized as domestic concerns mount, public finances are becoming increasingly strained, and a rebranding as climate change adaptation and mitigation funding is considered more openly. In the short-term, strong political determination will be required to restructure budgetary expenditures in a way that ODA commitments can be reached and are not curtailed at a time when developing partners need this support most. In the longer term, ways need to be found and new coalitions to be built to maintain the political commitment around development aid that has characterized the past decade. On the African side, leader's primary responsibility is to set and drive a national and regional development agenda that is responsive to peoples' needs and aspirations, and for which leaders are then accountable. Without such leadership, opportunities to forge common national positions and promote economic growth will be squandered.

### **Conclusion**

Individual success stories in Africa provide the evidence that even in the most difficult conditions, extraordinary advances are possible. Countries can recover from conflict, entrepreneurs can be incentivized to deliver goods and services that improve the lives of the poorest, impoverished lands can be regenerated, people living with HIV and TB can be helped to live productive lives, children from the remotest villages can become professors, and women can become Heads of State.

Many of Africa's problems have been imported, including financial instability and climate change. Her partners share responsibility with Africa's leaders for protecting people from the negative impact of the economic crisis, for promoting stability, growth and human development. At the same time, Africa can also contribute solutions to global problems. Her vast human and economic potential, natural resources and sources of clean energy offer highly attractive investment opportunities which can be utilized for the benefit not just of Africa, but the world. For this to be realized, Africa needs a stronger voice on the international stage, in the multilateral architecture and at key decision taking fora, whether the G8, G20, trade and climate change negotiations, to attract the political, financial and technical support required.

Progress in Africa depends upon partnership and mutual accountability between African leaders and their donor and business partners, whether governmental or corporate. Donors must honor their commitments; trading partners and corporations respect international human rights, environmental and transparency standards; and African governments implement their own commitments to good governance.

Ultimately, responsibility for driving progress rests with Africa's leaders. Their task is not easy, given capacity constraints and the many challenges they face. But only they can provide the direction that can attract and retain the investment and support that Africa's people need and deserve, and ensure that revenues are used to achieve development results.

## **Final Report of the African Roundtable**

### **‘The Political Dimensions of the World Economic Crisis: An African Perspective’**

**By Andie Davis**

*“Unless this crisis is handled urgently, the Millennium Development Goals will be unattainable, Africa will be further removed from development objectives and security will be worsened.”*

**Benjamin Mkapa**

Former President of Tanzania  
Club of Madrid Member

The economic crisis that gripped rich countries with increasing severity throughout 2008 has undoubtedly engulfed Africa as well. Early forecasts of containment within Western financial markets, or of a mitigating surge in oil and commodity prices, now seem myopic in the light of the complex range of reactions being experienced across the continent. African financial institutions that had steered clear of toxic assets nonetheless have felt the effects of evaporating global liquidity. Commodity-producing countries have seen the price of oil fluctuate and those of other commodities stall or plummet below pre-crisis levels, even as the costs of essential inputs have increased steadily. Compounding the challenges with which African governments were already contending in shoring up food security and responding to the effects of climate change, the economic crisis has come to bear down particularly hard on some of the world’s poorest and most vulnerable people, those furthest from its epicenter.

In development terms, the consequences are daunting. Decreases in trade, aid and investment mean fewer resources available for health, education and basic service delivery. And contracting job markets in rich countries inevitably shrink remittances to poorer ones – with potentially dire repercussions. After half a decade of steady increase, remittances are now projected to drop by over 8 percent. This shortfall would have a major impact on poverty alleviation in places like Ghana and Lesotho, a country of which remittances comprise 28 percent of GDP. These setbacks, in addition to hindering progress toward achieving the Millennium Development Goals and other development objectives, also carry the potential to incite civil unrest.

On the whole, the current situation brings into sharp relief a paradox that, while perhaps not unique to Africa, is certainly egregious in the African context: that deeper integration into the global economy has coincided with a relative diminution in African influence over the setting of the global economic agenda. Two decades of expanding democracy, rising incomes, resourceful responses to pandemics, and sound policies for open and inclusive growth, trade and development have done little to alter the continent’s status as a bit player in

the fora and institutions that govern its economic fate. Despite multiplying demand for its natural resources, and rates of growth unparalleled anywhere in the developed or developing world, Africa remains a continent relegated to the sidelines of the discussion, often spoken for or lectured to but little heard from and less heeded.

A quantum shift is needed in the nature of Africa's role in the global community. There is a clear call for a new paradigm, consisting of truly democratic multilateral institutions that afford Africa a strong and effective voice and decision-making capacity. Africa should insist on much stronger representation and on being a more central force in the international governance architecture.

### **Good governance for growth and stability**

*"A story is being told here. And no one but Africans ourselves will be able to determine its direction."*

**John Kufuor**

Former President of Ghana  
Club of Madrid Member

One of the most striking lessons of the global economic crisis is the importance of governance. The lingering repercussions of profligate deregulation and lax oversight in Western banking and financial sectors serve as grim reminders that responsible governance remains both a challenge and an imperative for rich and poor nations alike.

For African governments, that imperative has taken on a renewed urgency. Now more than ever, African leaders need to articulate and execute a clear vision for the continent's development. The articulation will call for lucid analysis that prioritizes long-term sustainable progress over short-term political expediency; the execution will be a function of the capacity to design, implement and monitor solutions, particularly at an institutional level.

When institutions such as the judiciary, press, academia, parliament and electoral systems are able to withstand (and even mitigate) the effects of political and economic change while remaining free of inappropriate influence, they rise to their highest purpose as the tools by which ordinary people can better their lives.

The current crisis may be reconfiguring existing challenges in new ways, but the strategies to address them must be grounded in a deep investment in institutional integrity and in the long-established basics of good governance: accountability; investment in human capital; respect for human rights and the rule of law; preservation of security; and an unwavering commitment to democracy and broad-based political engagement.

Even during the best of times, these fundamental principles can be easier to aspire to than to achieve. In the current climate, therefore, African governments must undertake an open and honest appraisal of their capacity to deliver, and of the political, economic and social costs involved.

Such an appraisal begins with a thorough understanding of the mechanics of globalization and of the strategic advantages it affords the continent. From this perspective, African leaders must be proactive in seeking out the information and partnerships that further the development interests of their people – and in weighing the risks and opportunities inherent in partnerships initiated by others. African countries need a clear sense of what they can achieve on their own and what can be achieved only in collaboration with regional and global partners, both traditional and emerging.

Regional institutions can play an essential role in ensuring that good governance transcends borders. Organizations such as the African Union must be vigilant in holding member states to high standards of accountability. Sub-regional economic communities must coordinate efforts to stimulate growth and development (including by establishing free trade areas and facilitating the circulation of goods and services), implementing policies that can enhance the continent's appeal as a high-opportunity, high-return business environment while also advocating for favourable treatment for Africa in bodies such as the European Union and the World Trade Organization.

Fortunately for leaders faced with dwindling resources, good governance is largely a matter not of money but of political will. African countries can look within the region to examples such as Rwanda, which against global trends continues to record impressive growth and to rapidly upgrade its physical, technological and regulatory infrastructure. Its drive to lay the foundation for its people to make the most of their domestic assets – decimated by years of conflict – reflects the view that economic and social stability are mutually reinforcing conditions.

Rwanda's success points to another principle worth recalling: that the democracy flourishing across the continent is a process, a *means* to development, and not simply an event or an end in itself. Free and fair elections, once held, are merely the preface to a sustained discourse between civil society and its chosen leaders. Democratic processes set the terms whereby a well-informed leadership serves the interests, needs and aspirations identified by those it has been entrusted to serve. However, delivering effectively on those terms depends as much on the acuity, capacity and integrity of the leaders as on the degree to which citizens are empowered and engaged. The more robust the engagement between government and society, the better equipped both will be to navigate periods of difficulty.

It may be tempting to focus prescriptions on sweeping macroeconomic reform when responding to a crisis of the current magnitude and complexity. But in the African context, there is much to be said for thinking small as well, for cultivating practices and building institutions to local scale. African governments should incentivize savings among the populace – however paltry such sums may seem against today's deep deficits – and broaden the tax base by closing loopholes and enforcing existing tax provisions. Governments would also do well to channel the resourcefulness and ingenuity of the vast informal sector, where most economic activity occurs and to which many in the formal sector seek recourse in times of economic hardship. Informal sector assets need to be monetized, including through establishing rights to land and other property, as a means of legally empowering the poor and expanding opportunities in the formal sector. These efforts should be supported by improving infrastructure

– roads, telecommunications and border controls – to encourage the flow of goods, services, information and ideas throughout the region.

As Africa continues to advocate for due voice and influence in an altered economic paradigm, one hobbled in part by ineffective global governance, its leaders on the home front must recognize that those whom they have been tasked to serve are themselves entitled to no less.

### **Nurturing recovery, building resilience**

*“Structural adjustment... What were we adjusting?”*

**Olusegun Obasanjo**

Former President of Nigeria  
Club of Madrid Member

*“If you can’t feed yourself, how do you start talking about growth?”*

**Benjamin Mkapa**

Former President of Tanzania  
Club of Madrid Member

In the wake of any natural disaster, the imperative is to ‘build back better’. This must be the response to the multilayered crisis facing the world today.

Many African countries are still reeling from the effects of scale-backs in social investment imposed by the structural adjustment programmes of the Bretton Woods institutions during the 1980s and 1990s. While these policies are by no means the sole cause of Africa’s ills, it may be argued that their legacy has put much of the continent at a disadvantage in weathering extreme crisis. Basic capacities to effectively assess, design, implement and manage responses are lacking at all levels, from individuals to communities to governments.

Decreases in the flow of aid, trade and investment have already stiffened the blow, with another 53 million people estimated to be at risk of falling into extreme poverty if current downward trends persist. Africa needs to build back better, and key to this effort must be an investment in its human capital.

One distinctive feature of the region is its booming young population. Africa’s population has doubled over the last 28 years and quadrupled over the last 55; and over 40 percent of Africans are below the age of 15. Whether these statistics represent a challenge or an opportunity for the continent depends chiefly on the extent to which Africa’s youth are empowered to perform as responsible and effective global citizens. Their capacities must be developed and their energies channeled for social, political, and economic progress. And the most effective vehicle for this is education.

Education, to be sure, has always been a pillar of human development. What the current climate underscores is not *that* Africa needs to prioritize education, but *how*. Education needs to be targeted to development objectives – not only to provide the practical skills and services demanded by rapidly evolving



societies, but also to cultivate a cadre of leaders, thinkers and visionaries who can propel the region forward. To keep pace with demographics, educational opportunities must multiply in breadth (by extending the range of options in all directions, from technical and vocational training to ICT, sciences and language arts) as well as in depth (by setting and enforcing adequate standards of instruction from kindergarten through to university). The blend of creativity and innovation coupled with practical know-how will serve the region well in fulfilling its development agenda – and in combating future crises.

In the present crisis, the most pressing concern for Africa has been food security. Tumbling commodity prices and abrupt increases in fertilizer, fuel and other costs combined with severe drought in some of Africa's breadbaskets to cause a worrying shortage of food staples. Here again, the scale and severity of the crisis has exposed a shortcoming in the region's growth strategies: a tendency to deprioritize agriculture in favour of other sectors, and a narrow focus on urban development without complementary schemes for rural development. Thus, while a significant percentage of the region's population remains agrarian and rural, national development plans place disproportionate emphasis on urban development and on non-agrarian service sectors. At the same time, too little has been done to accommodate heavy rural migration to urban centres. The resulting high unemployment and strain on infrastructure and public services create a volatile mix that in times of acute crisis can heighten the potential for civil unrest. Now is the time for agriculture to resume a central role in African development – through investment in technology and research, as well as through the judicious use of agricultural subsidies to improve food security and to enable producers to compete in national, regional and global markets.

Investments in youth and in agriculture will yield their greatest impact by targeting women. As principal drivers of Africa's economic growth and social progress, women need to be empowered to their full potential. Eliminating gender gaps in health, education, income, employment and political participation will not merely level the playing field; it will strengthen African resilience and exponentially advance its development.

A population that is healthy, adequately fed and educated, with equal access to opportunities becomes its own engine of progress. It is the role of government to fuel this engine by focusing public policy and expenditure on providing the infrastructure and services to foster growth. Support to small and medium enterprises is critical across the region, especially in countries where a fast-emerging middle class is increasingly driving economic prosperity, such as Botswana, Kenya, Nigeria, Tanzania and South Africa. Of these, commodity-based economies like Botswana and South Africa are finding themselves particularly susceptible to the crisis, with rising unemployment and faltering businesses threatening to roll back the ranks of the entrepreneurial middle class. Government must create an enabling environment to generate a robust private sector with which it can partner to expand economic progress and sustain growth.

Africa needs more than quick-fix solutions; it needs resilience. Governments must invest in strengthening social and economic foundations so that the building blocks of development can better withstand global crises.

## True Democracy

*"Where is the democracy in the management of the global economic system? It's dismally absent."*

**Percival N. J. Patterson**

Former Prime Minister of Jamaica  
Club of Madrid Member

Organizations like the Bretton Woods institutions and the United Nations have largely maintained the hidebound governance structures set up at their inception, structures increasingly at odds with modern geopolitical realities. As a result, Africa, like much of the developing world, continues to be marginalized where global economic decisions are made.

Part of the blame for this marginalization rests with Africa itself. The slow pace of regional integration – particularly the urgent imperative of economic integration in terms of free trade, establishment of customs unions and harmonization of policies – has undercut African negotiating power and kept many countries from accessing the full benefits of participation in a global economy. Moreover, the failure to effectively mobilize domestic resources and stimulate private sector development has meant an overreliance on extra-regional support (in the African Union, for example, over 80 percent of financing comes from external partners) that amplifies external influence and clouds the region's ability to tailor development solutions solely to its own objectives.

Nevertheless, the fact remains that African countries too often bear the brunt of situations that are neither of their own making nor within their power to prevent. Given the disastrous consequences for the continent of global phenomena such as climate change and the current crisis, it is clear that the structure of the international policy-making apparatus is ripe for reassessment.

Africa remains woefully underrepresented in international fora and, where represented, its capacity to influence or negotiate tends to be poor. A new multilateralism is urgently needed, one that reflects the dynamics of today's global economy and places Africa at the centre of international decision-making processes and institutions.

The benefits of such a paradigm could be significant. A stronger voice at the World Trade Organization could yield preferential market access for African products that must now compete not only with heavily subsidized Western producers, but with high-volume producers from China and India as well. Real clout at the Bretton Woods table could help adjust definitions governing LDC status, making more emergency aid available to solid but struggling economic performers like Ghana and Kenya. With higher negotiating capacity, Africa could endeavour to do more than merely shame the G8 and G20 into honouring their commitments on aid, partnerships and operational transparency. And a multilateral body that actively reflected and defended the security interests of the world at large – not just those of rich countries or of historic colonial powers – could contemporize the balance of power among nations, and serve as a truly effective and dynamic force for peace.

Now more than ever, these possibilities lie within reach. What is needed is a shared and active commitment to the very democratic ideals on which the international institutions have been based. As the world reappraises its economic governance mechanisms in the midst of this crisis, Africa should seize the opportunity to insist on true democracy, voice and influence in the institutions and structures that determine its well-being.

Few of the observations presented in this report are new. Africa's challenges were well known before the crisis, and many of the prescriptions offered here reflect those proposed in the past. But there is now a new urgency to implementing them, and to finding new ways to shore up resilience to shocks present and future. More effective governance at national, regional and global levels; stronger support for the drivers of sustainable growth; and genuine influence over global economic decisions are the way forward not only for Africa, but for an ever more integrated world in which the strength and stability of the part determines the social, economic and financial prospects of the whole.

### Final Declaration

The global economic downturn has hit Africa particularly hard, not only through the direct effects of decreases in trade, foreign direct investment, remittances and aid levels, but also as a result of the response measures put together by the developed world. Ultimately, responsibility for dealing with the crisis rests with Africa's leaders, who must articulate, implement and assert an appropriate strategy to mitigate the impact of the crisis. This cannot be done in isolation, but must be part of a larger effort to open up the international governance architecture to the equitable and meaningful participation of developing countries.

The crisis has underscored the imperative of economic prudence, sound developmental policies and good governance. It has compounded existing challenges of food security, unemployment, poverty reduction, basic public service delivery, climate change and migration, any of which has the potential to foment civil strife and to undermine achievement of the Millennium Development Goals.

As Members of the Club of Madrid, we met in Accra, Ghana on 3 November 2009 to discuss the political dimensions of the world economic crisis from an African perspective.

Together, we arrived at the following conclusions:

1. Good governance is the foundation of sustainable and equitable growth. Leadership in the region must articulate and execute a clear vision for development, including an honest appraisal of the costs involved, especially during economic contraction.
2. Africa's greatest resource is its people. A much greater investment in human capital, especially women, is needed. The energy of the continent's large and youthful population must be channeled for the benefit of social, political, and economic progress. Youth must be empowered by widening and deepening educational opportunities, including providing adequate education at all levels as well as vocational training.
3. Agriculture needs to be reprioritized. Investment in technology and research, as well as reconsideration of protection and support measures such as subsidies, are essential to improve food security.
4. Africa's economic growth strategy has been too oriented to global markets to the neglect of cultivating local and regional markets. African countries need to strengthen their own domestic markets as a first recourse to drive competitiveness. Accordingly, domestic economic assets must be more fully mobilized. African governments should incentivize savings and broaden the tax base. The ICT revolution must be put to the service of national and regional development plans, to inform and educate the population as well as key stakeholders such as organized labour.
5. The informal sector comprises the great bulk of economic activity on the continent, and must assume greater prominence in Africa's economic planning. Informal sector assets need to be monetized, including rights to land and other property, as a mechanism for legally empowering the poor and expanding opportunities in the formal sector.
6. African countries must cultivate a climate conducive to private sector development, particularly for small and medium enterprises. Public sector resources need to be

deployed and managed (including, where appropriate, through partnerships with the private sector) to facilitate inclusive growth.

7. At the same time, Africa needs a more strategic integration into regional and global markets. It needs to make itself an attractive hub for investors by providing a high-opportunity, high-return business environment. This can be achieved through regulatory reform, strengthening of institutional capacity, and the redefining of eligibility criteria for EU and WTO preferences.
8. Regional fiscal and trade policies need to be made more coherent. Regional and sub-regional bodies such as the African Union and the regional economic communities need to coordinate more effectively to stimulate growth and development. Customs unions, common markets, free trade areas, all supported by joint investments in improved national and regional infrastructure will empower Africa to realize its full potential.
9. Africa needs partners, not mere donors. It needs greater capacity strategically to negotiate its own best interests with external partners, whether traditional or emerging. African countries need a clear sense of what they can achieve on their own and what can be achieved only in collaboration with regional and global partners. Mutual accountability and respect for democratic principles will be key.
10. A quantum shift is needed in the nature of Africa's role in the global community. There is a clear call for a new paradigm, consisting of truly democratic multilateral institutions that afford Africa a strong and effective voice and decision-making capacity. Africa as a region should insist on much stronger representation and on being a more central force in international institutions and within bodies like the G20.

In light of the above, we call for a more inclusive, more democratic and ultimately more effective multilateral paradigm that will help us to overcome today's challenges and make the most of tomorrow's opportunities.

### **Abstract**

The world financial crisis that hit the world in 2007 has now become a systemic global economic crisis which will affect socially, economically and politically, all the countries and regions differently depending on their level of development and grade of insertion in the world economy. Since there is a strong interdependence between the rich economies – where the crisis was generated – and the emergent and developing economies, to which the African continent pertains, there is no doubt that the crisis will have a deep impact in this region.

Over the last decade the region has gone through major breakthroughs in terms of economic growth, poverty reduction and access to basic social services, but in spite of that, 36.2% of the African population lives on less than one dollar per day. The current economic crisis has evidenced that this progress to date could be washed away and that much needs to be done to achieve the Millennium Development Goals in the region.

The socio-economic and political impact arising from this crisis may be very profound. The changes in the region could be reflected on the one hand, by the significant reductions of export earnings, growth targets, remittances from the African Diaspora, direct foreign investments and development aid and on the other hand, by the increase of unemployment and the possible rise of social and political tensions.

If the adequate measures are not adopted soon enough, the crisis may also put at serious risk the democratic development achieved in the last decades, as well as creating conditions of social outbreak with possible violence, and worsen the conditions of injustice in which a significant part of the African population lives.

In their response to the economic crisis, African governments, along with international organizations, will have to address the challenges resulting from the current economic crisis in conjunction with finding solutions to other critical issues Africa has been severely hit by, e.g. poverty, food security, global warming, human rights and peace-building, whose management will be crucial in strengthening democratic values, good governance and human development.

Finally, in addition to an effort to design and adopt a new world order capable of responding to the political challenges of the 21<sup>st</sup> century, arising from the current world economic crisis, as well as effectively sustaining democratic values at a global, regional and national level, one will also need to set off reflexion and decision-making processes that will tackle the challenges democratic leadership is facing.

In this sense, Members of the Club of Madrid, Members of the Africa Progress Panel and other prominent experts and decision-makers, will be gathering at this African roundtable to discuss the political impact of the crisis from an African perspective and to formulate practical recommendations to the political institutions and policy-makers in charge of responding to the political challenges arising from the crisis, at a global, regional and national level.

The results that will come out of both this roundtable and the other ones organized in Europe, Latin America, Asia, the Arab World and the BRICs (Brazil, Russia, India and China), will become the building blocks of the Club of Madrid's Annual Conference focused on "*The Political Dimensions of the World Economic Crisis: National Interests, Stability and Global Governance*" in which participants will be formulating a global political perspective of the current crisis.

## Programme

*Monday, 2<sup>nd</sup> November*

20:30 – 22:00 Welcome Dinner offered by the Government of Ghana

*Tuesday, 3<sup>rd</sup> November*

9:30 – 18:00 **Roundtable:** “*The Political Dimensions of the World Economic Crisis: An African Perspective*”  
*Moderator:* Michael **Keating**, Director Africa Progress Panel  
*Rapporteur:* Andrea **Davis**, Strategic Communications and Policy Consultant, and Roundtable Content Coordinator

9:30 – 10:00 **Welcoming words**  
María Elena **Agüero**, Director of Special Projects and Institutional Relations, Club of Madrid  
Ofosu-Amaah **Paatii**, Special Adviser to the President, African Development Bank  
Ricardo **Martínez Vázquez**, Director General, Casa África

10:00 – 11:30 **Block 1: The effects of the crisis in the region: an internal look**

### Key issues to be discussed:

- What are the social and political implications of the crisis in the region?
- Which African countries have been the hardest hit by the crisis? Why?
- The economic crisis added up to other crises (food security, fuel, climate change, violation of human rights) and its implications. What are the implications for African leaders and African leadership?

### Experts:

Andrea **Davis**, Strategic Communications and Policy Consultant, and Roundtable Content Coordinator  
Ernest **Aryeetey**, Director Department of Economics - University of Ghana, and Director of the Africa Growth Initiative, Brookings Institution

### Discussants:

Benjamin **Mkapa**, Former President of Tanzania.  
Member of the Club of Madrid  
Olusegun **Obasanjo**, Former President of Nigeria.  
Member of the Club of Madrid



12:00 – 13:30

**Block 2: Drivers of change****Key drivers to be discussed:**

- Youth of the population
- Gender empowerment
- New African entrepreneurial middle class
- New relation between the African region and new world players interested in resources Africa offers
- Impact of new technologies and communications

*Experts:*

Ofori-Amaah **Paatii**, Special Adviser to the President, African Development Bank

Guillaume **Grosso**, Chief Operating Officer and Policy Counsellor, OECD Development Center (African Economic Outlook)

*Discussants:*

John **Kufuor**, Former President of Ghana. Member of the Club of Madrid.

Festus **Mogae**, Former President of Botswana. Member of the Club of Madrid

13:30 – 15:00

Lunch

15:00 – 16:30

**Block 3: Regional integration and the insertion of Africa in the international scene****Key issues to be discussed:**

- The Economic Crisis: an opportunity or a threat to regional integration?
- Relationships within Africa: how to strengthen regional cooperation
- Place of Africa in global governance

*Experts:*

Maxwell M. **Mkwezalamba**, Commissioner for Economic Affairs, The African Union

John **Page**, Former Chief Economist for Africa and Director of Poverty Reduction, World Bank and current Senior Fellow, Global Economy and Development, Brookings Institution

*Discussant:*

Percival Noel James **Patterson**, Former Prime Minister of Jamaica. Member of the Club of Madrid

16:30 – 18:00

## **Conclusions**

Andrea **Davis**, Strategic Communications and Policy  
Consultant, and Roundtable Content Coordinator

## Participants list

### Members of the Club of Madrid

John Kufuor	Former President of Ghana
Benjamin Mkapa	Former President of Tanzania
Olusegun Obasanjo	Former President of Nigeria
Percival Noel James Patterson	Former Prime Minister of Jamaica

### Experts and Invitees

Adam Abdul-Rahaman	European Bureau, Ministry of Foreign Affairs
Yan Adjei	Director of Europe Bureau, Ministry of Foreign Affairs, Government of Ghana
Kathy Addy	Dissemination Coordinator, Center for Democratic Development
María Elena Agüero	Director of Special Projects and Institutional Relations, Club of Madrid
Emmanuel Anyambod Anya	Board Chairperson, West African Network for Peacebuilding
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## **‘Adjustments to the Global Economic Crisis by India and China’**

**By Sanjay Peters<sup>54</sup>**

### **Purpose of the Study**

The re-emergence and growing influence of India and China as economic powers is now widely accepted. The global business revolution that has been unfolding in India and China over the past 15 years is currently also having, and will continue to have a major impact on the economies of the US, the EU, and on other parts of Western Europe, Africa, Latin America and South Asia over the next two to five decades; albeit in varying degrees. However, the difference in performance on measures of human development as well as adjustments to the present crisis could shape the future progress of both countries.

This discussion paper aims to address a number of pertinent issues in relation to the possible outcomes and adjustments being made by India and China in response to the current global economic crisis. The range of questions for which answers will be sought, include, for example, to what extent the crisis is derailing the development achievements in China and India? In what ways are the development malaise manifested (i.e. rising poverty levels, inequality and deterioration rural development programs, education, health and unemployment)? What have been, and are likely to be the outcomes of the stimulus packages in both countries? Is the current global economic crisis likely to increase political instability in Asia and the threat of war? If so, what might provoke such an outcome? What are the international implications of China and India becoming more influential in terms of their rising percentage share of global GDP growth? Is the Renminbi likely to become a regional currency without being floated as an official global reserve currency? Can the two countries compensate for declining demand in export markets through consumption driven growth given the enormity of their internal markets? Are foreign investments likely to be discouraged by both India and China as a result of the crisis and a more inward oriented focus? If yes, will this not lead to retaliation and protectionism? Will the current crisis contribute towards greater cohesion and support of ASEAN by India and China or will it lead to decoupling in Asia, led by China and India? What useful trends (empirical data from the World Bank, the IMF and OECD) do we have to guide us to better understand the magnitude of the tasks that lay ahead for Asia's emerging giants?

The structure of the paper is as follows. The first section focuses on the impact of the crisis on Asia's emerging giants and exposes some the direct ramifications that it is having on the lives of the general population in both India and China. The second section sets out to highlight the type of reforms and changes in government policy that India and China will need to implement in order to overcome the current global economic downturn. The third section

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draws attention to the present, as well possible future challenges in international relations that China and India are likely to confront. Finally, section four offers some concluding observations and remarks.

## 1. The crisis

### *Collateral Damage on Emerging Asia from Failure of Western Financial Markets*

While several Chinese sovereign wealth funds have lost US\$ billions by investing in US banks such as Morgan Stanley and Lehman Brothers, on the whole, the sub-prime crisis and toxic assets in the US and in Europe have not directly affected the Chinese economy. The speculative bubble in the luxury housing market in major urban areas of China has also burst, but given that over 12 million migrants gravitate annually to different Chinese cities, the demand for a different type of housing will at least partially absorb decline in demand in the high end housing market. On the other hand, the sharp drop in demand from the US, China's key export market, is clearly having a detrimental indirect impact on employment. China is fortunate to have a number of internal solutions to combat the crisis including, domestic demand and fiscal balance. Private consumption is still less than 50% of GDP. Hence the government is taking measures to increase consumption. The government's fiscal package increases spending on education, health and pensions to 5% of GDP. A US\$ 586bn central government initiative in new infrastructure projects will also ensure that economic growth is not derailed. China is a net oil importer and benefits from the drop in oil prices. Lower inflation permitting the central bank to lower interest rates and the reserve requirement ratio may also contribute to growth. The decrease in exports does pose a risk to China, but possibly not a very high one given that the nature of production involves majority of inputs being imported from neighboring Asian countries. Therefore, the fallout of the crisis will greatly harm China's suppliers of inputs (La Caixa Monthly Report, 2009). Moreover, according to Jonathan Anderson, at UBS bank (The Economist, January. 3ed 2008), China's growth is not as highly dependent on exports as commonly thought, than it is to productivity gains. Labor productivity is around 7-8% and average annual growth total factor productivity has been in the region of 4% (by far the highest in the world) over the last two decades (see Chart 1).

While the major Indian IT companies such as Infosys, Wipro and Tata Consulting Services have been hit hard by the financial crisis, due to the fact that many of the loss making US financial institutions were their key clients, on a national scale, India is protected from the decrease in global trade, as exports form a relatively smaller part of GDP. The drop in oil prices will also benefit the country and reduction of subsidies on fuel contributes to the government's ability for maneuver. Nevertheless, India and also China should expect to receive less investment flows, resulting in less liquidity in the financial system, but, the drop in inflation has led to the government's ability to reduce the interest rate and reserve requirement ratio. Moreover in China, the government has released a stimulus package amounting to more than 16% of GDP (1,5% in India) to be spent in 2009 and 2010.

In sum, these policies should enhance the national economic development goals for both countries, but instability and uncertainty around the effectiveness of the

stimulus package, coupled with the fact that emerging markets in the region are plagued with liquidity problems raises serious concerns. The risk of rising inflation and demands for currency appreciation adds yet more pressures.

### *The Impact of the Global Financial Crisis on Poverty Control and Employment*

An Estimated 470 million and 827 million people earn less than \$2 a day in China and India, which represents the median poverty line for all developing countries. A decline in growth prompted by the recent global economic crisis in China and India, even if in relative terms substantially lower than in OECD countries will surely have a damaging effect on poverty alleviation, unless concrete policies are employed (such as those carried out in China's rural areas mainly to support consumption in non durables), to curtail the knock on effects of gross indulgence by the very wealthy on the lives of the very poor (Bajoria, 2008). The rising prices of basic food items could exacerbate poverty in both China and India. Hence a subsidization program to ensure that essential food items reach the neediest groups should be seen by policy makers as paramount to avoid social and political backlash. In both India and China, a major destabilizing aspect of the global economic crisis is the rise in unemployment. Hundreds of thousands of migrant workers from rural India have had to return back to the countryside due to loss of work produced by declining demand in export markets. Research by Vashist and Pathak (2009) reveal that merchandise exports dropped by 17% from October 2008 to May 2009. Meanwhile monthly figures in December 2009 show that the drop in exports from its peak in July 2008 are still high 23.3% (but lower than 43.6% registered in April 2008). In China, from the onset of the crisis in September to the end of 2008, more than 20 million migrant laborers had lost their jobs due to a decline in demand in export markets. It is estimated that around 25 percent of China's 6.1 million new college students in will be unable find work when they graduate in 2009 (Pei, 2009). The political legitimacy of the Chinese Communist Party, as Minxin Pei rightfully points out, rests on ensuring that economic needs of the masses are satisfied, and more concretely, on controlling the decline of job losses and creating new employment opportunities so that millions of rural migrants are not discontented and ready to carry out protests and demonstrations. If high growth rates are sustained in China in spite of the crisis and the growth rates of developed economies remain bleak for the next three to five years, the likelihood of protests against restricted political freedoms, social and individual liberties are likely to be slim even amongst the Chinese youth. In such case, overheating and currency pressure will be the greatest danger. However, in the event that the stimulus package is withdrawn too soon and growth rates decline substantially in China, neighboring India and the international community in general should expect internal instability in China, and subsequently also within the region. Human rights violations would grow ten fold as millions of protesters battle it out with security forces of the state. The greatest danger in such a scenario is that China may become too focused on controlling domestic unrest and internal political objectives at the expense of absolving its growing responsibility in the region and to the international community, particularly when global demand is for China to play a more active role on issues such as climate change, monetary policy and reducing macroeconomic imbalances (Pei, 2009).

A major drop in exports brought about by the current financial crisis and contraction in western markets has led to the closing down of 67,000 factories

across China during the first half of 2008, producing nationwide street protests by laid off workers. (Bajoria, 2008). The Impact on the industrial sector in India has been less severe, as much of India's growth over the past decade has come from the service sector. Nonetheless, both countries are experiencing a massive exodus to rural areas by millions of migrant workers, with no clear signs for the vast majority of returning to urban centers anytime in the near future to earn a more stable living. Poverty levels in China and India have been brought down substantially over the past two and a half decades. No other country in the history of human civilization has been as successful as China in pulling out over 600 million from extreme poverty (those earning less than \$1 a day) in such a short span of time (since 1981). This was achieved largely through sustaining 10 percent growth rates since the beginning of the 1980's. India with a 6.2 percent average annual growth over the same period has also succeeded in uplifting 30 million people out of abject poverty. Nevertheless, the World Bank maintains that approximately 100 million Chinese and over 250 million Indians remained under the extreme poverty line in 2005. Kumara and Jayaskera (2009) report that,

"While the Indian and world corporate elite have made much of the 9 percent annual growth India experienced for four successive years beginning in 2004-5, the reality is that the gains of India's boom flowed almost entirely to big business and more privileged sections of the middle class. Rural India, meanwhile, has been ravaged by the flip side of the pro-investor policies pursued by successive Indian governments. State investment in agriculture has been slashed, so governments can lower taxes and pursue the megaprojects required by big business to make India a cheap-labor producer for the world market. Agricultural price supports and subsidies for fertilizer and other inputs have been pared back or eliminated."

A reorientation of focus is hence urgently needed in practice by the incumbent government of Manmohan Singh to ameliorate the growing inequality between urban and rural India and to reduce poverty levels.

## **2. Reforms**

### *Political Challenges Facing China*

China and India are enjoying sustained economic growth in spite of the current global economic crisis. There are of course serious problems facing both countries in terms of the distribution of wealth. Government policies in areas such as public education, health and social welfare need urgent attention. Otherwise the widening disparities in living standards, in per capita income and well-being in regions within these two countries, between rural and urban areas and within urban areas could result in disastrous consequences which could threaten social and political stability.

China's ruling Communist Party, led by President Hu Jintao, wants continuing economic liberalization and sustainable economic growth alongside enduring political control. The biggest domestic challenge the Communist Party faces are the tens of millions who have lost out since economic reforms began in the 1970s. Economic prosperity has been uneven; many rural areas, outskirts of cities and inland regions have been "left out" from the development gains,

creating huge populations of unemployed and disadvantaged citizens who constitute a political liability. Wang (The Chinese Academy of Sciences' and Institute of Psychology) estimates, China had more than 80,000 riots and demonstrations in 2007, a huge increase from 10,000 in 1993. In September 2004, a survey of Chinese scholars and think tank analysts reported that China would likely experience serious social unrest as a result of a combination of social challenges including environmental problems, corruption, a weak financial system, poverty and unemployment. "Accordingly, the balance of economic development is being tipped towards social priorities" (Political Forces, 2005). The rural poor are receiving much more attention, particularly through tax reduction, and cleaning up government corruption is another priority.

### *Required Educational Reforms in China and India*

China's education system is the biggest in the world, but only a very small percentage of the vast number of university graduates possess the necessary skills and knowledge to be employed for firms specializing in export markets (Farrel, Grant; 2005). China's educational system is overly biased towards theory, with too few graduates having the necessary practical skills to work in a multinational environment. Poor English and lack of team work experience are other reasons contributing to the perceived weakness of Chinese tertiary level graduates. This shortage of homegrown talent will place limitations on both the ability of domestic firms to globalize and also potentially restrict China's ability to develop world class service sector companies. An additional problem that China needs to address is the lack of accessibility to primary and secondary education being granted to families of rural migrant workers in major cities. Though the laws on mobility has been uplifted for people to move freely throughout the country to look for stable employment, the rights of individuals are restricted to public services offered by the city if they are not registered residents. Migrant workers from rural China are not automatically eligible to become residents in major cities. This policy foments rather than reduce inequality between citizens of rural and urban China.

While India has a core of highly skilled and educated workers, it too needs to significantly improve many aspects of its education system. An educated and skilled labor force is a critical part of a developing economy, but even more so for India as it aims to exploit its knowledge economy. While India has made substantial progress in literacy and school enrolment rates, it still has the largest number of illiterate people in the world and the participation of girls in elementary education is low. Other areas that India needs to invest in order to educate a large pool of agile and skilled workers is to encourage more on creative learning, rather than on schooling, and focus more on practical skills rather than theory, which has created a "mismatch between education and the labor market." (World Bank, 2005). The record on education in India however is even more worrisome in many respects than that of China. The high drop out rates at a primary and secondary school level mean that approximately only 10% enter into higher education. Moreover, around 70% of those who do enter higher education end up pursuing studies in law, literature, history and other liberal arts subjects, thus making them less prepared for the job market in technical fields which India is so well reputed in (Kumar et al, 2007). The gender disparity in India in the area of education is lagging considerably behind that of China. More than 70% of the female population of highly populous states, such as Bihar, with over 100 million inhabitants, is illiterate. Such trends clearly harm



India's hopes for balanced future growth and development. Approximately 44% of the country's over one billion population resides in seven of the poorest states such as Bihar, Uttar Pradesh, Jharkhand, Orissa, Assam, Madhya Pradesh and Rajasthan. One of India's major problems is that it places an excessive amount of priority on the service sector. This sector cannot absorb the surplus supply of labor in agriculture. Manufacturing sector development therefore has to be sought to balance the spread of employment creation in India. Both countries will also have to find ways to avoid the loss of brain drain caused by their most gifted scientists relocating to Europe and the US to carry out advanced degrees. Innovation can only be achieved through an expansion of investment in higher education and in R&D. Both countries will need to find ways to provide the right incentives to keep their brightest minds from immigrating to industrially advanced countries.

The crisis will play an important role here. Only sectors with high productivity will maintain strong demand for labor. On the one hand, this may offer strong incentives for the State and private entrepreneurs to promote such sectors and subsequently the skills and know-how, and therefore economic growth. On the other hand if the educational gap persists and incentives are not guided properly, the greatest part of the population could be left behind.

### *China's Goal of Political Harmony through Focus on Social Welfare Protection*

As a result of the total collapse in GDP of western economies brought about by the most recent financial crisis, it is increasingly clear that the growth prospects of the global economy over the next 25 years depend heavily on Asian growth, and especially so on China and India's growth. In both these countries, the growth story will increasingly be about consumption, though India has been focusing on such a strategy since it began economic reforms in 1991. Between 2003 and 2007 the majority of the increase in consumption came from the G3 economies, the US, Euro zone and Japan. Consumption growth in the G3 over the next few years will be anemic at best (though recent trends in the US cast some doubts on this line of reasoning), leaving emerging Asia to pick up the slack, and China definitely has the potential to fill this vacuum. An additional five percentage point increase, for example, of private consumption in China would have meant China offsetting the poor consumption trends of the G3 during the current crisis. There are several reasons to believe that consumption, particularly in China is going to increase, not least because it could hardly get much lower. At a mere 37% of private domestic share of GDP in 2008, consumption in China is the lowest of any large economy (see Chart 2). The figure for the US and Mexico is 71% and 73%, while in Brazil and India, the share of consumption in GDP is 65% and 57% respectively over the same period (García-Herrero and Peters 2010, forthcoming).

Two major underlying factors should accelerate this re-balancing trend in China towards a more consumption driven economy over the next few years. Those factors will come emanate from the Central Government because what China understood from the Asian financial crisis was that liberalization is not as important as prudence or guiding the market is. China's response to the crisis is going to be continued presence of state owned enterprises and active public sector, as has been the case for the past three decades. Concrete policy measures are being taken by the central government to improve the social

safety net and to reduce corporate savings, and such steps will no doubt act as major instruments to foment consumption. One of the main reasons for low consumption in China is that Chinese households tend to save a lion share of their earnings. Gross household savings have averaged in the region of 20% of GDP over the last few years. Thus far, the lack of a social safety net combined with the one-child policy has meant that most people have resorted to precautionary savings in order to support themselves during retirement age. Due to the low penetration of even basic financial products such as life insurance, most households end up saving in excess. The Chinese government has designed several policy measures to increase the social safety since the onset of the recent financial crisis. For example, it has pledged to provide medical insurance to 90% of the population over the next three years (using 1/5 of fiscal stimulus package of \$586 billion). A three-pillar pension system has also been introduced in urban areas and a plan is now being worked out to provide pensions for rural residents. Plans are starting to be developed to make education financially more accessible to all students, thus reducing the need for parents to save for their children's college education. Affordable housing has become a top priority for the government (over 5% of the fiscal package has been devoted to it) not only to support growth but also to help develop a middle class in China. An increase in home ownership rates could thus lead to increasing consumption, not just through the "wealth-effect" of owning a home, but also through increased spending on home improvement (García-Herrero and Peters, 2010, forthcoming).

In the developed Asian economies (Taiwan, Korea, and Japan) consumption as a share of GDP increased gradually as per capita GDP increased. China's GDP per capita has long been nearly at subsistence level, which is generally associated with a low share of consumption to GDP. As GDP per capita increases in China over the next few years, it is likely to follow the same well-trodden path as its Asian peers, and consumption as a share of GDP will gradually increase.

Most of the increase in Chinese savings has also come from the corporate sector. The notable increase in corporate savings, from 2002-2007 is mainly due to the rising profitability of state owned enterprises (SOE's), which have not distributed their excess profits back to the government. This has started to change since 2007, where 10% of profits have to be paid out as dividends to the government. More steps in this direction over the next few years will help ease government pressures (García-Herrero and Peters, 2010, forthcoming).

The strong consumption oriented focus by both China and India suggest that these two large emerging markets can no longer be relied up on simply as destinations for outsourcing of low cost manufacturing and service sector work. Western companies will need to learn how to sell products and services to these large economies rather than to just export products and services from these countries.

### *Key Drivers of the New Consumption Driven Growth in China*

Though the economic reforms ushered in by Deng Xiao Peng in 1978 has undoubtedly facilitated greater privatization of the national economy, it is still hard to determine in any sort of clear way as to what extent Chinese private entrepreneurs have witnessed visible improvements in their ability to set up and run successful businesses. Although productivity gains have been important,

according to Zha Daojiong, Professor of Political Economy at the International University of Beijing, the productivity rate of, for example, an auto worker in China is still only 20 percent of that of his counterpart in Japan (Zorilla, 2006, p. 53). Low productivity in China is attributed by Zha to the excessive role played by the state in key sectors of the economy. The Chinese economy continues to remain highly interventionist in the first decade of the 21<sup>st</sup> century, in spite of the fact that the general perception is to the contrary. To substantiate this claim, Zha points out that the state has monopoly control in a number of key areas such as, alcohol, tobacco, telecommunications, railways, aviation, petroleum and other strategic industries (ibid, 2006. p. 53), for example, such as in banking. The visible and excessively interfering hand of the state can even be seen such small scale businesses as the taxi industry in Beijing. The taxi business in China is cited as one of the most regulated and controlled in the world. How so? Firstly, the cost of obtaining a taxi license is said to be exorbitant. Secondly, taxi drivers are required to hire their vehicles from a specific company that the state obliges them to work with. Thirdly, authorization is required by operators from state regulators to replace an existing taxi with a new one. Fourthly, the make and model of the car to be used as taxis is decided by the state. The taxi driver has no say whatsoever with the brand he would like to have for his car (ibid; p. 53). Zha insists that the core of the problem with low productivity in China is directly linked to the lack of institutional reform in the political arena. He asserts that, individuals who normally take decisions on policy matters related to business strategy in China are between 50 and 60 years old. This means that they were either educated in the former Soviet Union or they received their training during the Cultural Revolution. If it were the latter, which is the case for most decision makers in China today, it is unlikely that they got much of an education according to Zha, because studying anything other than Maoist ideology was outlawed in China between 1966 and 1977. From the Communist Party of China's standpoint, the ability to read and write is all that was required to become familiar with Mao's ideas and to learn from his wisdom. Coupled with the fact that most of the current decision makers in China come from humble social class backgrounds without any tradition in education, it is unsurprising to Zha that the end result of policy making is nothing short of corruption and ignorance. He argues that the communist party is the spinal column of China. Even at a technical level, one has to belong to the communist party in order to take important decisions. Zha maintains that leadership within the Communist Party of the People's Republic of China is not based on meritocracy. In order to ascend within the party, seniority (old age) and loyalty to the party oligarchy is much more important than merit. As a result, it is very hard to see any signs of real innovation within Chinese firms. China may be able to send rockets to space, but they are unable to solve problems associated with water leaks in household and public latrines (ibid; 2006, pg 53-54). Any real hope for China to modernize, become innovative and develop its own competitive industries in a continually globalizing world, according to Zha, will only take place after the XVIII Party Congress in 2012, when those such as Hu Jintao, the current President of China and members of his generation who were educated during the Cultural Revolution will have retired from politics. Current encouraging signs however can be seen in the fact that prominent members of the Chinese business community are now being allowed to form part of the central government apparatus (ibid; 2006, p. 61). One of the important outcomes of the current financial crisis is that it has legitimized the role of the Chinese State in effectively managing the economy. Hence, what we are likely to witness over the next three years at least, until the

change of guard in 2012 and the replacement of Hu Jintao, is an increase in the role of the state, with a greater focus on self-reliance as opposed to export led growth and dependence on foreign direct investment. This policy of heavy state control may become more accentuated depending on who takes over. (Summers, 2009).

Xi Jinping and Li Keqiang, are seen as the leading candidates to succeed Hu Jintao and Wen Jiabao respectively in 2012. President Hu's goal for the remainder of his term in office will be to uphold the necessary political clout so that the transition will be smooth and free of uncertainty and instability. His economic aims are likely to be short term in nature. For the various aspiring candidates however, the process of transition might offer a unique opportunity to radically reform the existing system through ushering in major political and social reforms. Such a contrasting stance could severely undermine the authority of the state and inadvertently provoke further political instability. (Pei, 2009).

Important lessons could be learned by China from looking to its neighbour India, on how to promote private entrepreneurship amongst the local population rather than to be overly dependent on foreign direct investments. India meanwhile could also learn from China on how to develop its manufacturing sector more and to encourage foreign investment, but without becoming overly dependent on this source as major driver for GDP growth, as the service sector boom is not going to be sufficient to absorb India's surplus labour force.

### *Environmental Challenges*

China's economic development, based on manufacturing sector growth, over the past two decades has produced serious environmental problems, which in turn are creating a range of other social, political and economic challenges. Skyrocketing rates of air and water pollution, severe land degradation, and increasing resource scarcity are all creating huge pressures. China's reliance on coal for three quarters of its energy has made its air quality among the worst in the world. In 2001, the World Bank reported that 16 of the 20 most polluted cities in the world were in China. Acid rain, resulting from sulfur dioxide emissions from coal burning, affects over one-fourth of China's land. Unregulated economic development has also contributed to the devastation of China's forests. However, "China's dramatic growth in automobile use poses the greatest future threat to China's air quality. China today has over 20 million cars, trucks, and buses; 20 million agricultural vehicles, and 50 million motorcycles. By 2020, conservative estimates suggest that China will have 110 million cars." (Elizabeth, 2004).

However, the most serious environmental challenge China confronts is access to water, which stems from both growing demand and rapidly increasing levels of pollution. Approximately 700 million people drink contaminated water on a daily basis. More than three-quarters of the water in China's urban areas is considered unsuitable for drinking or fishing. China's water pollution problems were demonstrated in November 2005 by an industrial accident which contaminated a river and left four million residents in Harbin (a major city in the northeast) without water for several days.

China's leadership has recently realized that its environmental practices are having a significant negative impact on the economy. The World Bank reports

that the cost of environmental pollution and degradation in China is equivalent to 8-12% of GDP annually. Lost days of work, contaminated crops and fisheries, and industry closures due to lack of water all contribute to such costs. The prospect of social unrest is causing the government to pay closer attention to the environment. As early as the mid 1990s, the Central Committee of the Chinese Communist Party published a report acknowledging that environmental degradation and pollution was one of the four leading causes of social unrest in the country. Moves towards more sustainable development is also supported by academic studies. The “Environmental Kuznets Curve” suggests that as an economy grows and wealth increases, governments allocate more resources to environmental protection. “Rising per capita income spurs consumer demand for luxury goods, including environment protection. Consumers will spur a shift in production away from environmentally very stressful heavy industrial production to the production of environmentally less stressful consumer goods and services.” (Peters, 2005) The early signs of this trend are already underway in China.

### 3. International relations

#### *Status of Bilateral Relations between China and India*

There is a notable increase in the body of literature in scholarly journals about China and India and the supposed rise in competition between these two countries along with speculations about the likely winner of the race in the medium to long term (Gibb and Li, 2003; Majumdar 2004; Arora and Athreya, 2002; Contractor and Kundu, 2004; and Srinivisan 2004). Often, erroneous assumptions are made suggesting that China and India are bitter adversaries. Whilst it would be inaccurate to suggest that they do not fear each other at all at a military level, particularly given the relatively recent history of border disputes, the most salient one being the war in 1962, it would be a gross mistake to draw the conclusion that a military threat from each other once again is the main concern that occupies policy makers. This somewhat narrow debate overshadows other relevant issues, such as the growing trade between them. Though there is a healthy amount of competition between China and India to aspire to be the leading player in Asia, most analysts tend to completely overlook that there is also a considerable rise in cooperation and trade between these two countries. For example, the bilateral trade figures between India and China amounted to \$43 billion in 2009. This is a notable rise from the year 2001, when bilateral trade figures amounted to a meager \$1.2 billion. China for example, surpassed the US and the EU to be India's main trading partner since 2007. The debate over the so called rising competition between China and India also downplays important lessons that both countries could learn from one another, about the benefits of bilateral cooperation as means to reduce the possibility of geopolitical conflicts (ie. such as over access to global energy supplies) and about the positive or adverse impact their re-emergence as global economic powers could have on other countries both within Asia, the EU, the US, Latin America and Africa. To further illustrate the growing closeness between China and India, it may be worth highlighting that as recent as 2002, there were no direct flights between China and India. As of 2007, there are 22 weekly direct flights between major cities in China such as Beijing and Shanghai to Delhi and Mumbai. There are also over 90 Indian companies from various sectors such as pharmaceuticals, IT and automobile components that have registered offices

in China as of 2005. As a result of the rise in global demand for IT specialists, more than 25,000 Chinese software engineers have received their training from NIIT, one of India's major software engineer training companies, that has 170 training centers across major cities in China. The FDI's have not been strictly unidirectional in the recent cooperation and growth in bilateral trade between these two Asian countries. Leading Chinese companies such as Huawei Technologies and TCL, specialising in telecommunications and household electronic components have also invested approximately \$250 million in setting up production facilities and R&D centres to serve as suppliers to the rising middle class in India and to remain internationally competitive (Peters, 2005).

### *Impact of China and India's Rise on Industrialized and other Emerging Economies*

Irrespective of the current global economic crisis, the adverse or positive affect of India and China as global players varies across countries. For example, Eastern European countries such as Poland, Hungary and Slovakia who have recently gained accession to the EU are likely to suffer more than say, France Italy or Britain, that are producers of technologically advanced goods such as luxury cars, commercial aeroplanes and household electrical components. The mentioned East European countries suffer more because of the export of jobs due to the comparatively lower cost and abundant supply of skilled labour in China and India in manufacturing and services. Boeing, Airbus, Volkswagen, GM and Siemens are the type of multinational firms from industrially advanced countries that are benefiting from China and India's economic rise. The potential for accessing the large internal markets within these two Asian countries, in addition to producing and exporting to other markets in Asia and Europe also mean that East European and other Asian countries which specialise in traditional industries such as textiles and footwear have also suffered rather than benefited from the rise of China particularly. On the other hand, the rise of China and India as major global players has also resulted in higher GDP growth rates in commodity exporting countries from Africa and Latin America that are feeding the industrial growth, particularly in China. For example, for Brazil, China has become the leading export market for minerals, steel and other commodity goods during the past decade.

The rise in commodity prices during the decade of the 2000's has been directly linked to increase in imports by China and India. This has been a blessing for Africa as a continent, at least over the short term. For example, Sudan, Angola, Burkina Faso, and the Congo are important exporters of cotton to China. Angola and Sudan mainly export oil to China. In addition to cotton, Cameroon also exports wood and oil to China. Over the past 30 years, there has been a 90% demand in growth for oil in developed countries. In Asia, the increase in demand has reached a staggering 400% (Santiso, OECD, 2006). One of the downsides to rising commodity prices and to the commodity goods export trend however is that it encourages developing countries from Latin America as well as Africa to continue to specialise in primary goods exports rather than to diversify into other higher end activities in manufacturing where returns are likely to be greater over the medium to long term. Secondly, the dependency on China for oil, coal, cotton, steel and other primary goods exports could mean that if there is overheating in the Chinese market and consumption is correspondingly reduced, then demand for these commodity goods would subside. Such a scenario would therefore expose these commodity exporting



countries to severe unforeseen shocks. In addition, China's footprints in Africa are becoming a great concern for human rights organisations and corruption observers as for unions and political actors. As an example, in Namibia 2009, China companies were accused of bribing authorities, in Sudan authorities accused mining Chinese companies of ignoring local labour force.

Developing countries from Latin America and Africa are not the only ones who have to adapt to developments in China and India. The outward flight of major multinational companies like Samsung and Philips from a one time low cost labour destination such as Spain, to China and India has also resulted in employment loss in certain areas. The phenomenon commonly referred to as "deslocalizacion", which refers to the process of relocation of multinational firms to more competitive overseas markets, has also created new opportunities for agile Spanish firms to increase their international competition by outsourcing R&D and manufacturing activities to these large Asian markets. Given that Spain's main area of comparative advantage is in banking, telecoms, the energy sector, logistics, construction and tourism, areas which fortunately for Spain also happen to be high demand areas for China and India, new business opportunities will present themselves to compensate for losses in other manufacturing areas. The key however will be to identify these challenges and to adapt to the specific conditions and needs of both these Asian markets. Spain, for example, can also play an important intermediary role between China and India in Latin America. Apart from the advantages that certain key sectors such as banking, telecoms and infrastructure have, firms across a broad range of sectors from Spain can benefit from the opportunities presented to them by China and India. The clear beneficiaries of the rise of China particularly, are consumers in the EU and the US. Consumers in both these regions are able to benefit from lower cost goods such as computers, sport shoes, television sets, washing machines and electric blenders produced in China by foreign firms. The quality of these goods is also no longer compromised by lack of technological inputs.

China and India are clearly aiming to become global powers in the 21<sup>st</sup> century, through exploiting the potential of their huge populations to take their rightful place on the world stage. In terms of the demographic changes that are expected to take place by the year 2030, India is forecasted to have a much younger working population in relation to China, with 28% of the working population between the ages of 15-29 compared to 19% for China. More alarmingly is that 23% of China's population is expected to be in the 50-64 year old group compared to only 9% for India (Financial Times, 2004). These projected demographic advantages do not guarantee that India will be able to achieve higher growth rates than China. Unless the primary and secondary educational system is improved as well as made more accessible and malnutrition and poverty levels are brought under control, advantages of being younger will not amount to much. In sum, both countries face different economic, political, social and environmental challenges in their ambition to become global leaders and to deal with sudden shocks as the current global economic crisis.

### *Reform in the Global Monetary System and the Rise of the Renminbi*

The British Pound was the main reserve currency throughout a large portion of the 19<sup>th</sup> century and when the British Empire declined the US dollar replaced it

in the 20<sup>th</sup> century. Early signals in the 21<sup>st</sup> century suggest a change of guard in the international monetary system with China's Renminbi threatening to replace the US dollar. However, serious doubts remain whether the Renminbi poses a real challenge to the dollar any time before the next decade, as history has shown that it generally takes time for confidence to be acquired by agents to carry out trade transactions and to accumulate foreign exchange reserves in a new currency.

### *Conflicts of Interest*

Considerable resistance would be met by China to have an alternative reserve currency replace the dollar, as this would substantially reduce the ability of the US to inexpensively finance its budget and trade deficits. The burden of responsibility prompted by the fall in value of the dollar has so far been shouldered by its creditors, who lend in the same currency. Commodities priced in dollars have also meant that imports to the US do not become more expensive when there is drop in the value of the dollar. Borrowing hence, would become more expensive for the US if countries were to diversify their reserve currencies. At present 67% of global foreign exchange reserves are in US dollars. There are several other factors which restrict the viability of the Renminbi becoming an alternative regional currency in Asia. For example, China would have to remove restrictions on money entering and leaving its borders, make the currency fully convertible for trade transactions and make its bond market more liquid and transparent. The fact that China means serious business on the other hand, can be seen in the setting up of currency swaps with Argentina, Belarus and Indonesia and permitting financial institutions in Hong Kong to issue bond denominated in Renminbi. This is an important step in creating a significant domestic and international market for its currency. If the Renminbi were to replace the dollar in the medium term, for the US it would mean that the high cost of borrowing would lead to a decline in consumption, investment and growth. For Asia, transacting in Renminbi's would foment an increase in regional trade. For China, on the other hand, it would mean adopting on a role very similar to that of Germany in the EU, by subsidizing the economically weaker countries in the region. In sum, it would mean shifting the focus to regional security as opposed to solely protecting its national interests. Other substantial challenges facing China up until now has been the political barrier in collaborating with Japan (the only country in the region with international banking experience), its historical adversary in the development of an Asian Currency Unit. The fragility of the existing international monetary structure brought about the current financial crisis has now once again reopened the debate.

### *Contradiction and Problems with the Existing International Monetary System*

The US has gone from being a net lender since WWII to becoming a net borrower, whereas in the 21<sup>st</sup> century, China has turned into a creditor country with strong growth, low debt in proportion to GDP and large current account surpluses. In the late 1980's, China's foreign exchange reserves were estimated to be around \$167 million. At present, China's foreign reserves are in the region of \$2 trillion, and approximately \$1.5 trillion of it is invested in dollar assets, mainly US treasury bonds and quasi-sovereign securities issued by Fannie Mae and Freddie Mac. With the onslaught of the 2008 global financial crisis, world attention is heavily focused on China's massive stock pile of US dollars in foreign



exchange reserves. The Chinese government is understandably very concerned about the safety of its investments in the United States. However, even with an ongoing global recession there seems to be no sign of decline by China to accumulate US dollars, as the Euro is perceived as even less stable than the US dollar due to fears over the future of European Monetary Union. To offset the vulnerability created by the projected decline in value of the dollar, policy makers in Beijing are pushing for a greater role in international trade through the use of special drawing rights (a currency devised by the International Monetary Fund in 1969), while being well aware that the US can veto an IMF decision. Hence China's position can be taken as a warning signal to the United States rather than as any sort of immediate threat or demand for global monetary policy reform. During G20 meeting held in April 2009, China and other emerging economies acquired greater influence within the IMF. The crisis, which resulted in greater harm on the economies of many developed countries, has enabled emerging economies to become more aware of how the world is transforming in terms of power relations and how their own power and influence is rising. China will soon want to have the Renminbi included in the new international currency, which China's central bank governor, Zhou Xiaochuan, describes as a "super-sovereign" reserve currency that doesn't belong to any particular nation, and made up of SDR's (a basket of dollars, Euros, pounds and yen), for use as a means of payment in bilateral trade. In the short run, the existing monetary structure is unlikely to change, but cracks in the system are more visible and it is only a matter of time before the US dollar's influence as the dominant foreign exchange reserve is offset by re-emerging China (Peters, and García-Herrero, 2010, forthcoming).

#### **4. Conclusion**

##### *Concluding Observations and Remarks*

The principle aim of this discussion paper has been to draw attention to the broader social and political implications of the current global economic crisis for both India and China rather than to focus purely on its direct economic outcome on both countries. The paper highlights the significant changes that are taking place in the bilateral relations between China and India and the impact that these two countries are having on industrially advanced and other emerging economies. The paper also identifies the main challenges to governance faced by China and India that stem from the current crisis, which are linked to rising unemployment, controlling poverty, providing universal access to and improving the quality of education, environmental degradation, global imbalances and monetary policy shifts. An additional critical factor that is likely to place serious social and political stress on both countries is regional instability brought about by a decline in economic growth in neighboring countries. Rather remain too focused on meeting national goals both India and China will have to play a more important role at a regional level as well as on a global scale. This challenge will be particularly acute for India, with politically unstable neighbors such as, Pakistan, Nepal, Bangladesh, Myanmar and Sri Lanka. Though India has been largely spared of the direct harmful economic consequences of the global economic crisis, its neighbors certainly have not. Moreover, the austerity measures being carried out by industrially advanced economies suggest that development aid to these mentioned countries in South Asia will likely be scaled back substantially or cancelled altogether. India will hence need to play

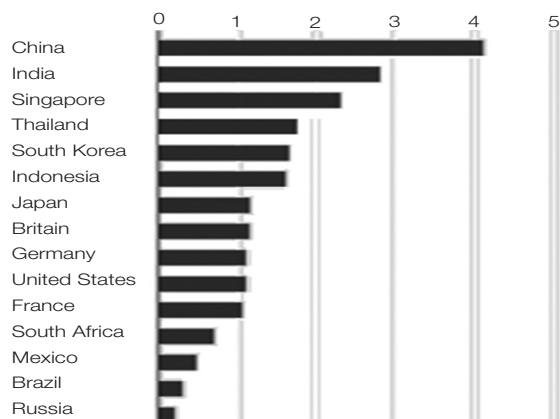
a much more active role to ensure economic stability in the region instead of focusing purely on national interests. It is in India's long term national interest, for example to have a stable Pakistan as its neighbor. The long standing conflict over Kashmir could become accentuated if Pakistan's economy falls further into a state of disarray and social unrest increases. India runs the risk of having to face large scale immigration into the country from bordering nations and other social tensions connected to Pan-Islamic fundamentalism if it focuses too much on self preservation and solely promoting national interests. The fight against global terrorism may become a secondary priority for countries such as the US and for the EU, in order to address challenging domestic pressures, and India will need to fill this vacuum through international dialogue and greater economic commitment. Regional cooperation in South Asia has one of the poorest records thus far. The countries in the region share public commons such as environmental degradation, water resource management, security and terrorism which cannot be effectively managed by any single country. The signing of the India-ASEAN free trade agreement in April 2009 was a positive step towards sharing the burden of responsibility in economic development in the region.

Both India and China are undergoing a major demographic transformation, with a shift to urbanization of more than half the population in both countries, amounting to one billion people. This process is taking place at exponential speed and both countries will need to adjust to the social and environmental impact of resource use and the availability of services to absorb such a rapidly growing population from rural areas. Inclusive growth will have to be given higher priority in both countries, to avert social unrest. Thus far, the level of inequality in living standards, per capita income and general well being in rural versus urban populations in both countries is one of the most major sources of political and social instability.

The current global economic crisis is different from previous financial crises, which have either been restricted to a country or to a specific region. The dilemma of addressing global imbalances thus goes far beyond the responsibility of one or two countries such as China and the US, or a specific region of the world. Developed nations of the world will need to cooperate and work closely with economically powerful emerging economies such as China and India rather than to perceive their growing influence as somehow threatening to their own economic stability. It is only through viewing the challenges faced by India and China in sustaining high economic growth to address poverty reduction, minimize inequality, control environmental degradation and achieve socio-political progress as a collective problem that we can collectively find solutions that face an ever globalized and integrated world economy. This harsh realization, fortunately for the welfare of humanity at least in the short term seems to be gaining steady ground over national interests.

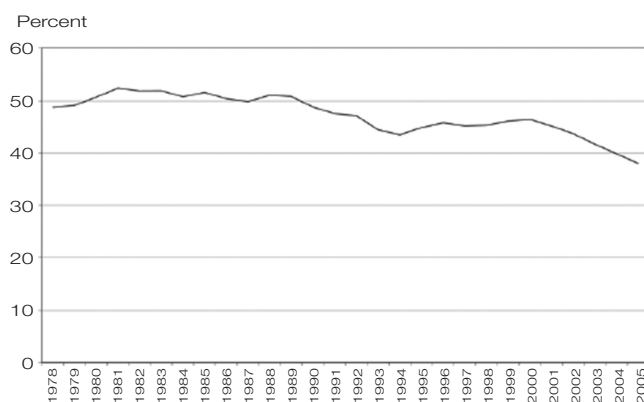
## Annex

Chart 1. Total Factor Productivity, average annual growth 1990-2008, %



Source: The Economist "Secret Sauce" 12<sup>th</sup> Nov 2009.

Chart 2. China's Household Consumption as Percent of GDP, 1978-2005



Source: China: Rebalancing Economic Growth. N. R. Lardy 2007

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## **‘The Road to Sustainable Growth: An East Asian Perspective’<sup>55</sup>**

**Yun-han Chu<sup>56</sup>**

### **The Resilient East Asia**

Asian economies were not insulated against the impacts of the global financial crisis. Their dependence on trade through global production networks and export-led growth strategies made them vulnerable to the sharp contraction of demand from the North American and European economies. However, the region has proven to be more resilient than the rest of the world and is poised to lead the global economic recovery.

By late September of 2009, the Asian Development Bank has upgraded economic growth forecast in East Asia to 4.4 per cent from 3.6 per cent. China alone is now expected to grow by 8.2 per cent in 2009 and 8.9 per cent in 2010, up from the March forecast of 7 per cent and 8 per cent, respectively. The prospects for South Asia have also improved with growth expected to hit 5.6 per cent this year, up from the initial forecast of 4.8 per cent. Emerging signs of a recovery in private business confidence and a continued large fiscal stimulus announced in the July 2009 budget helped bolster India’s projected economic expansion to 6 per cent this year, upgraded from 5 per cent. The aggregate growth in South-East Asia was projected to slow to 0.1 per cent in 2009, still slightly better than the initial forecasts of a negative 0.7 per-cent growth. Rising growth in Indonesia and Vietnam has partially overcome drops in other South-East Asian economies most exposed to international trade, such as Malaysia, Singapore and Thailand.

Four factors contributed to the region’s stronger than expected economic rebound. First, the region was relatively well insulated from the global financial meltdown as it had inherited a relatively healthy state of financial systems prior to the sub-prime loan crisis and built up a huge foreign reserve as a hedge against a replay of the 1997 regional financial crisis. Asset bubbles were either not alarmingly threatening or they had been contained well before the current crisis as in the case of China. Second, most East Asian economies have shown considerable resilience, thanks in part to high household savings during good times on which they could fall back upon during lean times without having to make drastic cutbacks in private consumption. Third, the macro-economic

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55. This paper was prepared as an input document for the discussion that took place during the Club of Madrid’s Annual Conference

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fundamentals were quite healthy in most East Asian economies. Except for Japan, most governments were not heavily indebted and they still enjoyed spare fiscal capacity to borrow and spend. So most East Asian governments and central banks responded to the global financial crisis with decisive and firm fiscal and monetary actions. Last, but not least, the region's resilience should be attributed to the rapid turnaround in the region's larger, less export-dependent economies. Although adversely affected, China and India are not in recession: their huge domestic sectors helped cushion the impact. Exports constitute just 35 per cent of China's GDP and 22 per cent of India's.

## **The Root Causes of the Crisis**

Most East Asian policy makers and economic thinkers take issues with the view that a savings glut from Asian surplus nations was the main culprit of the global crisis. It is true that after the Asian financial crisis of the late 1990s, most developing countries in the region insured themselves through managing exchange rates and building huge currency reserves. So that they could be protected against the tempests of currency speculation and never again would have to call on the emergency lending windows of the IMF.

While some of these insurance measures contributed to imbalances and tensions in the global economy, they were the symptoms, rather than the root causes, of the inherent vulnerabilities and systemic risks in the existing international monetary system. The frequency and increasing intensity of financial crises following the collapse of the Bretton Woods system suggests that the cost of the current system has exceeded its benefit. The dollar, as the predominant international reserve currency, is not anchored to a stable benchmark and issued according to a clear set of rules. Furthermore, the supply of dollars is not disconnected with economic conditions and sovereign interests of the United States. As a result, an orderly issuing of reserve currencies for securing global financial stability and facilitating world economic growth has become an ever more illusive goal.

More broadly speaking, the current system of global economic governance forged in the middle of the 20th Century has been overtaken by the fundamental economic shift taking place in the last twenty years. The breakdown of the planned economies in the Soviet Union and Central and Eastern Europe, the economic reforms in China and India, and the export-driven growth strategies of East Asia contributed to an enlargement of world market economy at breath-taking speed. The size of active participants in this enlarged globalized economy has grown from about 1 billion to more than 4 billion people. Both the legitimacy and effectiveness of G8, the IMF and the World Bank, has been much undermined as their rules of representation and decision-making could not reflect the weights and new responsibilities of these emerging economic powers.

This outdated global system of economic governance was also intellectually flawed as it was designed around a dubious intellectual underpinning, namely "rational market" theory. The gospel of financial deregulation has given rise to an explosion of unregulated shadow banking activities by non-bank financial institutions and hedge funds. The complexity of their off-balance-sheet transactions and hedging strategies and the systemic risks they have created

were simply beyond the grasp of national and international regulators and supervisors.

Most East Asian thinkers agree with the diagnosis of Simon Johnson, the former chief economist at the IMF, who pointed out that the mismanagement in U.S. financial system was not a series of random accidents. Rather it was the result of loose government regulation and perverse incentives that tied executives' compensation with short-term performance. In the final analysis, they were the outcome of a political process through which regulators were captured intellectually by the Wall Street.

Many East Asian policy makers also shared the view that central banks in the developed world have been complacent about the gigantic risks that asset price bubbles posed to the real economy of jobs, production, savings, and consumption. The U.S. Fed's repeated efforts to contain the damage of the burst of bubble to the real economy through aggressive easing of interest rates have merely delayed the necessary structural adjustment and market correction and produced bigger asset price bubbles later on and aggravated the problem of "moral hazard".

In a nutshell, both the existing system of global economic governance and its intellectual tools have not been grounded on the "reality" for too long. This outdated system calls for not just some patched-up changes but a timely overhaul.

### Road to Sustainable Growth

With perhaps the exception of Japan, all East Asian countries welcome Barack Obama's announcement at the Pittsburgh Summit that in the future G20 will replace G8 as the world's premier coordinating body for economic issues and possibly other global challenges as well. Although revamping this premier global economic forum was introduced on an *ad hoc* basis to manage the financial crisis, it ushered in a new era of global economic governance. The G20 could play an important role in facilitating and inducing East Asia to pursue crucial structural reforms to rebalance the global economy. It could also facilitate discussion and deliberation to develop a set of new principles and guidelines for the adaptation of global economic institutions and arrangements to the new challenges.

Most Asian countries strongly felt that a sweeping reform of the international financial institutions, in particular the IMF, was long overdue. Many Asian leaders have consistently urged that the voice and representation of the developing countries be realigned to reflect their contributions to global outputs. They have also advocated an overhaul of the Fund's lending and conditionality framework. In that context, Asian countries generally support the introduction of "Flexible Credit Line (FCL)" as a new crisis prevention mechanism for countries with strong fundamental, policies, and track records of policy implementation. They also support IMF to enhance its cooperation with the Financial Stability Forum (FSF) and to complement each other's role in promoting financial stability, and strengthening the regulatory authorities' responsiveness to risks, including works on an early warning system.

Most East Asian leaders also endorsed a sweeping reform of national and supranational regimes of financial regulation. It is essential to revamp the regulatory



regime so as to cope with global conglomerates with too big to fail nature and pose systemic risks to the financial system. It is imperative to expand the scope and mandate of the existing regulators so that they are equipped to reign in non-financial firms that have grown out of traditional border boundaries and created new frontier of risks. It is also imperative that financial regulatory standards within and across national borders should be updated to effectively supervise new financial products and innovations. However, they don't have high expectation for a sweeping change because so far there is very little real reform under way or on the table.

Most Asian economic thinkers are inclined to endorse the recommendation to the United Nations General Assembly by the Commission of Experts on Reform of International Finance and Economic Structures. As Joseph Stiglitz, the chairman of the Commission, suggested, the crisis provided the impetus for pushing for a comprehensive regulatory system focused more intensely on large, "systemically significant" institutions and countries. The new regulations could be propped up by incentives encouraging good risk behavior and policies that would keep banks from becoming too big to fail.

The commission's report also promoted the ideas that countries and markets may also experiment with financings denominated in Special Drawing Rights (SDR), which reflect a portfolio of major currencies. Eventually SDRs could be upgraded to function as a type of global reserve currency. Moreover, an increase in SDR allocation would help the IMF address its resources problem and the difficulties in the voice and representation reform.

The Commission's recommendation reinforced the persuasive power of an earlier proposal put forward by Zhou Xiao-chuan, the Governor of the People's Bank of China. Zhou openly advocated with exceptional candor the creation of a super-sovereign reserve currency for the replacement of the United States dollar as the world's standard reserve currency. He argued that doing so will not only eliminate the inherent risks of credit-based sovereign currency, but also make it possible to manage global liquidity. A super-sovereign reserve currency managed by a global institution could be used to both create and control the global liquidity. And when a country's currency is no longer used as the yardstick for global trade and as the benchmark for other currencies, the exchange rate policy of the country would be far more effective in adjusting economic imbalances. This will significantly reduce the risks of a future crisis and enhance crisis management capability.

More specifically, Zhou proposed that special consideration should be given to giving the SDR a greater role. The SDR has the features and potential to act as a super-sovereign reserve currency. Therefore, SDR allocation should be increased steadily and the scope of its use should be broadened. As a first step, a settlement system between the SDR and other currencies need to be set up. This will make the SDR, which is now only used between governments and international institutions, a widely accepted means of payment in international trade and financial transactions. Another measure to increase its appeal is to create financial assets denominated in the SDR. In addition, the use of the SDR in international trade, commodities pricing, investment and corporate book-keeping should be actively promoted. These steps will eventually enable SDR to fully satisfy the member countries' demand for a reserve currency.

However, most East Asian policy makers don't think a transition from the current system to the new system designed around a super-sovereign reserve

currency is imminent. Nor do they think that the transition, if it ever comes to pass, will be smooth. So a fundamental fix to the inherent vulnerability and systemic risks of the existing global monetary regime is not in sight for the time being. The United States simply would not forego her seigniorage benefits of reserve creation in the foreseeable future. As a consequence, most East Asian economies still feel the need to build up their own shock-absorbing capacity through managing exchange rate and stockpiling foreign reserve to protect themselves from the tempest of financial turmoil. The implication, however, is straightforward. If the dollar remains the predominant reserve asset, specifically if the growth in reserves continues to consist principally of dollars, then East Asian economies' reserve objectives can be satisfied only if global imbalances persist. A new (but different) crisis will eventuate before long, this time most likely caused by an unacceptable level of indebtedness of the United States.

With that dire prospect in mind, East Asian countries are motivated to seek mutual assistance through bilateral or regional arrangements with greater vigor. First, major East Asian economies have expanded their bilateral currency swaps mechanisms with their major trading partners to make a larger share of their bilateral trade to be settled in local currencies rather than U.S. dollars. Next, under the auspices of ASEAN Plus Three (APT), two regional financial cooperation initiatives, the Chiang Mai Initiative Multilateralisation (CMIM) and the Asian Bond Markets Initiative (ABMI), are well underway. The CMIM established a framework of mutual assistance among APT countries to address each others' short-term liquidity difficulties. The ABMI initiative was designed to promote the local currency bond markets and enhance the recycling of regional savings towards developing regional bond markets.

At a special meeting held in Phuket in February 2009, APT members have agreed to increase the size of the CMIM by 50 percent from US\$ 80 billion to US\$ 120 billion, and to develop a more robust and effective surveillance mechanism to support the operations of the CMIM. In their May 2009 meeting in Bali the finance ministers of APT have reached agreement on all the main components of the CMIM, including the individual country's contribution, borrowing accessibility, and the surveillance mechanism, and decided to implement the scheme before the end of the year. At the Bali meeting, the finance ministers also reiterated their pledge for expanding the role and function of Asian Development Bank (ADB). A planned capital enhancement will augment ADB's capital base to an appropriate level. A Credit Guarantee and Investment Mechanism (CGIM) will be established as a trust fund of the ADB to support the issuance of local currency-denominated corporate bond in our region.

In private, most Asian sovereign holders of U.S. treasuries are deeply concerned that the U.S.'s spending and planned record fiscal deficit will eventually lead to inflation and a loss of confidence in the dollar. The deficit is projected to reach \$1.75 trillion in the year ending Sept. 30 from last year's \$455 billion shortfall, according to the Congressional Budget Office. However, publicly most Asian countries do not want to push this issue too hard. If they sound too alarmist and contribute substantially to a dollar and Treasuries sell off, they are going to feel more pain than the rest of the world at least in the short run. Collectively East Asian economies hold more than two third of the \$3.428 trillion foreign-owned Treasuries as of July 2009, with China and Japan respectively holding \$800.5 billion and \$724.5 billion.

Nevertheless, Asian countries will open their eyes for other options to the dollar. Disparaging demographics and growth prospects make Japanese Yen an

increasingly unlikely candidate. In the near terms, the Euro's acceptability could grow. Over the horizon, Renminbi poses the biggest challenge to dollar's status as the predominate reserve currency, especially in Asia. Most notably, China is moving toward gradual internationalization of its currency. China has introduced a series bilateral currency clearance centers along its borders with Central Asia, Vietnam, Laos, Thailand and Myanmar, to make it easier for trading partners to do business in Renminbi. China recently announced that foreign companies will be able to list their stocks in China, a step toward making Shanghai an international financial center. Also, as a substitute for full currency convertibility of its currency, in September 2009 Beijing issued for the first time Renminbi-denominated government bonds to offshore investors through Hong Kong. This is widely regarded as a strategic move for advancing its long-term objective of developing a fully-fledged offshore Renminbi bond market with enough depth and liquidity.

In the past, Asian economies have benefited immensely from trade liberalization and the process of economic globalization in general. They are fully committed to the principle of open regionalism and firmly uphold the WTO-centered rule-based system. They embraced the anti-protectionism and pro-Doha Round joint statements of the G20 London Summit. However, they are concerned with the recent political trends in the developed world. Virtually all OECD countries have violated in some degree their pledges not to take protectionist measures when they formulated their anti-recession policies and measures, or choose to target their financial support for specific industries, and the inhibitions on their doing so may erode with time.

They are equally concerned that the United States will not be able to provide international leadership needed in the trade arena for some time. The recent two American national elections, particularly the 2008 Congressional elections, brought large numbers of new, mostly Democratic members of Congress who are highly skeptical of freer trade agreements. Obama's campaign rhetoric, particularly his call for renegotiating NAFTA during the primary season, although skirting outright protectionism gave the appearance of a protectionist approach. Domestic U.S. industries may be further encouraged to seek protection as a result of a more sympathetic political environment for protectionism in the United States. This was widely regarded as one of the main dangers of the decision to award Section 421 safeguard protection against Chinese tires in September 2009.

Policy makers in the region also share a worry that the Doha Development Round has been the longest-running negotiation in the history of the modern trade negotiating system, and it threatens to be the first to fail. Delays have already prevented the harvesting of trade liberalization measures that have already been promised. This has already precipitated the proliferation of bilateral and mini-lateral agreements. South Korea has been the front runner in seeking bilateral preferential arrangements. It signed the FTA with the United States in 2007 and struck a similar deal with EU in October 2009. More Asian economies will follow South Korea's path.

In the aftermath of the crisis, all East Asian policy makers recognized that the old export model of growth won't be sustainable in a more "balanced" global economy in which the U.S. consumers will have to save more and spend less. A necessary strategic adjustment entails rebalancing the dependence on export-led

growth with more regional and domestic demand. Most East Asian emerging economies look to exploit the vast potential demand in China and India and the region's savings glut. This suggests that more of the region's savings should be intermediated within the region and that intra-regional production networks could be deepened by investing in regional infrastructure to speed up intra-regional shipments, by promoting trade in green technologies and by greater reliance on trade in services. The official launch of the ASEAN-China FTA in 2010 will be a crucial step in advancing this common vision.

All East Asian leaders also fully recognized that their economies are now entering a post-crisis, low-carbon world. They quickly adopted "low-carbon green growth" as their new paradigm of sustainable growth which uses less energy and is more compatible with environmental sustainability. Japan has already sped ahead of the rest of the world in hybrid-car technology. China is emerging as a leader in electric cars, solar power and wind power. The South Korean government is spending \$31 billion to fund research in 27 green technologies, including non-silicon-based solar cells, biomass fuels and carbon collection, storage and processing. Green projects account for 81% of South Korea's economic-stimulus programs and 38% of China's. At the latest Northeast Asia Summit held in Beijing in October, In particular, the leaders of China, Japan and South Korea share a bold vision to push for East Asia's bid for economic leadership in the low-carbon age. They have hammered out not only a united front for the Copenhagen climate conference in December 2009 but also a joint plan to pool their resources and expertise to develop and commercialize emerging green technologies. Many observers believe that it is a hardheaded, shrewd initiative to marry Japanese and South Korean high technology with China's manufacturing prowess, massive domestic market and bulging foreign-currency reserves.

### **Asia's Place in the World**

Many prominent Asian thinkers see the region at a crossroads. Asia is poised to occupy a unique place in the world. By 2030 three of the world's four largest economies will be located there and the world's two largest populations live side by side. By 2020 China will produce 44 per cent of Asia's economic output and India and Japan will account for 17 and 15 per cent, respectively, as estimated by the Asian Development Bank in its 2008 study *Emerging Asian Regionalism*. Together the three will be 20 per cent larger than the US economy. As China and India emerge as economic powerhouses they will compete with Japan and each other for influence and leadership of the region – unless a serious commitment to community building creates common goals and channels for closer cooperation.

The absence of an acknowledged leader, however, constrains the scope and speed of deeper integration in East Asia. Without an accepted champion to provide focus and set priorities governments have to be content with incremental change. For some time ASEAN has been regarded as the core, particularly by China which assumes any initiative it might take would be highly suspect by the smaller countries. Cooperative regional institutions serve China's objective of developing closer friendly relationships in the neighborhood and its desire to counter-balance US influence but the impetus must be provided by others. At present, evolving regional institutions have ASEAN at the core and other

countries joining extensions depending on the purposes of the group. The institutionalization of the Northeast Asia Summit has the potential to provide the region with a more visionary and resourceful collective leadership. This prospect looks much more promising after Japan's recent political earthquake as the Japanese new Prime Minister Yukio Hatoyama is firmly committed to the goal of building up an East Asian community.

The geographical scope of the burgeoning Asian regionalism is yet to be defined. The Japanese proposal to expand the membership of East Asian Summit to include Australia, New Zealand and India open up the possibility of building up a second layer of integrated economic community on the basis of the emerging ASEAN Plus Three trading bloc. Unexpectedly, the G20 leaders' summits organized on an ad hoc basis to manage the financial crisis may turn out to be the catalyst for a sharper focus on deeper regional integration on a grand scale. Six Asian economies are members, the three Northeast Asians plus Australia, India and Indonesia, and each is an equal at the global table. This new 'definition' of the six as equals in global strategy could be the basis for a more strategic approach to trade, finance, energy and environment in the region. The membership of the 'Asian 6' countries also confers an expectation that they will think and act in the global interest. This expectation could translate this into a sub-group providing strategic leadership on the world stage.

East Asia can drive the critical post-crisis structural reform of the global economy. For the time being, the G20 is for reactive purposes, with the financial markets still in shambles. In the near future, there will be other post-crisis management issues on which G20 members will have to cooperate. But looking down the road the G20 should move from being reactive to proactive. The question is if G20 leaders have the stomach and appetite to address these next-generation issues. East Asia does.

## **About us**

The Club of Madrid responds to the demand for leader-to-leader support to confront today's global, regional and national democratic leadership challenges. It is an independent organization dedicated to strengthening democratic values and leadership around the world by drawing on the unique experience and resources of its Members – more than 70 democratic former Heads of State and Government from 50 countries who contribute their time, experience and knowledge to this mission. The Club of Madrid's membership constitutes the world's largest forum of ex-Presidents and ex-Prime Ministers and offers today's leaders an unequalled body of knowledge and political leadership

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