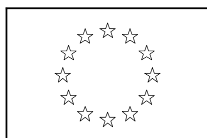

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Responses to the Challenges of Globalisation: A Study on the International Monetary and Financial System and on Financing for Development

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Responses to the Challenges of Globalisation: A Study on the International Monetary and Financial System and on Financing for Development

This report responds to a request by Finance Ministers to the Commission on 16 October for a study on the Responses to the Challenges of Globalisation. In line with the terms of reference, the Commission has focused on two main issues: the discussion on the reform of the international monetary and financial architecture as a response to global financial crises and the issue of financing and promoting development as a means to reduce global inequality. While the report reviews some of the economic facts and features of the current globalisation process, it does not focus upon many other important aspects of globalisation in the fields of social policy, health and environment. These topics are addressed in the Commission's Communication "Towards a Global Partnership for Sustainable Development", which sets the parameters for a comprehensive and balanced approach by the EU towards a global deal.

Given the limited time available and the broad scope of the terms of reference, the report does not include original research, but builds on existing literature. It attempts to reflect some of the ongoing debate among academics, policy makers and non-governmental groups as input for a policy discussion at Commission and Council level.

Globalisation: Where Do We Stand?

Globalisation is a process that has been ongoing, albeit not in a linear fashion, over a long period. Post-war globalisation has many facets. In the economic and financial sphere, which is the subject of this Communication, it has been characterised by a strong expansion of trade in goods and services and, more recently, by a strong expansion in capital flows. Several factors are underlying this growth process including technological progress, leading to dramatic reductions in transportation costs and an unprecedented increase in information processing capabilities, and public policy measures, such as a lowering of quantitative and tariff restrictions on trade and the liberalisation of capital movements.

The process of globalisation over the past fifty years has been accompanied by a six-fold rise in world output while the global population increased about two and a half times. This translates into major improvements in the income of a substantial part of the world's citizens and into increased resources with which to tackle policy challenges. The past fifty years have further witnessed major improvements in other indicators of human welfare and quality of life in a large number of countries, including significant improvements in life expectancies at birth.

Although correlation does not imply causality, there is little doubt that the substantial increases in global per capita income that have been achieved would not have been possible without continued progress towards deeper economic integration. Recent studies from the World Bank confirm that developing countries that have opened up their economies over the

last twenty years have had a growth performance superior to those that have not pursued international economic integration.

However, despite the overall increase in income and welfare, the gap between richer and poorer countries and between richer and poorer segments of the population within countries has probably widened. In particular, it should be recognised that while globalisation is likely to benefit overall those countries that are able to participate in it, it does create problems for certain categories of the population. An example of this is the mixture of reduced relative wages and employment opportunities that have affected low-skilled workers in industrialised countries. Public policies have an important role to play in tackling the difficulties faced by those that may lose from globalisation, while ensuring that those countries that integrate into the global economy are able to reap the overall benefits.

There also remains a group of, mostly very poor, countries that are less integrated into the global economy and that continue to be largely excluded from the benefits of the globalisation process. South Asia and Sub-Saharan Africa lag far behind regions such as East Asia and the Pacific. Their share in world trade has fallen, their terms of trade have deteriorated and they continue to be unable to attract foreign capital. Improving living standards and the economic situation in these countries is one of the major challenges for the global economy.

In addition, globalisation is associated with other challenges such as communicable diseases, climate change, loss of biodiversity or lack of international security. Addressing these issues - that is, providing the world with global public goods - can be seen as part of a strategy aiming at maximising the benefits of globalisation and minimising its negative effects. These global public goods benefit developing and industrial countries alike. They are an additional task to poverty reduction and their financing should be explored.

The increased internationalisation of economic activity that globalisation has brought raises issues about the appropriate level of economic policy-making and the capacity of national governments to set rules and standards. In this context, the report notes that over the course of the 20th century, the role of the state in economic activity has increased significantly in many developed countries. This has been partly due to the post-war development of social safety nets and welfare systems that are seen to play an important risk-reducing role in societies that are exposed to international competition.

The report also highlights the fact that since the end of the Second World War, major progress was made in establishing a set of international and regional institutions and fora that provide international economic and financial governance. The current institutional arrangements are seen to constitute a more robust set of institutions and fora to deal with global policy challenges than existed during previous waves of globalisation. However, new emerging challenges point to a number of inadequacies in the system, and reform proposals concerning various aspects of this governance system are currently discussed.

The International Monetary and Financial System in a Globalised World

The Commission study looks in more detail into the evolution and the functioning of the international monetary and financial system and finds that, overall, the system has functioned well over the past half century. It has complemented the strong growth in trade of goods and services by channelling savings into productive investment world-wide through open and well-functioning financial markets and by providing efficient clearing and settlement systems.

It has thereby contributed to global economic growth and has allowed countries embracing sound policies to raise the living standards of their population. The system has also been able to cope with periods of disequilibria in balance-of-payments and has ensured monetary stability in times of financial stress.

Nevertheless, recent experiences have brought to the fore a number of real or potential systemic weaknesses, posing new challenges to policymakers. Although the integration of financial markets and the institutional and regulatory frameworks in which they operate have spurred economic growth, the international monetary and financial system has continued to be crisis-prone. With the exception of the ERM crisis of 1993, the crises of the nineties have mainly affected emerging market economies and, for most of them, have had important consequences in terms of output loss, welfare, social conditions and unemployment. In addition, the changed international financial environment has been seen as allowing abuses in terms of money laundering, financing of illegal activities and tax evasion.

Recent years have seen the emergence of numerous proposals on how best to adapt the international monetary and financial system to the changes and challenges of a global economy. The report reviews the current policy debate and provides a short analysis of the pros and cons of the main reform proposals, their political and practical feasibility as well as an assessment of the necessary conditions for success. The reform proposals have been grouped into four categories: modalities of crisis prevention and management, initiatives to reduce the abuses of the international financial system, regional and global co-operation, and reform of the institutional framework.

Modalities of Crisis Prevention and Management

The proposed solutions are numerous: they range from very modest ones, such as increasing and improving the flow of information to market participants, to very ambitious ones such as the creation of a single world currency. Some initiatives are in the process of being implemented, reflecting a high degree of consensus among the international financial community; others lack at present sufficient political support or would imply a too high level of public interference in the markets. Whereas most of the proposed changes could be dealt with within the existing framework, some of the more ambitious ones would require the creation of a new institution or a much more profound reform of the international financial architecture.

At the crisis prevention level, suggestions for further progress that are broadly accepted include increasing transparency in policy design and implementation, and improving the flow of information to market participants; developing and deepening financial markets and strengthening domestic financial systems to make countries less vulnerable to crises; and strengthening the foreign exchange reserves of emerging market economies. Their implementation by many countries is already contributing to making the system more predictable and more resilient to shocks.

Progress is also being made on other fronts but at a slower pace because these proposals are either of a less consensual nature or more difficult to implement in practice. These proposals include the development of early warning systems; the introduction of collective action clauses into new international bond issues of emerging market economies; the creation of Clubs of Creditors; the development and use by emerging market economies of financing

instruments that can be used as a first line of defence in case of crisis; and the need to ensure an orderly and well-sequenced capital account liberalisation process.

Finally, there are a number of proposals that have yet to gather sufficient support by policymakers and which often require important institutional changes, the merits of which need to be carefully weighed. Establishing an international debt insurance agency, creating an international prudential supervisory agency or introducing a currency transactions tax are among the more visible proposals.

While not claiming to be exhaustive, the report pays particular attention to the use of a currency transaction tax as a tool to stabilise exchange markets. Proponents of a tax on international currency transactions argue that it would contribute to exchange rate stability by reducing arbitrage and speculation. The literature, however, suggests that the tax may actually increase volatility, as trading volumes are likely to fall significantly following its introduction.

At the crisis resolution level, a topic high on the international agenda is to find the proper balance between adjustment by the debtor country, official financing, and private financing. This balancing exercise has become much more complex than 20 years ago. The question also arises whether, and to what extent, the balance should be tailored to specific country circumstances. This highlights the importance of making further progress in clarifying and developing further the principles for private sector involvement in both the prevention and the resolution of financial crises. The international community has also recently recognised the need to analyse how a clearer and more solid legal framework for debt standstill, debt restructuring, and debt reduction could contribute to facilitate orderly crisis resolution. Here too, some proposals imply more significant institutional changes.

Reducing the Abuses of the International Financial System

The use of the international financial system for illicit purposes has become a major concern. Characterised by a high degree of openness and decentralisation, the system is being used for criminal activities, including money laundering and the financing of terrorism, for tax evasion and for the circumvention of regulations. In some cases, corporate entities are deliberately created for such purposes. The abuse problem is compounded by the existence of a number of countries and judicial territories that see their comparative advantage in granting favourable tax and regulatory environments for non-residents funds. Financial abuses can threaten the credibility and undermine the integrity of the international financial system and affect countries at every stage of development.

In response to these challenges international collaboration has been intensified through existing fora and organisations, such as the G7 Finance Ministers, OECD work on harmful tax practices and the Financial Action Task Force on money laundering and on the financing of terrorism. The Financial Stability Forum established in 1999 has worked on a variety of questions, including the activities of highly leveraged institutions and offshore financial centres. Specific actions have been taken against terrorist financing. In line with UN Security Council Resolutions, assets of targeted persons and organisations associated with the Taliban have been frozen. Increased corporate transparency and better integrated supervisory systems are seen as necessary conditions to prevent the misuse of corporate vehicles for illicit purposes.

A common challenge to most of the proposals reviewed is the question of how to ensure compliance of non-signatory third partners. It is sometimes argued that better compliance with international rules and practices could result from improved co-ordination between the existing institutions engaged in related projects. Furthermore, the fight against unfair practices has to be placed in the broader context of a coherent and sustainable approach to development.

Regional and Global Co-operation

The study also reviews initiatives to enhance the stability of the international monetary system through intensified macro-economic co-ordination within the context of regional groupings and among the three major currency areas (G3). Regional macroeconomic and monetary co-operation are frequently seen as a way of strengthening economic integration, growth and stability. The introduction of the euro provides an example of successful regional integration that has not only been beneficial for Europe but also is likely to contribute to the stability of the international monetary and financial system. Although the European experience cannot be translated directly, it provides an example to other regions of the world. While Asian economies have made progress in enhancing financial and monetary co-operation in the region, monetary co-operation policy has, so far, played no or only a negligible role in the design of regional economic integration schemes in the Americas. This raises questions about the compatibility of different exchange rate systems with the objective of regional integration.

Against the background of growing economic and financial interdependence, and the potential for more sudden and deeper spill-overs of shocks between the three major currency areas, a number of proposals advocate some kind of exchange rate co-ordination between the G3. Proponents argue that the targeting of exchange rates among the G3 currencies would increase the overall stability of the international monetary and finance system, implying fewer crises and higher growth for both the major currency areas as well as for emerging economies and developing countries. Others claim that this would imply that monetary policy authorities would lose to a significant degree the ability to react independently to external shocks and domestic policy priorities.

Towards Improved Governance of the International Monetary and Financial System

Discussions on improving the governance of the international monetary and financial system often focus on the International Monetary Fund (IMF), where significant decision making power related to the international monetary and financial system is vested. Over the past fifty years, the institution has been able to accommodate a substantial increase in both its membership, thereby becoming a quasi-universal institution, and in the scope of its mandate. Recently, however, there have been calls from emerging market economies, NGOs and national parliaments for more legitimacy, more accountability, and better governance for the Fund. Progress has been made to address these concerns, including through increased transparency of the IMF decision process; through the creation, outside the IMF, of groups such as the Financial Stability Forum and the G20; and through the transformation of the Fund's Interim Committee into a more permanent International Monetary and Financial Committee. However, proposals with a greater institutional content, such as transforming the International Monetary and Financial Committee into a Council with decision power and re-balancing the decision power within the Fund have made little progress or are still under review.

The report also reviews proposals to create new overarching bodies, such as a Global Governance Group or a UN Economic Security Council. Such initiatives would require widespread political support to be initiated.

Promoting and Financing Development

A number of poor countries have been largely unable to participate in the benefits of globalisation. They are trapped in a situation of low income and poverty, low levels of education and investment and sometimes high indebtedness. For these countries, international assistance is crucial. The report reviews four existing development instruments: official development assistance; debt relief; trade measures; and promotion of foreign direct investment. In addition, the report discusses some alternative sources of financing for development, including proposals for international taxes.

Official Development Assistance

Overall, trends in official development assistance (ODA) have been disappointing. Official development assistance by major donors in terms of their GNP declined from 0.33% in 1990 to 0.22% in 2000 (0.33% for the EC) and thus further away from the aid target of 0.7% originally put forward by the 1969 Pearson Report. The measurement of ODA has also been criticised for over-estimating the true level of ODA relative to that which would have been recorded had the original definition been strictly applied. The World Bank has recently estimated that current levels of ODA would need to be doubled in order to help low-income countries to reach their millennium development goals of halving poverty between 1990 and 2015.

In addition to concerns related to the level of ODA, there is a need to ensure an effective use of existing ODA resources. The debate on the effectiveness and quality of aid has led to the identification of a number of important elements, such as prioritisation, co-ordination, conditionality and ownership of policies, policy coherence and untying of aid, which are increasingly being taken into account by the EU and other major bilateral and multilateral donors.

One example is the debate on conditionality and ownership, which is related to the observation that economic reforms can be supported but “cannot be bought”. This implies that conditionality on adjustment lending will stimulate reforms better if they are in line with the government’s own programme. As a result, bilateral and multilateral donors now emphasise partnerships among governments, development co-operation agencies, civil society, and the private sector, in order to stress country ownership of the process. There is also a tendency towards refocusing aid towards “good policy - high poverty” countries, where the effectiveness of aid is seen to be highest.

The effectiveness debate also focuses on the requirement by some donor countries that the recipient country sources public procurement from companies in the donor country. OECD studies demonstrate that tied aid increases the cost to recipient countries of many goods and services by between 15 and 30%. There are therefore strong arguments in favour of “untying” aid, which were given new momentum when, in May 2001, donors agreed on a DAC (Development Assistance Committee) recommendation to untie ODA to the least developed countries as of 1st January 2002.

The fragmentation of aid and poor co-ordination have frequently been a major obstacle to aid effectiveness. The process of recipient country-led poverty reduction strategies should provide common ground for improving donor action at the country level in many of the poorest countries. Within donor countries, the promotion of coherence between development policies and those of trade, security, investment, social policies and the environment continues to be a major challenge.

Debt Relief

The report reviews progress with respect to alleviating the debt burden of developing countries, which saw their debt relative to GNP double between 1981 and 1998, with a slight decline in the following years. After repeated debt relief actions provided by official bilateral and private creditors, the HIPC debt initiative launched in 1996 dealt for the first time with the debt owed to multilateral institutions. The HIPC initiative was enhanced in 1999 to provide deeper, broader and faster debt relief and it is generally recognised that the initiative constitutes an important step in the right direction towards helping poverty reduction.

Apart from the issue of ensuring a rapid implementation of this initiative, there is a continued debate whether this action is sufficient to ensure sustainability and poverty reduction, even though the responsibility of the beneficiary countries in pursuing the right policies remains key to its long-lasting impact. There is also a discussion on whether enough countries are covered by this initiative. For poor countries in conflict, which are in principle eligible, but have not yet qualified, action has been taken by the G7 to reinforce political dialogue. Proposals have also been made to extend the initiative to more countries than the 42 HIPCs, but this comes up against significant financing constraints.

Trade Measures

As several studies reviewed in the report have shown, trade openness is a necessary, albeit not sufficient, condition for economic growth and thereby poverty reduction. Progress in this respect is conditional upon appropriate flanking policies, supported by trade related capacity building and further trade liberalisation by all countries, including developing countries themselves.

Although a number of developing countries have become more integrated into the world economy in recent years, they are too often disadvantaged as regards market access. Agricultural and labour-intensive manufactured goods (such as textiles), where developing countries' comparative advantage often lies, frequently face the highest trade barriers in developed and developing country markets, although the impact of such tariff peaks is to some extent offset by preferential access to developed economies. Initiatives such as the EU's 'Everything But Arms' initiative launched in early 2001, help to remove these distortions for least developed countries (LDCs)' exports to the EU. The adoption of such initiatives by other major developed countries, in line with commitments taken at the 3rd UN Conference on LDCs in 2001, could bring further benefits to LDCs.

At the multilateral level, the Doha WTO Ministerial Conference in November 2001 launched an ambitious negotiating agenda of trade liberalisation underpinned by strong and transparent multilateral rules – the Doha Development Agenda – which offers the prospect of significant gains to all WTO members, with a particular focus on the needs of developing countries. At

the regional level, regional trade agreements can provide an important stimulus to integration with the global economy and can reinforce regulatory co-operation, locking in reforms and providing clarity and consistency to potential investors. Such regulatory co-operation should, whenever possible, be based on agreed multilateral norms and attention should be given to potential additional administrative costs for developing countries and the provision of adequate technical assistance.

Promotion of Foreign Direct Investment

In recent years, foreign direct investment (FDI) has received increasing interest from policy-makers due to its growing importance for both developed and developing countries. Flows of direct investment towards developing countries increased seven-fold between 1990 and 2000, although they have been heavily concentrated in a limited number of countries (middle income countries capture 93 percent) and make up for less than one fifth of world flows. FDI can potentially play an important role for economic development and hence poverty reduction through employment creation, technology transfers, productivity increases and enhancement of export capacity. However, according to the studies reviewed, some specific conditions are needed for this potential to be realised. The notion of 'absorptive capacity' arises, as it has been demonstrated that a minimum level of knowledge is necessary to absorb the foreign technology. Similarly, to avoid monopolistic behaviour by powerful multinational firms, appropriate use of competition policies and their effective enforcement can be a useful instrument. Finally, a liberalised trade regime is a complementary tool to maximise efficiency and fully benefit from the potential of FDI to enhance the export capacity of the host country.

As far as active government investment-promotion policies are concerned, their desirability is not entirely clear. FDI is primarily determined by exogenous factors, such as geographical position, market size and availability of natural resources. Beyond these, necessary conditions include economic, political and regulatory fundamentals (such as the rule of law) that ensure a stable environment for foreign investors. These factors are mainly the responsibility of local governments. The main role and challenge for international institutions is to create mechanisms that facilitate FDI more globally. Many also argue that developing countries would benefit from a multilateral framework of rules for investment that would be cost-effective, transparent and stable and ensure non-discrimination.

Alternative Financing Instruments

The report looks into several alternative sources of financing that have been proposed, including international taxes, the De-tax and the allocation of Special Drawing Rights (SDRs). In addition to generating financing for development, international taxes are being discussed as a way to contribute to the provision of global public goods. The taxes discussed in the report are a tax on international currency transaction, a tax on carbon dioxide emissions, a tax on aviation fuel and a tax on arms exports.

All the international tax proposals reviewed in the report follow a dual objective. While they aim to raise revenue as a means of funding development and/or the provision of global public goods, they also have the purpose to motivate changes in behaviour by modifying relative prices and hence to correct international economic distortions and contribute to the provision of global policy objectives, such as financial stability, the protection of the global environment and the prevention of conflict.

While as a source of additional revenue a currency transaction tax may look appealing, its feasibility is, however, not demonstrated. Various proposals have been put forward, but even if applied in the settlement system, issues such as the enforcement of the tax and the preservation of the tax base need to be addressed. To be sustainable, such a tax would most likely require a multilateral approach, including the compliance of the major international financial centres.

An international carbon tax as well as a tax on the consumption of aviation fuel have been discussed as means to internalise the negative environmental effects of carbon dioxide and other types of emissions by increasing the costs of emission[1]. In terms of potential revenue, a global carbon dioxide tax might be the most promising; at international level, however, the political momentum has shifted to non-tax economic instruments such as emissions trading.

There is general acceptance that the international proliferation of arms has significant negative implications for international security and the taxation of trade in arms has been suggested as a way to curb this trade. While in principle the taxable base (production or trade) can be defined, there are various challenges and obstacles in practice. These include the lack of transparency in international arms trading and the voluntary nature of the existing international frameworks. Taking into account the data uncertainties characteristic of the international arms market, the revenue potential of a tax on arms trading is expected to be limited.

International taxes need to be administered. Collection at national level will require a very high degree of co-ordination among countries, while establishing a new international body raises a lot of additional issues, including those related to democratic control and transparency.

While more work needs to be done to validate these provisional conclusions on international taxes, it seems that meeting needs for enhanced financing of development and for the provision of global public goods in the short- to medium term will require more substantial contributions from national budgets and a further increase in the efficiency of resource use than is presently the case.

Proposed as an alternative to compulsory financing through taxation, the "1% De-tax" scheme advocated by the Italian government builds on voluntary consumer and vendor decisions to earmark one percent of the purchase at retail level to an international development project. The government would exempt this contribution ("de-tax") from VAT and company income tax. While this source of enhanced voluntary contributions lacks the predictability of tax-based revenues, it has the advantage that it can be introduced unilaterally.

An SDR allocation (a selective one targeted at the poor countries or a general one whereby industrialised countries pool their new SDRs for use by developing countries) has also been proposed as a way to provide additional financing for development purposes. Ultimately, however, SDRs are not a free lunch. They constitute a right of a country to obtain a short-term

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[1] The European Union favours an international initiative on a tax on aviation fuel in the context of the International Civil Aviation Organisation (ICAO). However, the current policy of ICAO is that it recommends the reciprocal exemption from all taxes on fuel taken on board by aircraft in connection with international air services.

credit with another country, the one that it buys currency from, at a specified interest rate. Conceived in the sixties as a tool to supplement a perceived shortage of international liquidity at world level, using an SDR allocation as a way to provide unconcessional long-term credit to developing countries does not seem to be a suitable approach.