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UNITED NATIONS
Department of Economic and Social Affairs

Background Note on

**THE GLOBAL FINANCIAL AND ECONOMIC CRISIS,
ITS IMPACT ON DEVELOPMENT, AND
HOW THE WORLD SHOULD RESPOND**

March 2009

THE SETTING

1. **The world is mired in its worst recession since the 1930s.** The rapidly unfolding global financial and economic crisis is going to severely disrupt economic growth worldwide and endanger progress towards achievement of the MDGs and the other internationally agreed development goals. The ILO estimates that worldwide as many as 50 million more people will become unemployed and as many as 200 million will join the ranks of the working poor between 2007 and 2009, if the right policies to redress the situation are not taken immediately. If prospects continue to worsen, many more people could be affected. The UN's global forecast sees negative per capita income growth for much of the developing world in 2009, putting the livelihoods of billions at stake.
2. **The present crisis emerges on the back of an unsustainable global growth pattern** characterized by strong consumer demand in the United States, funded by easy credit and booming house prices. Far-reaching financial deregulation facilitated a massive and unfettered expansion of new financial instruments, such as securitized sub-prime mortgage lending, sold on financial markets worldwide. This pattern of growth enabled strong export growth and, eventually high commodity prices benefiting many developing countries, but also led to mounting global financial imbalances and overleveraged financial institutions, businesses and households. In the context of a highly integrated global economy without adequate regulation and global governance structures, the breakdown in one part of the system thus easily leads to failure elsewhere, as we are witnessing today.
3. **Developing countries are particularly adversely affected by the systemic flaws in the global financial system.** At lower levels of development, they are less resilient and thus more vulnerable to fluctuations in world markets:

- With fewer resources they are also more typically forced to pursue pro-cyclical monetary and fiscal policies, imposing greater variability in their economic performance and affecting long-term growth.
- They are also unable to provide massive guarantees and subsidized bail-out packages to financial institutions as these are being provided by developed countries to salvage their financial systems. This asymmetry may also be the source of unintended, yet unfair trade practices.¹ This highlights the need to ensure coherence in the global system of trade, aid, debt and finance, to avoid unfair trading practices as a result of imbalances in the capacity to respond to the crisis.
- Such asymmetries are exacerbating global inequality by inducing capital outflows from developing countries to provide liquidity to the financial systems in Europe and the United States.
- Following the breakdown of the Bretton Woods system of fixed exchange rates in 1971, exchange rates have been marked by high volatility. Especially for small open developing economies, it is not easy to maintain macroeconomic stability in the face of such volatility as it imposes high costs to firms engaged in international trade lacking adequately functioning insurance markets.

4. **Developing countries have limited capacity to respond with counter-cyclical policies.** But the system also does not work well for the developed countries. This is visible from the present recession and collapse of major financial institutions, but also from the persistent and large global financial imbalances. The huge reserves held by quite a number of developing countries as insurance against world-market volatility, has fed mounting trade deficits elsewhere, especially in the United States, which eventually will force a steep fall in the value of the dollar. If the global imbalances unravel in a disorderly fashion this may well turn into a hard landing of the world's reserve currency with major disruptive consequences.

5. **The current crisis comes on top of the 2008 food and energy crises:** At the beginning of the 21st century, half of the world population was living in poverty, surviving on less than two dollars a day. The World Bank estimates that 45 million more people will fall into extreme poverty in 2009 as their incomes will fall below \$1.25 per day; while an additional 53 million people would see their incomes drop below the \$2-a-day poverty line. The global financial crisis comes on top of the food crisis in 2008, which pushed already more than 125 million people into poverty. The current global economic crisis will hit even harder with rapidly unemployment rising rapidly, real incomes falling and fiscal resources shrinking and forcing many countries to cut back on social spending.

¹ For example, bailout money provided to domestic automobile companies in a developed country in fact is an implicit subsidy putting such industries in competitive advantage to comparable industries from developing countries.

6. **The current crisis, therefore, must be addressed in ways that:**
- reflect the realities of the existing global imbalances;
 - will reduce the asymmetries between developed and developing countries in undertaking necessary counter-cyclical policies and providing additional social protection;
 - tackle the systemic flaws in the global financial system;
 - prioritize job creation and poverty reduction; and
 - lay the foundation for truly sustainable global development.

Unless this is done, poverty will increase sharply worldwide, with major set backs in the world's efforts to achieve the MDGs. The high oil and food prices which preceded the present crisis already constituted a major setback for many developing countries and also made them even more poorly prepared to face the consequences of the present crisis. Rising unemployment and poverty will confront countries with increased social needs, but decreases in government revenues will provide them with fewer resources to meet those needs. If countries are forced to cut back on social expenditures, this will have long-lasting effects on education and health of their populations, with lifelong effects on children and youth.

7. **Failing to meet those social demands could well trigger devastating social tensions**, especially in a context in which trillions are spent on financial sector bailouts. Failing to do so may also impair the sense of global solidarity, making agreement on other key global issues, such as responding to the challenges of climate change, more difficult.

8. **World leaders have recognized the need for concerted global action to combat the crisis:**

- Major industrialized countries have already coordinated a set of monetary measures and massive financial rescue packages totaling about \$11 trillion, though without producing desired results.
- Major economies, including some developing countries have put together fiscal stimulus packages totaling (as per mid-February 2009) about \$2 trillion (about 3% of world gross product, WGP), but to be spent over a number of years. Yet, despite rhetoric by world leaders that these packages should be implemented in coordinated fashion, little such coordination has taken place in practice. The size of the combined package seems to fall short of what is needed, which more likely should be in the order of about *3% of WGP per year* (see below).
- At a special session of the UN General Assembly held on 30 October 2008, Member States called for concerted, major reforms of the international financial architecture and the President of the GA appointed a Commission of Experts to advise on reforms of the international monetary and financial system.
- A meeting of the Group of 20 major developed and developing countries met in Washington D.C. on 15 November 2008 to set in motion a plan of

action of concerted responses to the crisis and reforms of the financial system.

- At the *Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus*, held in Doha, Qatar, from 29 November to 2 December 2008, Governments agreed to address systemic problems and to fundamentally reform the global financial system. They also requested the General Assembly to organize a meeting at the highest level on the world economic and financial crisis and its impact on development; a meeting which is now scheduled for 2-4 June 2009.

A TEST OF MULTILATERALISM

9. **The global economic crisis presents a test of the strength of multilateralism.** Lack of adequate international coordination in practice not only endangers economic recovery and achievement of the MDGs, but may have wider security repercussions. History shows that economic unilateralism has often also led to political unilateralism and increased tensions among countries.
10. **Protectionist responses must be resisted.** The crisis has already given rise to intended and unintended protectionist measures and unfair trading practices, as indicated. Rejecting protectionism is not an easy course to follow, but will be essential. Trade amongst countries provides a powerful stimulus to the global economy. Leaders of the G20 pledged in their meeting of November 2008 to refrain from raising new barriers to investment and trade, imposing new export restrictions, or implementing WTO inconsistent measures to stimulate exports. Nonetheless, there have been instances of introduction of new protectionist measures. These must be reversed and a mechanism should be put in place to monitor and challenge new protectionist measures.
11. **Leadership of major countries in pursuing internationally concerted action is important, but not sufficient.** Ad-hoc gatherings of leaders of major countries, such as through meetings of the G-7/8 and the G-20, now seem to provide the main platforms for finding internationally concerted solutions. It is clear that the G7/8 can no longer function as a credible global steering group. The London summit will be based on the G-20, though not fully restricted to G-20 members. Further, the main focus of the summit is now only on economic issues. While the G-20 process could well pave the way for a broader consensus, the United Nations can enable the engagement of the entire international community, providing a legitimate basis for the responses and reforms and ensuring these are aligned with broader sustainable development objectives.

12. **The UN system can contribute by assisting countries in improving and developing monitoring systems** that track the impact of the crisis, the effectiveness of policies to address it and the degree of alignment of these responses with achievement of the MDGs and sustainable development objectives (see also paragraphs 29 - 31 below).
13. **The functions and responsibilities of the United Nations Economic and Social Council will need to be strengthened** to ensure the coherence of a new global economic governance framework and provide multilateral responsiveness and legitimacy for global responses to emerging crises (see paragraph 28 below).

DEALING WITH THE GLOBAL FINANCIAL AND ECONOMIC CRISIS

14. **Globally concerted action is now urgently required in four key areas, balancing needs for immediate impact and longer-term development objectives:**
 - a) Coordination of macroeconomic stimulus packages
 - b) Special financial support measures to developing countries
 - c) Addressing systemic issues and reforming global economic governance mechanisms
 - d) Monitoring, accountability and security

a) Coordination of macroeconomic stimulus packages

15. **Urgent fiscal and monetary stimulus is needed:** Failure to act quickly to address the global downturn will increase its depth and duration and the cost of recovery. Despite some massive interventions, the action taken thus far has proven insufficient to reverse the cause of events. At present, it is clear that policy makers can no longer solely rely on monetary policy measures and financial sector bailouts to prevent the global economy from falling into a spiral of contraction. While financial sector rescue operations should become more forceful to restore the flow of credit to productive sectors and while countries should use all remaining space for further monetary stimulus, clearly the main countercyclical action now must come from fiscal stimulus to reactivate economic activity worldwide and to curb employment losses. The latter is not only crucial to raise the level of expenditures in the global economy, but also to fend off a substantial rise in global poverty and the spread of social unrest.

16. **Without coordination, the stimulus may fall short of what is needed.** Though substantial, the fiscal stimulus packages put together by national governments so far seem to fall short of what is needed and would be unevenly distributed. Furthermore and crucially, despite the recognition that concerted action is needed, thus far little to no coordination of the fiscal stimulus has

taken place in practice. The lack of coordination in the size and timing of the implementation will limit the multiplier effects of the stimuli, thus reducing the impact on employment and economic growth. Some countries hesitate to take further action over concerns of possible negative repercussions in the medium run from widening of fiscal deficits and larger public debts. The severity of the financial crisis calls for policy actions that are commensurate with the scale of the problem, and should thus go well beyond any normal range of budgetary considerations. Looking ahead, the overall costs of widening fiscal deficit due to stimulus packages, if they can effectively reduce the depth and duration of the economic downturn and save employment, could well be smaller than the total economic and social costs of a depression.

17. **Immediate stimulus needs to be balanced with long-term investments in human development and a more sustainable economy.** Fiscal stimulus should be such that it provides immediate traction in order to restore consumer and business confidence and avoid major social costs. At the same time, the crisis provides an opportunity to align the fiscal stimulus packages with sustainable and equitable development goals:

- This applies to developed countries where much of the stimulus could take the form of investments in infrastructure, technology development and production of renewable energy, and greater energy efficiency in the fight against climate change.
- Similarly, developing countries should try and align new fiscal stimulus with long-term development goals. Increased public spending on infrastructure, clean technologies, agricultural development, sustainable natural resource management, education and health would help diversify their economic structures and reduce their dependence on a few commodity exports, and thereby help them meet key development goals, including achieving greater food security, addressing climate change and meeting the MDGs.

18. **The macroeconomic stimulus needs to be coordinated within a medium-term financing framework.** Both the financial rescue operations and stimulus packages will demand potentially large contributions from current and future tax payers and may involve large redistributions of wealth. The financing of the fiscal stimulus should therefore be transparent in terms of how the costs are expected to be distributed over time across countries and across population groups. International coordination will be required to avoid undesirable negative impacts of the way in which the fiscal stimulus is financed, including on exchange rates, global inflation and interest rates, the sustainability of public debt, and the global imbalances.²

² For instance, if as is to be expected a major part of the fiscal impulse is generated in the United States and this ends up in a large increase in US public debt or, alternatively, large issuance of dollars, this could precipitate, either way, a strong depreciation of the dollar. Given the dollar's role as major reserve currency, this may have highly disruptive effects on financial markets.

19. **The stimulus should not come at the cost of delivery on aid commitments.** As to bilateral aid, with the current financial crisis, and economic slowdown in most donor countries, there is a general fear that aid budgets will be cut as happened, for instance, after the recession in the early 1990s. However, donors have repeatedly pledged to deliver on existing aid commitments, including at the Doha Follow-up Conference on Financing for Development of November-December 2008. To confront the present crisis, more, not less aid will be needed, especially for the poorest developing countries. Accelerated delivery towards existing commitments can provide the necessary resources to also allow the poorest countries to engage in fiscal stimulus and avoid major social setbacks (see below).

20. **The stimulus packages should be free of protectionist clauses and avoid contributing to unfair trading practices.** Protectionism will be self-defeating and could prolong the worldwide recession, with especially damaging consequences for developing countries.

21. **Strong position should also be taken against the imposition of further restrictions on migration.** Although the precise impact of the crisis on international migration and remittances is still uncertain, there are already clear indications that many migrants have a high probability of losing their jobs and income with commensurate effects on the flow of remittances, which form an important source of income to many poor families in the developing world. The world community should ensure the crisis does not lead to a backlash against migrants in receiving countries and should avoid development in countries of origin is harmed even more that way through an even stronger drop in remittances.

b) Substantial financial support for developing countries is needed

22. **Substantial increases in compensatory financing, official development lending and assistance are needed for developing countries** to enhance their scope for countercyclical responses. The international community has been slow to recognize the crisis-related need for exceptional access to financing for developing countries. The IMF has expanded its compensatory financing facilities, but these have remained highly conditioned to undesirable pro-cyclical policy conditionality. The international donor community has pledged to meet aid commitments, but in practice aid budgets of bilateral donors are under political attack in many countries.

23. **What is needed is a compensatory and development financing plan for a total of \$1 trillion for 2009-2010** to meet needs of both middle- and low-income countries, and especially of the least developed countries amongst them, in order to enhance their countercyclical responsiveness and allow them to avoid having to cut necessary public expenditures. This plan should consist of two main components:

(1) *\$500 billion for enhanced short-term, compensatory financing:*

24. According to the World Bank and the Institute for International Finance, private capital flows to developing countries declined by about \$500 billion in 2008 from 2007 levels and a further decline by about \$630 billion is forecast for 2009. The decline has been the result of among others a severe squeeze of trade credits, which is affecting trade and growth of developing countries directly. Well over \$1 trillion in corporate, external debt in emerging markets and other developing countries will mature in 2009 and will need to be rolled over. As commodity prices and exports decline and income from worker remittances subsides, most developing countries will experience severe balance of payment problems. The World Bank estimates that 98 of 104 developing countries are expected to fall short of covering external financing needs, with an estimated external financing gap which could rise to \$268 billion in 2009 alone, but may well be as high as \$700 billion under an envisaged scenario of further declines in private capital flows and increased capital flight. For low-income countries alone, the IMF estimates that the balance-of-payments shock could amount to \$140 billion in 2009.
25. While some developing countries have accumulated vast amounts of international reserves, these are unequally distributed (most held by China) and insufficient for most developing countries to cope with the magnitude of the external shock provided by this crisis.
26. To overcome these short-term external financing gaps, and allowing short-term debts to be refinanced and ensure trade credits can start flowing again, the following is needed for developing countries over 2009 and 2010.
- **At least \$500 billion in enhanced international liquidity for compensatory financing** will be needed to allow developing countries to refinance their sovereign debts as well as existing bank and corporate debts of their private sectors and accordingly unlock their domestic credit markets and regain access to trade credits and international capital markets.
 - The additional resources for compensatory financing could be mobilized through issuance of at least \$250 billion in special drawing rights (SDRs)³, complemented by the utilization of unused special borrowing facilities of the IMF and through the mobilization of reserves and resources accumulated in sovereign wealth funds from surplus countries.⁴
 - To ensure immediate accessibility to funds, the additional liquidity should be channeled through existing mechanisms, including the IMF and regional institutions. This will require closer collaboration between the IMF and regional institutions of financial cooperation.
 - **Adequate oversight of the usage of resources will also need to be established**, ensuring in particular that the compensatory financing is not

³ Such SDR issuance could amount to \$250 billion as has been proposed in the past, but was not backed at the time by the United States government.

⁴ Japan has already lent \$100 billion of its reserves to the IMF.

subject to the kind of pro-cyclical policy conditionality which is typically attached to existing mechanisms.

(2) *\$ 500 billion in increased multilateral development lending and official development assistance:*

- **An additional \$500 billion in enhanced long-term official financing** will be needed to cover fiscal revenue gaps (due to falling export revenues and falling growth) and provide developing countries the required space to protect social spending and finance fiscal stimulus packages. Spread over two years, this would amount to about 3 per cent *per year* of the combined GDP of developing countries (excluding China and major oil-exporting countries) to the worldwide stimulus.⁵ As indicated, the fiscal stimulus programs should be aligned as much as possible with long-term development needs, for increased public spending on infrastructure, clean technologies, agricultural development, sustainable natural resource management, education and health to meet key development goals, including adequate job creation, achieving greater food security, addressing climate change and meeting the MDGs.
- **The increased resources should come through two windows:** \$250 billion for increased multilateral development lending and another \$250 billion through concessional loans and grants targeted at the poorest countries
- **The increase in development lending by \$250 billion** could be mobilized through the multilateral development banks:
 - a) By optimizing use of available capital, the World Bank could make new development financing commitments for about **\$100 billion**.
 - b) With a \$60 billion replenishment of their capital and maintaining solid leverage ratios, regional development banks could expand development lending by about **\$150 billion**.
- **The \$250 billion in additional development assistance** would be targeted at low-income countries and could be mobilized as follows:
 - a) **\$50 billion** could be mobilized by front-loading resources in the already replenished International Development Assistance (IDA) window of the World Bank and those in the concessional windows of the regional development banks.⁶

⁵ China and major oil-exporting developing countries with vast accumulated international reserves may not need the access to the additional financing. According to the UN forecasts, average developing growth (excluding China and major oil-exporters) may drop by 6 percentage points or more from the robust growth of the past few years. Assuming a multiplier effect of about 1.7 from well-designed fiscal stimulus packages, would imply that the stimulus should be about 3 per cent of developing-country GDP per year.

⁶ The World Bank's concessional window (IDA) was already replenished by \$30 billion in 2008 to cover three years of credits and grants. This could be frontloaded to make these resources available during 2009 and 2010. Equally concessional lending windows of regional development banks (ADB, AfDB, IDB and others) could be frontloaded to provide the additional \$20 billion.

- b) **\$200 billion** can be mobilized through an acceleration of the delivery on existing ODA commitments.⁷
- These additional ODA resources could be channeled through existing bilateral channels and by enhancing aid provided through multilateral agencies, including the United Nations system. The World Bank's proposal for a "Vulnerability Fund" of the size of 0.7 per cent of the developed countries' stimulus packages (amounting to about \$15 billion) might form a part of this broader proposal.
 - Delivery on the additional ODA resources should follow through on donor commitments to improve aid effectiveness and improving the predictability of aid flows for recipient countries.
- c) *Systemic reform of the international financial architecture and global economic governance*

27. As in the crises of the 1930s which led to the Great Depression, the systemic causes of the present crisis are ultimately based on fundamental weaknesses in global economic governance and overcoming these defects is the only genuine solution. These weaknesses underpin haphazard financial deregulation, the explosion of global imbalances and vulnerabilities, and irresponsible behaviour promoted by the international reserve system. Much more fundamental changes are needed to reform the international financial system in order to provide better safeguards that can prevent it happening again, and to create a framework for global economic governance in line with 21st century realities.
28. Given the existing systemic flaws, it is paramount that urgent progress is being made towards the design of a new international financial architecture and, more broadly, a new global economic governance structure:
- **Major deficiencies in international mechanisms of financial regulation and supervision must be urgently addressed**, such as to avoid excesses of the recent past which were at the root of the present crisis and safeguard international financial markets from recurrence of the problems that have emerged. Apart from deep reforms of existing regulatory frameworks, **strengthened international tax cooperation** should form a critical element of a more effective global system of financial regulation. The establishment of an international mechanism for sovereign debt restructuring and relief is also urgently needed. While urgent, it should be stressed that financial reform will only be part of the solution. It would be a mistake to limit attention to "fix" the financial markets, as these cannot be repaired fully as long as there are deeper problems in the global economy.

⁷ At the 2005 Gleneagles Summit, the G8 committed to raise ODA to at least \$160 billion per year (at 2008 prices) by 2010⁷ (up from \$103.7 billion in 2007). Meeting this commitment should increase existing aid flows by a total of about \$115 billion over 2009-2010. Further delivery towards the agreed UN target of 0.7 per cent of their annual GNI could provide the remaining \$85 billion needed over 2009-2010, which would bring ODA to about 0.4 per cent of GNI of OECD/DAC members.

- **Reform of the global reserve system.** A new global reserve system must be created which no longer relies on the US dollar as the single major reserve currency. The dollar has not proven to be a stable store of value, a requisite for a stable reserve currency. Also global instability and deficiencies the international financial institutions to address this instability have led many developing countries to accumulate vast amount of reserves on their own. This build up has contributed to the deflationary pressures to the world economy. A new system needs to be developed which allows for better pooling of reserves at the regional and international levels and which is not based on a single or even multiple national currencies, but which permits the emission of international liquidity (SDRs or an equivalent thereof) so as to create a more stable global financial system.
- **A fundamental reform of the governance structure of the Bretton Woods institutions.** At the Doha Conference on Financing for Development, member states already agreed that the Bretton Woods institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to current and future challenges and to strengthen the legitimacy and effectiveness of these institutions. Beyond the rebalancing of voting power in these institutions, it is important to introduce a fundamental revision of their functions and equip them with the necessary resources, such that they can effectively safeguard global financial stability, coordinate macroeconomic policies and provide adequate long-term development financing.
- **Strengthening the United Nations Economic and Social Council.** Broader reforms of the global economic governance structure must be considered as well, including a strengthening of functions and responsibilities of the United Nations Economic and Social Council to ensure coherence between the financial architecture and the global governance frameworks for climate change, development, the multilateral trading system and new governance mechanisms for international financial regulation. A strengthened ECOSOC is further needed to provide **political legitimacy for global responses to emerging crises**. The urgency of action should not undermine inclusiveness in decision-making. The protection of the world's global goods – whether financial or climate stability – requires inclusive decision making. Discussions among groupings of countries play an important role, but choices – that affect each and every country – cannot be made by some on behalf of others. For effective decision-making smaller membership, but reflecting constituency-based representation for groups of countries, may be considered.

d) Monitoring and accountability

29. The world economy is in a state of great uncertainty and many did not see this crisis coming. The bold and globally concerted actions as proposed will require vast amounts of resources. The crisis as well as the mobilization of the

resources to combat it will have substantial distributional consequences. If the measures do not make visible impact within a reasonable time horizon and tax payers are insufficiently informed of how resources are being used, there is a danger of increased social unrest and threat to global security.

30. There is thus an **urgent need to take swift and synchronized actions to improve existing global monitoring and reporting systems** using economic, financial and sustainability indicators, based on but not limited to official statistics, which will:

- provide insight in vulnerabilities in the global economy at large (including financial sectors) and serve that way as early warning systems;
- identify which countries and population groups within these are most at risk to swings in the global economy;
- monitor and provide insight into how stimulus packages are being spent and financed and into the distributional effects of these;
- signal effectiveness of measures taken and provide information to facilitate decision-making to correct course when needed; and
- set new micro and macro-prudential standards for improved monitoring of the stability of the financial systems in collaboration with the International Accounting Standards Board (IASB) and regulatory agencies.

31. The UN system, in collaboration with Member States and relevant international agencies, could lead the coordination and development of such systems that should contribute to improved accountability of global public action.