

THIRD WORLD *Economics*

TRENDS & ANALYSIS

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Budget battle to rage on in US

After intense negotiations that went down to the wire, a tax deal was agreed by the US Congress and President Barack Obama that prevented the US economy from falling off the “fiscal cliff” at the turn of the year. But a bigger tussle over government spending now looms over the months ahead – one which, given the size of the American economy, will have repercussions for the rest of the world.

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Trends & Analysis

131 Jalan Macalister
10400 Penang, Malaysia
Tel: (60-4) 2266728/2266159
Fax: (60-4) 2264505
Email: twnet@po.jaring.my
Website: www.twn.my

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US fiscal crisis far from over

The United States avoided going over a "fiscal cliff" on 1 January, but has scripted a new and bigger crisis over the "debt ceiling" in what appears to be a never-ending tug-of-war between President Obama and the Republicans.

by Martin Khor

So, the United States at the last minute averted a "fiscal cliff" crisis, and the world gave a sigh of relief, since the fate of the US economy has strong impact on other countries.

But that sigh was accompanied by a shake of the head at how this drama involving a contest of wills between the President and the Republicans in Congress has become an American way of life.

Have the economy of the US and the rest of the world economy become too dependent on how Washington's budget politics plays out? It seems so, for some time to come.

From the "fiscal cliff", there will now be an even bigger fight over government spending. Will it have to be cut? By how much overall? And which items will be cut more, and which will be saved?

The "fiscal deal" was supposed to cover the two issues of tax increases and spending cuts. Only the tax part was agreed to on 1 January by Congress and President Barack Obama.

The tax deal involved raising the top end of income tax rates of the richest 1-2% of Americans and increases in capital gains tax and estate duty. But it also raised by 2 percentage points the payroll taxes that employees pay as part of their salaries towards social security.

Thus it is not true that only rich Americans are affected by the fiscal deal. Ordinary American workers have to pay an estimated \$113 billion more in payroll taxes.

Nevertheless President Obama and the Democrats are seen to have won a victory because he fulfilled a campaign pledge that richer Americans would have to bear a higher tax burden in the overall effort to reduce the government deficit.

Still, the tax increase is only a small dent on how wealthy Americans have captured most of the gains of economic growth in the past three decades. This rise in inequality led to the grassroots movement of the "99%" fighting for their

rights against the 1%.

With the increase of taxes on the rich, Obama has made his point. And the Republicans, who had vowed that there would be no tax increases at all, have had to give in, though many voted individually against the deal in Congress.

Debt ceiling

However, the bigger part of the social equation is not yet settled. The deal did not cover the spending issue – by how much and what to cut.

The Republicans are cleverly trying to link this to a separate issue of the "debt ceiling." By law the US administration is allowed to take loans only up to a limit, and the present limit was reached around New Year's day.

Without Congressional approval to raise this limit, the government would be forced to go into partial default. It would not be able to pay some of its bills or salaries or pensions, or to service its debts.

For the rest of the world, the most sensitive issue is whether the US could default on its foreign debt. Most countries hold a large part of their foreign reserves in US Treasury bills, notes and bonds; China alone has over a trillion dollars of US debt.

It is unthinkable that the US could default on its debt, but not as unthinkable as before. Last August when Congress postponed to the last day its decision to raise the debt limit, when it bargained with Obama over how much to cut government spending, the credit rating agency Standard & Poor's downgraded the US' credit rating from AAA to AA-plus.

The US Treasury is able to use some accounting devices to keep spending for two more months before needing more loans. Thus, between now and March, expect to witness a new President-Congress, Democrat-Republican tug-of-war over spending cuts.

On the broad economic front, econo-

mists like Joseph Stiglitz and Paul Krugman argue against overall spending cuts as the weak economy requires fiscal stimulus instead, and there is no harm in increasing the budget deficit in the short term. For them, a drastic spending cut now will unnecessarily plunge the economy into recession. Concerns on the deficit and excessive spending can be dealt with when the economy is strong.

Obama and the Democrats accept that there should be some spending cuts, but want these in sectors such as defence, while shielding welfare and social security benefits from too much cuts, to protect the poor and middle class.

The Republicans, in contrast, want an across-the-board spending cut, including on welfare and social security. They are ideologically for "small government", boosting the income and interests of the rich (on the theory that they hold the key to investment and growth), and cutting welfare aid and social security subsidies (on grounds that these have burdened society with debt and are a

disincentive to people to do their fair share of work).

The budget fights have to do with ideology, but they have both social and economic consequences.

Obama has indicated he is fed up with the Republican strategy of tying the issue of spending cuts to the debt ceiling, saying he will not negotiate with "this Congress" over the debt ceiling. In previous years, raising the debt ceiling was automatic, until Congress used it as leverage last year to make their point over spending cuts.

Now, the Republican leaders are adamant on again using the debt-ceiling leverage to get the size and type of spending cuts they want.

So the world will have to watch the continuing saga of the budget tug-of-war, because what happens in the United States affects the rest of the world. □

Martin Khor is Executive Director of the South Centre, an intergovernmental policy think-tank of developing countries, and former Director of the Third World Network.

Urgent action is needed to restore growth

Developing countries cannot bear the burden of supporting global growth alone, writes *Supachai Panitchpakdi* – the developed economies need to weigh in with pro-growth policies of their own.

GENEVA: The global economy weakened significantly towards the end of 2011 and further downward pressure emerged in the course of 2012. The growth rate of global output, which had already decelerated from 4.1% in 2010 to 2.7% in 2011, is expected to slow down even more in 2012 to around 2.3%.

Developed economies as a whole are likely to grow by only slightly more than 1% in 2012, owing mainly to the recession currently gripping the European Union (EU).

This contrasts with a much stronger performance in developing and transition economies, where growth should remain relatively high, at around 5% and 4% respectively. However, even in these economies growth is losing steam, showing that they cannot avoid the impacts of economic troubles in the developed countries.

On top of already weak private demand, fiscal tightening has been adopted in several developed countries with a view to reducing public debt and restor-

ing the confidence of financial markets. However, these policies have further weakened domestic demand and growth, which is detrimental to the goals of fiscal consolidation and improved confidence.

Some governments are trying to stimulate growth through increasing exports, and are working to improve their competitiveness by reducing nominal wages and other costs. For several European countries within the monetary union, this would be the way to achieve a real devaluation. The danger with this policy is that it will severely damage domestic demand before it can help to regain competitiveness, thus putting into question the adjustment process.

Developed economies should therefore change the focus of their policies from fiscal consolidation and internal devaluation to restoring growth, because this is the only way in which they can avoid a recurrence of a financial and fiscal crisis. Countries with larger fiscal space and current account surpluses

should take the lead by expanding their domestic demand. This would be in line with their commitments at the last G20 summit, and contribute to a growth-friendly global rebalancing.

Most developing and transition economies have actually supported their growth by encouraging domestic demand and pursuing counter-cyclical policies, including the provision of fiscal stimulus and expansionary credit. They have also succeeded in preventing a significant rise in unemployment, and have enabled the continued growth of real wages. All this, together with public transfers in several countries, has promoted private consumption and, consequently, productive investment, even though this has not always been sufficient to avoid growth deceleration.

Indeed, the developing and transition economies are being affected by slow growth or economic contraction in the developed countries. This is reflected in stagnating export volumes to those markets and a declining trend in commodity prices since the second quarter of 2011.

Moreover, financial instability and excessive reliance on monetary policies in developed countries is affecting financial flows to emerging market economies and adding to the inherent volatility of commodity prices.

Therefore, the risk of a new major shock in global financial markets cannot be excluded, with a potentially large impact on international trade volumes, asset and commodity prices, risk spreads, capital flows and exchange rates, all of which would affect developing and transition economies.

Structural reforms

Some governments are looking to implement structural reforms to overcome the crisis. The United Nations Conference on Trade and Development (UNCTAD) has always supported the need for structural reforms, since no development process can happen without changes in economic and social structures. However, today, structural reforms are often focused on attempts to introduce greater labour market flexibility.

Yet, such reforms would undermine the incentives for investment and innovation. Indeed, if less efficient firms can compensate for their lower profits by cutting wages, they are not forced to increase their productivity to survive and expand. Such reforms also threaten to

further undermine domestic demand. In order to revitalize sustained growth, governments must take measures to reduce income inequality, by assuring the participation of all social groups in productivity gains stemming from economic and technological advancement.

Labour market reforms are not a way out of the crisis, because the crisis did not originate in the labour market. Additionally, structural policies cannot be a substitute for pro-growth macroeconomic policies. Structural reforms have to address the very roots of the present crisis, namely the fragility of the financial system and the trend towards increasing income inequality.

In contrast, the structural reforms being adopted by a number of developing countries have tended to create or reinforce social safety nets and to expand the role of public policies for supporting investment and structural change. Most of these measures are counter-cyclical, as they aim to safeguard employment and support economic activity in troubled times.

The renewed fragility of the world economy, and the growing downside risks, including for developing countries, have brought us to the brink of a second recession. The developing countries cannot bear the burden of supporting global growth alone. Urgent action is therefore needed to restore growth, particularly in the developed world, and to take measures to prevent a recurrence of the financial and economic crisis. (IPS) □

Supachai Panitchpakdi is the Secretary-General of the United Nations Conference on Trade and Development (UNCTAD).

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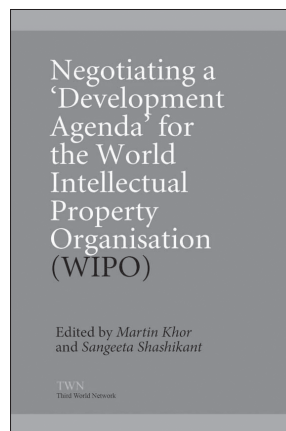
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For subscription details, please contact:

Third World Network/
Red del Tercer Mundo,
Juan D. Jackson 1136/11200
Montevideo, Uruguay
Fax (5982) 419222
Email: redtm@chasque.apc.org

Negotiating a 'Development Agenda' for the World Intellectual Property Organisation (WIPO)

Edited by Martin Khor and Sangeeta Shashikant



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The World Intellectual Property Organisation (WIPO), a UN agency that deals with issues of intellectual property rights, has been undergoing an interesting change in recent years. In 2004, many developing countries initiated a process of reform to make WIPO development-oriented, which they consider to be important for a UN agency. The initiative, which is known as the 'Development Agenda', has since snowballed into a movement to review the role of intellectual property rights in the process of development.

According to developing countries, NGOs and experts, WIPO has been too much oriented towards promoting IP at the expense of the wider development concerns and public interest. Whether the Development Agenda movement

succeeds in reorienting WIPO remains to be seen especially since this initiative has been resisted by developed countries, that want to cling on to the status quo.

On the 'Development Agenda' initiative, this book is an eyewitness account of the twists and turns of the Development Agenda movement. It is indispensable for those who want to understand the origins, rationale and history of the Development Agenda at WIPO.

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The myth of Africa's rise

Contrary to the rosy pronouncements in the Western media, Africa is in fact making little headway up the development ladder. *Rick Rowden* explains why.

Recent high growth rates and increased foreign investment in Africa have given rise to the popular idea that the continent may well be on track to become the next global economic powerhouse. This "Africa rising" narrative has been most prominently presented in recent cover stories by *Time* and *The Economist*. Yet both publications are wrong in their analysis of Africa's developmental prospects – and the reasons they're wrong speak volumes about the problematic way national economic development has come to be understood in the age of globalization.

Both articles use unhelpful indicators to gauge Africa's development. They looked to Africa's recent high GDP growth rates, rising per capita incomes, and the explosive growth of mobile phones and mobile phone banking as evidence that Africa is "developing." *Time* referred to the growth in sectors such as tourism, retail and banking, and also cited countries with new discoveries of oil and gas reserves. *The Economist* pointed to the growth in the number of African billionaires and the increase in Africa's trade with the rest of the world.

But these indicators only give a partial picture of how well development is going – at least as the term has been understood over the last few centuries. From late-15th-century England all the way up to the East Asian Tigers of recent renown, development has generally been taken as a synonym for "industrialization." Rich countries figured out long ago that, if economies are not moving out of dead-end activities that only provide diminishing returns over time (primary agriculture and extractive activities such as mining, logging and fisheries), and into activities that provide increasing returns over time (manufacturing and services), then you can't really say they are developing.

What's striking about the two articles cited above is that they don't mention manufacturing, or its disturbing absence, in Africa. And that, in turn, confirms once again the extent to which the idea of development as industrialization has been completely abandoned in the last few decades. Free-market economics has come to advise poor countries to

stick with their current primary agriculture and extractive industries and "integrate" into the global economy as they are. Today, for many champions of free markets, the mere presence of GDP growth and an increase in trade volumes are euphemisms for successful economic development. But increased growth and trade are not development.

For example, even if an African country like Malawi achieves higher GDP growth rates and increased trade volumes, this doesn't mean that manufacturing and services as a percentage of GDP have increased over time. Malawi may have earned higher export earnings for tea, tobacco and coffee on world markets and increased exports, but it is still largely a primary agricultural economy with little movement towards the increased manufacturing or labour-intensive job creation that are needed for Africa to "rise."

Manufacturing indicators

The failure to mention industrialization thus renders most comparisons of growth in Africa and East Asia spurious. For example, the *Time* article, which suggests that "during the next few decades hundreds of millions of Africans will likely be lifted out of poverty, just as hundreds of millions of Asians were in the past few decades," cites the divide that has opened up between rich and poor in China and India as a warning that inequality could also become a problem as Africa's progress continues. The *Economist* article cited a World Bank report that claims that "Africa could be on the brink of an economic take-off, much like China was 30 years ago," noting that, in both cases, a mass population of young workers stood at the ready to boost growth. It also touched on the importance of education: "Without better education, Africa cannot hope to emulate the Asian miracle."

There are, of course, several indicators that offer a more precise picture of how well Africa is developing (or not). We can look at whether manufacturing has been increasing as a percentage of GDP, or whether the manufacturing value added (MVA) of exports has been

rising. In these cases the comparison between Africa and East Asia is actually quite revealing – as demonstrated by a recent United Nations report that paints a far less flattering picture of Africa's development prospects.

It finds that, despite some improvements in a few countries, the bulk of African countries are either stagnating or moving backwards when it comes to industrialization. The share of MVA in Africa's GDP fell from 12.8% in 2000 to 10.5% in 2008, while in developing Asia it rose from 22% to 35% over the same period. There has also been a decline in the importance of manufacturing in Africa's exports, with the share of manufactures in Africa's total exports having fallen from 43% in 2000 to 39% in 2008. In terms of manufacturing growth, while most have stagnated, 23 African countries had negative MVA per capita growth during the period 1990-2010, and only five countries achieved an MVA per capita growth above 4%.

The report also finds that Africa remains marginal in global manufacturing trade. Its share of global MVA has actually fallen from an already paltry 1.2% in 2000 to 1.1% in 2008, while developing Asia's share rose from 13% to 25% over the same period. In terms of exports, Africa's share of global manufacturing exports rose from 1% in 2000 to only 1.3% in 2008. Africa is also losing ground in labour-intensive manufacturing: Its share of low-technology manufacturing activities in MVA fell from 23% in 2000 to 20% in 2008, and the share of low-technology manufacturing exports in Africa's total manufacturing exports dropped from 25% in 2000 to 18% in 2008.

Finally, Africa remains heavily dependent on natural resources-based manufacturing, which is an indication of both its low level of economic diversification and low level of technological sophistication in production. The share of resource-based manufactures in Africa's total manufacturing exports declined only slightly in recent years, from 52% in 2000 to 49% by 2008. In East Asia and the Pacific, the number dropped to as low as 13% by 2008.

Such statistics and comparisons with East Asia are, of course, completely at odds with the "Africa rising" narrative.

A recent report by the African Development Bank makes a similar point. "Africa's growth tends to be concentrated on a limited range of commodities and the extractive industries," the

report states. "These sectors are not generating the employment opportunities that would allow the majority of the population to share in the benefits. This is in marked contrast to the Asian experience, where the growth of labour-intensive manufacturing has helped lift millions of people out of poverty..." The report goes on to note that "[p]romoting inclusive growth means ... broadening the economic base beyond the extractive industries and a handful of primary commodities."

This point was also not lost on recent Ghanaian presidential candidate Nana Akufo-Addo, who warned: "About 30 years ago, some African nations, beginning with Ghana and Uganda, implemented liberal economic reforms to stop their economic decline. But in many cases we opened our markets to global competition when, beyond the extractive industries, we had nothing to compete with. So while the continent's share of global foreign direct investment projects has improved steadily over the past decade, much of this investment has reinforced the structural deficits of our economies."

Industrial policies

Today many African countries need to use industrial policies, such as temporary trade protection, subsidized credit, and publicly supported R&D with technology and innovation policies, if they are ever to get their manufacturing sectors off the ground. This is true for all the same reasons that it was true for the UK and other nations that have industrialized successfully. According to today's ideology of free trade and free markets, however, many of these key policies are condemned as "bad government intervention." Bilateral and multilateral aid donors advise against them (and structure loan conditions accordingly). WTO agreements and new regional free trade agreements (FTAs), as well as bilateral investment treaties (BITs) between rich and poor countries, frequently outlaw them.

Critics of industrial policies are correct to cite some historical cases where industrial policies have misfired in developing countries. But these critics are often selective in their criticisms, ignoring successful cases and neglecting to explain why industrial policies worked so well in the United States, Europe and East Asia while failing so badly in Africa and elsewhere.

From the 1950s to the 1970s, particularly in Africa and Latin America, many

industrial policies failed because they were used inappropriately, with poor sequencing, and were often driven by political considerations or corruption rather than economic analyses or strict efficiency grounds. In Latin America, often the industrial policies were kept in place too long, and were too inwardly focused on small domestic markets, neglecting the need to develop international competitiveness. In contrast, the political economies of East Asian countries included institutions that tended to enforce stricter rules for which industries got subsidies and trade protection, and which got cut off from them when they failed to meet performance targets. They also adopted a more outward orientation in their industrialization strategies. Crucially, this history says more about *how* industrial policies should be implemented – not *if* they should be implemented at all.

But some nations are increasingly rebelling against such constraints. Coalitions of developing countries within the WTO, such as the G33 and NAMA 11, are asking for more time to implement trade liberalization and for broader exemptions to increase tariffs when their domestic agriculture or manufacturing industries are threatened by floods of cheaper imports. This problem of the lack of necessary "policy space" was noted in a recent report by the Africa Progress Panel, chaired by former UN Secretary-General Kofi Annan. The Panel expresses concerns about the European Union's proposed Economic Partnership Agreements (EPAs), which seek to make

access for African goods into EU markets conditional on Africa eliminating or lowering tariffs on 80% of imports from the EU. The report suggests that this would be highly damaging to domestic industries.

Though African countries desperately need the policy space to adopt industrial policies, the rich countries are pushing loan conditions and trade and investment agreements that block them from doing so, all the while proffering a happy narrative about "the rise of Africa." The very idea of industrialization has been dropped from the official development agenda. Yet there's a reason why we all regularly refer to the rich countries in the OECD as "industrialized."

Despite the important gains in services industries and per capita incomes, Africa is still not rising, and services alone will not create enough jobs to absorb the millions of unemployed youth in Africa's growing urban areas. Instead, steps must be taken to revise WTO agreements and the many trade agreements and bilateral investment treaties currently being negotiated so that Africa has the freedom to adopt the industrial policies it needs in order to make genuine progress. □

Rick Rowden is a development consultant and doctoral candidate in economics at Jawaharlal Nehru University in New Delhi. Previously he worked on economic development policy at the United Nations Conference on Trade and Development (UNCTAD) in Geneva and at ActionAid in Washington DC. He contributed the above article by invitation to ForeignPolicy.com, from which it is reproduced.

Resolving the emerging debt crises

More countries are facing a debt crisis, and the world urgently needs an international system of debt arbitration and restructuring.

by Martin Khor

The issue of foreign debt has made a major comeback. This is due to the crisis in Europe, in which many countries had to seek big bailouts to keep them from defaulting on their loan payments.

Before this, debt crises were associated with African and Latin American countries. In 1997-99, three East Asian countries also joined the indebted countries' club.

This year, European countries, notably Germany, insisted that private creditors share the burden of resolving the Greek crisis. They had to take a "hair-cut" of about half, meaning that they

would be repaid only half the amount they were owed.

It is increasingly realized that bailouts, where new loans are given to indebted countries in order to keep them up to date with paying their old loans in full, are not enough and may even be counter-productive when the countries are facing a problem of insolvency and not just a temporary lack of liquidity.

The restructuring of some Greek debt that was owed to private creditors is an example of what needs to be done.

However, the ad hoc restructuring undertaken in the case of Greece is not

enough. There needs to be a more systematic framework for countries on the verge of debt default to conduct a proper debt workout, with principles agreed to internationally.

In the absence of this, unilateral debt restructuring will probably be messy. When a country is forced by desperate circumstances to declare a default and propose its own debt restructuring, it may or may not succeed in getting its creditors to agree to the terms. Even if a majority of creditors agree to take the "haircut" proposed (for example, that 30 or 50 cents of every dollar of the debt is repaid), a minority may hold out against the restructuring and this may disrupt the whole exercise. The current court case taken by a "vulture fund" that is holding out against Argentina's debt restructuring is a clear example.

Though the debt crisis now has Europe as its epicentre, many developing countries may soon also be facing the same predicament. Due to the effects of the global economic slowdown, with export prices and earnings beginning to take a significant hit, many developing countries are becoming vulnerable to a debt crisis. An increasing number have dwindling foreign reserves that can only pay for less than three months of the value of their imports.

International debt workout mechanism

Recognizing the widening global crisis of debt, the United Nations General Assembly held a special event in October on "Sovereign debt crises and restructurings: Lessons learnt and proposals for debt resolution mechanisms".

As one of the speakers, I noted that there was a real need for an internationally coordinated system of debt workout. There are many weaknesses in the present situation of voluntary systems such as including an element of burden-sharing in collective action clauses in loan agreements, or in unilateral workouts that countries seek.

These voluntary methods may be either inadequate or messy and unpredictable in design and effect as they do not have the benefit of an internationally agreed system. There should thus be new efforts to find an international solution such as a statutory debt workout mechanism.

The elements of such an international sovereign debt workout system have been analyzed by the UN Confer-

ence on Trade and Development (UNCTAD). Even the International Monetary Fund (IMF) secretariat came up with a proposal for a sovereign debt restructuring mechanism some years ago, but it faced opposition from some countries and faded away.

The pioneering UNCTAD model is mainly based on the principles of US bankruptcy law. The principles from this law can be applied to countries in an international-level statutory debt workout mechanism. The elements of such a system are as follows.

First, a country facing debt difficulties can declare a temporary standstill on its external debt servicing. This gives breathing space for the country to formulate a proper debt servicing plan. The plan should cover all debt servicing, whether the difficulty is due to solvency problems, in which case the debt has to be reduced, or liquidity problems, in which case the debt has to be rolled over.

Second, there is an automatic stay on litigation by creditors during the standstill. This is to prevent a situation where many creditors scramble for an exit or line up to sue the country.

Third, an independent panel of legal and economic experts would be established to address the issues arising from the standstill, including assessing the country's debt situation. Creditors should not be on the panel as they have a direct interest in the case.

Fourth, the country concerned

would have to also undertake selective capital controls to prevent capital flight that can result from the standstill on debt payments.

Fifth, new loans should be provided to the debtor country, in a situation known as lending into arrears, in order that the country can continue to implement policies for economic and social development.

Sixth, the new loans contracted after the standstill should be given seniority status. This is to facilitate the emergence of new creditors and new loans.

Seventh is the debt restructuring exercise. It should include the rollover of existing loans, especially if the problem is only a liquidity problem; and partial debt write-down or write-off if it is a solvency problem. The terms should be the result of negotiations between the debtor country and creditors. If they cannot reach agreement, they can seek arbitration through the independent arbitration panel that is an important part of the system.

The UN is well placed to take the lead in this whole exercise of establishing a statutory debt workout mechanism.

This conclusion was also made at the special UN event by several other speakers, including the UNCTAD Secretary-General Supachai Panitchpakdi, Harvard professor Kenneth Rogoff, the Norwegian Vice Minister of Development and the Finance Secretary of Argentina. □

Internal audit warns of IMF politicization by US

The independent watchdog unit of the International Monetary Fund (IMF) has questioned the Fund's policy stance on foreign exchange reserves, which it suggests may have been influenced by political considerations.

by Carey L Biron

WASHINGTON: The International Monetary Fund (IMF)'s internal auditor has criticized the Fund's recent policy on foreign currency reserves, and has offered an implicit warning that the United States' outsized influence within the institution has resulted in policy that was insufficiently evidence-based.

The findings, which were publicized in an unusually narrow report on 19 December but follow months of discussion, are seen as a victory for a bloc of "middle income" developing countries, particularly China, that have advocated hoarding larger stockpiles of foreign cur-

rency as insurance against the effects of the international financial crisis.

Starting in 2009, the IMF began advising governments around the world not to depend too greatly on such reserves, anxious over the potential impact on the global economy. The Washington-based Fund offers yearly inspections on – and in certain cases nearly oversees – economies around the world, and remains one of the most powerful forces in defining the functioning of the international financial system.

That system has been upended in the aftermath of the 2008-09 financial

meltdown, however, and some key IMF tenets have increasingly been called into question, particularly by fast-rising economies such as Brazil, China, India and others. The IMF itself has realized that the Fund now needs to offer advice on finance rather than just macroeconomic policy, a new focus for which it is still strengthening its capacity.

Now, auditors with the Independent Evaluation Office (IEO) of the IMF have suggested that the Fund's spotlight on reserves was "not helpful", criticizing its economists for focusing on symptoms rather than on underlying causes of financial instability.

Around the world, the analysts point out, foreign reserves amount to only around \$10 trillion – a large amount, though not when compared to the \$105 trillion in the banking system or the \$117 trillion in the fund management industry.

Also, the governments and central banks that hold these reserves are relatively more interested in maintaining the stability of the international monetary system than are private-sector interests, seemingly further decreasing the potential for reserves to upset the global financial equilibrium.

Many officials, the report states, feel that IMF advice would have been better served by focusing instead on "other developments ... that they considered to be of more pressing concern than reserves".

Political factors

The IEO investigators hint that the IMF may have chosen to follow such a policy approach for less than apolitical reasons.

"The evaluation found a broadly held view that [the IMF management's] emphasis on excessive reserve accumulation was a response to frustration among some member countries with the IMF's inability to achieve exchange rate adjustments in Asian countries with persistently large current account surpluses," the audit states.

This appears to be a direct reference to longstanding frustrations voiced by the IMF's single largest shareholder, the United States, about a chief economic rival, China.

"When the IMF talks about imbalances, that's generally code for China and the United States," Jo Marie Griesgraber, executive director of New Rules for Global Finance, a Washington-based international network, told Inter Press Service (IPS).

"While the United States is desperately trying to jumpstart its economy,

(continued on page 16)

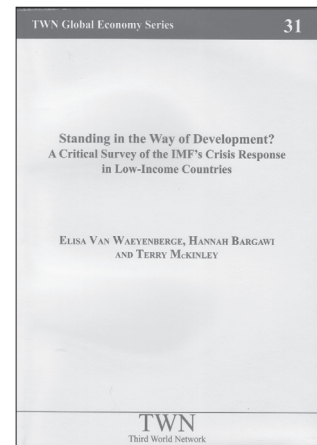
Standing in the Way of Development? A Critical Survey of the IMF's Crisis Response in Low-Income Countries

By *Elisa Van Waeyenberge, Hannah Bargawi
and Terry McKinley*

The International Monetary Fund (IMF), which has been criticised for the rigid economic policy conditionalities attached to its lending programmes, says it now provides borrower states greater flexibility to adopt expansionary policies. *Standing in the Way of Development?* assesses this claim in the context of the IMF's central role in dealing with the effects of the global financial crisis in low-income countries (LICs).

This paper evaluates the general macroeconomic policy scheme promoted by the Fund and closely examines the nature of its engagement during the crisis in a representative sample of 13 LICs. The authors find that, despite some relaxation of policy restraints, the IMF essentially remains wedded to its longstanding prioritisation of price stability and low fiscal deficits over other macroeconomic goals.

Such a policy stance, it is argued, could undermine not only LICs' prospects for a quick recovery from the crisis but also their longer-term development outlook. In light of this, this paper outlines the broad contours of an alternative macroeconomic policy framework geared towards supporting long-run equitable growth and poverty reduction.



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Thai-EU FTA raises alarm for people with AIDS

Public health advocates in Thailand fear that the country's planned free trade agreement with the EU will stem the supply of affordable generic medicines to those in need.

by Marwaan Macan-Markar

BANGKOK: Days before leaders of the European Union (EU) arrived in Norway to collect the Nobel Peace Prize, Thai public health activists sent a letter to the Northern powerhouse warning that the EU's 2012 accolades face a credibility test in this Southeast Asian country.

They had in mind the fate of Thailand's generic drugs supply line when Bangkok and the EU begin talks in early 2013 for a free trade agreement (FTA). The letter to Joao Aguiar Machado, deputy director general for trade at the European Commission, called for the bloc to respect special provisions in global trade rules for developing countries.

The EU's history of pressuring various developing countries around the world to comply with its conditions and requirements in free trade negotiations – which seek to remove all barriers to EU firms wishing to do business abroad – runs “contrary to the expectations” of a Nobel peace laureate, added the letter sent days before the 10 December awards ceremony in Oslo.

Generics under threat

“We are worried that the EU negotiators will force Thailand to accept new conditions on patents that would make access to new generic drugs more difficult,” says Chalerm Sak Kittittrakul, campaign officer at the AIDS Access Foundation. “People with HIV and patients needing medicines for cancer, heart disease and diabetes will have to pay more.”

“These clauses in a Thai-EU FTA would make it difficult for Thailand to produce or import generic drugs,” he told Inter Press Service (IPS). “It will pave the way for big pharmaceutical companies to monopolize the market and undermine generic competition.”

The EU is Thailand's second largest trading partner after the 10-member Association of Southeast Asian Nations (ASEAN). According to Thai officials,

bilateral trade between the two partners stood at \$35 billion in 2010.

Thai activists want the negotiating text for the bilateral trade deal to stay within the bounds of the World Trade Organization (WTO) law on Trade-Related Aspects of Intellectual Property Rights (TRIPS). The TRIPS rules permit developing countries with health emergencies to break the drug patents of pharmaceutical giants to either produce or import generic drugs.

But the FTA negotiations the EU has pursued with Thailand's southern neighbours, Malaysia and Singapore, have raised concerns about what could lie in wait when the EU begins its bilateral trade talks with Bangkok this year.

“They [the Brussels negotiators] are pushing for TRIPS-plus demands such as data exclusivity,” says Paul Cawthorne, an officer with the Access to Essential Medicines Campaign launched by the global humanitarian agency Doctors Without Borders (known by its French abbreviation MSF).

According to a leaked document from a Thai trade negotiating team seen by activists here, there is a chance that the EU-Thai FTA could include five years of data exclusivity for new drugs, a clause designed to stop safety-related clinical test or trial data submitted to regulatory authorities from being used by the manufacturers of generic drugs.

“This will slow down the process to produce and supply new drugs to the generic market,” Cawthorne told IPS. “This blocking tactic using data exclusivity will have a broader impact because Thailand has been a producer of generic drugs for years.”

Data exclusivity is not currently required by international law, argues Cawthorne. “The TRIPS agreement requires [WTO] member states to protect clinical data, but there is no obligation to grant any period of monopoly or exclusivity in the use of these data.”

Successful record

Thai health activists are hoping that their record of mounting successful campaigns against pharmaceutical giants – even from the United States – to ensure a thriving generic drugs market for patients in the country and across the region will remain intact.

The last showdown was in mid-2007, when activists threw their weight behind the then Thai government to invoke a WTO rule to secure generic drugs.

In January that year, Bangkok issued a “compulsory licence” (CL) to buy cheaper alternative antiretroviral drugs (ARVs) from India, bringing the country a reputation as another battleground for pharmaceutical giants determined to protect their intellectual property rights and profits from the generic drugs lobby.

Thailand, once one of the region's countries worst hit by AIDS, is currently home to about 600,000 people with HIV, of whom 200,000 have access to first- and second-line ARVs from government hospitals.

Such ARV coverage has earned the country praise in the region, adding to a long list of achievements to contain the spread of the killer disease and care for those infected.

Issuing CLs has meant Thais with lung and breast cancer and heart disease have had access to cheaper generic drugs since 2007, the year that even saw the Thai push for generics being endorsed by the World Bank.

The Washington-based financial institution revealed in a report that the use of CLs in Thailand's AIDS treatment programme would slash the cost of second-line drug treatments by 90%, helping the country to save an estimated \$3.2 billion over 20 years.

Such details are expected to fortify the current campaign. “It makes economic and public health sense for Thailand to strengthen its generic drugs supply and not expose it to TRIPS-plus measures,” says Jacques-chai Chomthongdi, research associate at Focus on the Global South, a Bangkok-based think-tank.

“Activists want the process to include public participation to protect the interests of people who need generic drugs,” he told IPS. “They have received word that the EU is insisting that TRIPS-plus provisions be included as a prerequisite to the FTA talks.” (IPS) □

Reforming and rebalancing finance in developing countries

Recent experience has underscored the need for developing countries to better regulate and organize the financial system in the interests of economic stability and development. *Yilmaz Akyüz* outlines several key issues that should be addressed in such financial restructuring.

A fundamental question raised by recurrent financial crises in mature and emerging economies is how to ensure that the financial markets and institutions serve growth and development rather than being a constant source of instability and disruption in pursuit of self-interest. This is not only a question of how best to regulate the existing institutions and markets, but also how to restructure and organize them.

Starting in the 1980s, most developing and emerging economies (DEEs) have rapidly liberalized their domestic financial markets and institutions, dismantling control over interest rates and credit allocation, privatizing state-owned banks and allowing entry of foreign firms in financial services, both in banking and in insurance. Many of them, including several African countries at a rudimentary state of industrialization and development, have also sought to establish and expand stock markets along the Anglo-American system of market-based finance even before establishing a modern banking system capable of supporting industrialization and development. The public sector has shifted almost everywhere from direct to indirect financing, but market discipline has failed to ensure greater fiscal discipline and restrain public deficits. Rather, many governments have seen a rapid accumulation of domestic debt.

There has also been widespread liberalization of the capital account, allowing freedom for most types of inflows from non-residents. Domestic equity and debt markets have been increasingly opened to foreigners in order to provide external financing for public and private sectors and to deepen these markets in the belief that this would make a major contribution to stability and growth. More recently, resident investment abroad has also been liberalized in several countries, in part in order to alleviate the pressure that the surge in capital inflows has exerted on currencies and balance of payments.

The record of DEEs with respect to stability and growth under extensive state intervention in the financial system, described as "financial repression" by orthodox economists, is mixed. While several economies had a poor record in terms of public sector deficits, inflation, savings, investment and growth, there were also notable exceptions, particularly among the late industrializers in East Asia. Similarly, Japan and many other mature economies which resorted to varying degrees of financial control in the decades following the Second World War enjoyed rapid and stable growth. For instance, in the US where Regulation Q prohibited, until 1980, payment of interest on demand deposits and imposed a cap on interest rates on savings deposits, private savings were much higher than in the subsequent period of financial liberalization and financialization – that is, rapid growth of financial activities and incomes relative to the real economy. Today, several fast-growing DEEs such as China and India still retain elements of extensive control over financial markets and institutions, and they have a much better record with respect to savings and

investment than many other DEEs with significantly liberalized financial systems.

Evidence suggests the absence of a strong link between the financial intensity of an economy and its growth rate. By contrast, excessive financial liberalization has clearly resulted in greater macroeconomic and financial instability in almost all countries, as well as compromising the ability of governments in DEEs to use financial policies for industrialization and development. The pendulum has swung too far, with the benefits of free financial markets falling rapidly as liberalization surged ahead at full speed. Now, a rebalancing is necessary between state intervention and free markets in the sphere of finance in search for greater stability and sustained industrialization and growth. In this context, at least five key issues need to be examined, drawing on the recent experience of both mature and emerging economies: the pros and cons of bank-based and market-based financial systems; the role of state-owned banks; public intervention in private banking; the role and impact of foreign banks; and capital account liberalization.

Bank-based versus market-based financial systems

The first issue is whether DEEs should focus on developing and modernizing their banks along the lines of the German-Japanese bank-based system or promoting direct financing through securities markets following the Anglo-American market-based system of finance. Bank-based finance involves long-term lending by banks to enterprises and, hence, necessitates substantial own capital to safeguard solvency. By contrast, in market-based finance, banks focus on short-term lending and hence need only adequate reserves and access to lender-of-last-resort financing in order to avert liquidity crises, while corporate investment depends mainly on share issues. It is often argued that the bank-based system allows better monitoring of enterprises by banks and of banks by the state, gives access to finance to larger segments of the society and generates more evenly spread wealth. On the other hand, stock markets are said to provide wider options in the allocation of risks and monitoring by shareholders, but foster short-termism.

Historically the bank-based system is found to be more stable. However, there are also important instances of severe banking instability and crises. The Japanese banking crisis starting in the late 1990s is a well-known example. It was triggered by massive equity-based loans to private enterprises to support excessive and unviable investment, and it cost the country at least a lost decade. Another example is Korea where extensive short-term foreign borrowing by banks to support global expansion of chaebols was a major reason for the 1997 crisis. A similar situation emerged in 2008 but the crisis was much less deep thanks to the existence of large reserves.

With the outbreak of the subprime crisis, a view emerged that “the world has turned a page on the Anglo-Saxon model” (then French President Nicolas Sarkozy, after the London G20 summit in April 2009). But in reality, with the repeal of the Glass-Steagall Act in 1999, the US had moved to universal banking, lending long-term and securitizing and marketing their illiquid, non-traded claims. On the other hand, banks in Germany had invested heavily in the so-called toxic assets produced during the subprime bubble and consequently suffered large losses. More importantly, the bank-based system in Europe has been experiencing serious difficulties as a result of massive and rapid lending to support speculative private investment in property as well as to meet growing budget deficits in some of the peripheral countries. These developments no doubt hold valuable lessons for DEEs in organizing and regulating their financial systems.

Role of state-owned banks

Despite widespread privatization, state-owned banks continue to hold prominent positions in a number of DEEs, including major emerging economies such as Brazil, China and India. In some advanced economies too such as France, state ownership still continues to be important in the banking sector. Moreover, as a result of bailout operations necessitated by financial crises, governments in several countries have come to be major shareholders in previously privately owned banks. These include not only developing countries facing BOP-cum-financial crises in the 1990s and early 2000s (e.g., Malaysia and Turkey) but also some mature economies such as the UK where the government is the dominant shareholder in Northern Rock and Royal Bank of Scotland.

Privatization has always been advocated on grounds that state-owned banks are prone to inefficiency, waste and political capture. However, after recurrent crises involving private banks, it is now widely recognized that what is privately profitable is not necessarily socially efficient, and waste and political capture are not peculiar to state-owned banks. Indeed, private and public banks now appear to have reached a *modus vivendi*, and in some DEEs state-owned banks are now considered as more secure than private banks, with the public shifting deposits from the latter to the former during the recent crisis.

Public banks appear to have three main advantages compared to private banks. First, they can accelerate industrialization and development by directing credits on appropriate terms and conditions to sectors that have greater capacity to contribute to overall development. Second, they can embrace all segments of society in providing financial services, including the poor and self-employed in rural and urban areas and small and medium-sized enterprises (SMEs). Efficient operation in these areas calls for reciprocity between support and performance and clear identification of the subsidy elements in lending and provision in the budget. Third, public banks have proved to be more effective in providing counter-cyclical financing during the recent economic downturn brought about by the subprime crisis.

However, it is also true that there are political cycles in lending by public banks in DEEs, with credit expanding rapidly before elections even when macroeconomic conditions do not warrant such an expansion. A main challenge thus is how to ensure that the public banks effectively render the function of developmental, inclusive and counter-cyclical lending while avoiding political cycles and rent-seeking.

Public intervention in private banking

State ownership is not always necessary for many of the above functions to be rendered effectively. In Japan, without ownership the government exerted considerable control over the banking system through moral suasion and other means in the course of its industrial development. Again, late industrializers in East Asia implemented policies of directed credit for industrialization through private banks, using administrative control, cross-subsidies and incentives. However, in many cases intervention in the credit market was designed to provide cheap finance to the public sector by means of control over interest rates and compulsory holding of non-interest-bearing government paper.

Such controls existed until the 1980s not only in DEEs but also in advanced economies. Restrictions on interest rates are estimated to have made a major contribution to the reduction of government war debt in the US and the UK between 1945 and 1980. Recent interventions in several mature economies are also seen in this light. Increased purchases of government debt by central banks, negative real interest rates, higher liquidity requirements to be held in government securities and legislation forcing pension funds to hold government debt are all seen as signs of return of financial repression in mature economies. Still, it remains true that these measures have been introduced not out of ideological conviction but to address the problem of increased public debt resulting from bailout operations and counter-cyclical policies necessitated by the financial crises triggered by speculative lending and investment by private banks.

The US experience with community banking also holds lessons for DEEs on how arrangements in a system dominated by private banks can help promote inclusive finance. Until 1980, the US legislation placed constraints on geographical diversification of activities of private banks. This forced them to focus on the neighbourhood in which they were operating, allocating much of their credits to communities in which they collected deposits. These restrictions were dismantled after the 1980s, leading to a rapid concentration in the banking sector, a factor widely seen as having made a major contribution to the subprime crisis.

Another factor that favoured community banking in the US is the Community Reinvestment Act of 1977 designed to promote lending by commercial banks and savings associations to all segments of the society, notably in low- and medium-income areas. It has been argued that lending under this Act, as well as property lending by government-sponsored agencies Fannie Mae and Freddie Mac, was responsible for the subprime crisis, but studies by the US Federal Reserve and the Bank for International Settlements (BIS) have found no evidence on the role of the CRA lending. Nevertheless, the policy of providing shelter to all segments of the society allowed the banks to engage in reckless lending without coming under close scrutiny. This experience thus holds lessons on how to prevent attempts to take financial services to all segments of the society becoming a source of instability.

Foreign banks

Entry of foreign banks to DEEs is often encouraged for two major reasons. First, by bringing knowhow, technology and competition, foreign banks could increase efficiency in the banking system, improving financial services and reducing intermediation margins. Second, greater presence of for-

eign banks is seen to increase the access of DEEs to international financial markets and enhance their resilience to external financial shocks. These considerations have no doubt played an important role in several DEEs making commitments under GATS negotiations in the WTO on trade in financial services.

However, it is also recognized that the presence of foreign banks in DEEs enhances the scope for regulatory arbitrage. Such banks can easily shift large deposits and lending abroad in order to benefit from more favourable regulations. They also tend to focus on more profitable operations such as trade credits, credit card lending to consumers and lending to large corporations, leaving less profitable activities and weaker borrowers, including SMEs, to domestic banks.

Significant presence of foreign banks in DEEs could increase their susceptibility to external financial shocks. In this respect, the recent experience of Central and Eastern European countries holds many useful lessons. The banking system in several countries in that region is dominated by foreign banks. These banks were heavily involved in carry-trade-style lending before the outbreak of the global crisis, externally funding their domestic lending and benefiting from large arbitrage margins. When the subprime crisis broke out and banks in advanced economies came under liquidity squeeze, these subsidiaries acted as a conduit of capital outflows in support of their parent banks. The resolution of the consequent payments difficulties faced by several countries in the region necessitated international intervention involving the International Monetary Fund (IMF) and the European Commission, under the so-called Vienna Initiative, and entailing pro-cyclical policy conditionality.

The pros and cons of opening markets to foreign banks in terms of efficiency, its effect on vulnerability to external shocks and regulatory arbitrage need to be assessed, drawing on such lessons. This is also necessary for DEEs to develop a viable negotiating strategy for GATS in the WTO.

Capital account liberalization

Just as in the case with domestic financial liberalization, there is no strong link between capital account openness and economic growth. But there is mounting evidence that capital account openness tends to lead to increased susceptibility to financial instability due to swings in capital flows and international contagion. However, despite recurrent crises triggered by reversal of capital flows in the 1990s and early 2000s, DEEs have continued to liberalize international capital flows in more recent years, including for both non-residents and residents.

Several emerging economies in Latin America and Europe have left their balance of payments and exchange rates to the whims of capital flows, but in Asia most countries have taken measures to reduce the likelihood of payments crises associated with boom-bust cycles in capital flows, by pursuing strong payments and reserve positions. The typical response of these countries to the surge in capital flows that developed alongside the global liquidity bubble after 2003 and sharp cuts in interest rates and rapid liquidity expansion in response to the consequent crisis of 2007-08 has been sterilized interventions in currency markets. In many cases interventions have also been accompanied by increased liberalization of resident investment abroad as a means of alleviating the pressures on the currency.

While preventing adverse impact of surges in capital flows on external trade and payments, these measures have not ad-

ressed a number of other problems associated with surges in inflows. Currency market interventions cannot prevent currency and maturity mismatches in private balance sheets, but only provide public insurance against private risks. It is costly to the government since rates on government debt used for sterilization exceed the return on reserves. It is also costly for the economy as a whole because returns earned by foreigners on investment in DEEs exceed the yield on reserves by a wide margin. More importantly, full sterilization is difficult and the consequent liquidity expansion often leads to bubbles in asset markets. In fact, asset markets in DEEs are now increasingly correlated with swings in net capital flows.

Similarly, liberalization of resident investment abroad could ease pressure on the currency and prevent liquidity expansion and the possible asset bubbles. But it does not prevent currency mismatches in private balance sheets. It also increases exposure to financial instability and crisis abroad, as seen in many European countries during the subprime turmoil where large sums were lost on investment in toxic assets. More importantly, it could mean one-way traffic – there is no guarantee that money will come back during bad times. In other words, unlike reserve accumulation, resident investment abroad does not provide self-insurance against reversal of capital inflows.

All these can make control over capital flows an indispensable tool in responding to destabilizing surges. Appropriately extended prudential measures can limit mismatches in banks' balance sheets and credit-related forex risks. But these may not be enough to contain destabilizing impulses since about 70% of inflows to DEEs are not intermediated by the banking system. More direct measures may be needed. Indeed, several DEEs have made attempts to introduce controls over capital inflows in recent years. But these tax-based, market-friendly, ad hoc and partial measures have not been very effective in containing destabilizing impulses.

In view of heightened instability of capital flows due to self-seeking policies and increased financial difficulties in the advanced economies, it is important to reconsider the policy response to surges in capital flows to DEEs. A key question in this respect is whether DEEs should establish a permanent regime of controls, to be used in appropriate doses as and when required, rather than introducing ad hoc market-friendly measures on a temporary basis, as now advocated by the mainstream, including the IMF. □

Yilmaz Akyüz is Chief Economist of the South Centre. The above was first published as a South Centre Policy Brief (No. 14, December 2012) titled "Key issues in the organization of and government intervention in finance in developing countries: Lessons from recent experience".

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The World Bank and industrial policy: Hands off or hands on?

Carlos Fortin considers whether the World Bank is likely to rethink its long-held suspicion of industrial policy.

In a 2002 article, Nobel economics laureate Joseph Stiglitz pointed out that industrial policies had obtained a bad reputation¹: “As my predecessor at the Council of Economic Advisers put it, it makes no difference whether the economy produces potato chips or computer chips – the economy should produce whatever maximizes GDP, and the market is in the best place to make those decisions.”

The World Bank has long been singled out as leading the criticism of industrial policy, mainly because of its overall approach to development policy, which involves a limited role for the state in the economy to allow markets to function well (Singh 2011). Industrial policy, which is by definition a non-neutral governmental intervention aimed at altering market price signals in order to steer investment in desired directions, would appear to be excluded in this approach.

Therefore development scholars and practitioners greeted with some excitement a series of papers by then Bank chief economist Justin Yifu Lin, as he appeared to put forward a different, more positive view of industrial policy as a tool for development. If Lin’s ideas were adopted by the Bank as official policy, it was suggested it would be tantamount to a major turnaround. As is often the case, on closer inspection the situation turns out to be more nuanced.

Evolution of the Bank’s views

To start with, the Bank has never rejected industrial policy under all circumstances, although its distaste for it has always been evident. The *World Development Report (WDR) 1991* puts it this way:

“In several respects, government intervention is essential for development. What then are the conditions under which government intervention is likely to help, rather than hinder? Economic theory and practical experience suggest that interventions are likely to help provided they are market friendly” (World Bank 1991, p. 5).

This means that governments should “let markets work unless it is demonstrably better to step in ... it is usually a mistake for the state to carry out physical production, or to protect the domestic production of a good that can be imported more cheaply and whose local production offers few spillover benefits” (ibid.). It further means subjecting interventions to the test of the international and domestic markets, and withdrawing support when market performance shows that the industry is unviable.

The Bank elaborated on these issues two years later in a report on the so-called “East Asian miracle”, which analyzes the experience of eight East Asian economies – Hong Kong, Indonesia, Japan, the Republic of Korea, Malaysia, Singapore, Taiwan (China) and Thailand – which underwent rapid development with extensive use of industrial policies (World Bank 1993). The report acknowledges that “in most of these economies ... the government intervened – systematically and through multiple channels – to foster development” (World Bank 1993, pp. 5-6). Its conclusion, however, is that the inter-

ventions did not have much effect: “despite government intentions, the manufacturing sector seems to have evolved roughly in accord with neoclassical expectations; industrial growth was largely market conforming.”

The conclusion ran counter to those of several students of the East Asian experience, such as Alice Amsden and Robert Wade, who had argued that industrial policies had been important in consolidating the productive structure of the countries; and it was subsequently challenged by other analysts, such as Ajit Singh and Stiglitz just before he joined the Bank as chief economist.

Partly in response to those criticisms, the Bank produced its most detailed statement on industrial policy in its 1997 *World Development Report* devoted to the role of the state (World Bank 1997). This time the Bank recognized that industrial policy interventions can indeed be successful in some cases:

“Economic theory and evidence suggest that the possibility of successful market-enhancing activism cannot be dismissed out of hand ... as a way of kickstarting industrial growth, states have been tempted to supplant market judgments with information and judgments generated in the public sector. These efforts rarely work, although the success of some ventures by Korea’s chaebol (interlinked business groups), made at the initiative of government, suggests that the quest to pick winners is not inevitably a fool’s errand” (World Bank 1997, p. 74).

The report goes on to distinguish between “light touch” initiatives, such as those involving network-thickening, and “high intensity” initiatives, like coordinating investments and picking winners. The latter are not ruled out, but are subject to strict conditions. A basic condition for high-intensity initiatives to be successful is institutional capability: “strong administrative capability, commitment mechanisms that credibly restrain arbitrary government action, the ability to respond flexibly to surprises, a competitive business environment, and a record of public-private partnership” (ibid., p. 75).

Furthermore, and most importantly in the Bank’s view, “a country’s strategy for industrial development has to be guided by its evolving comparative advantage ... Some proponents of activist measures have favoured efforts to nurture a nascent comparative advantage by encouraging firms to risk more on a new market than they might otherwise have been willing to invest. Very few, however, would support wholesale leapfrogging”.

Lin’s new structural economics

In contrast to the essentially neoclassical approach adopted by the Bank in 1997, Lin’s overall framework is what he terms “new structural economics”, which involves combining neoclassical analysis with insights from the structuralist school of economic development. Specifically, it is “founded on structural differences between developed and developing countries and acknowledge[s] the active role of the state in facilitating the movement of the economy from a lower level

of development to a higher one" (Lin 2012).

This means that industrial policy is not just a last resort to be used only "reluctantly" (World Bank 1991, p. 5) but a legitimate, normal tool of development policy: "the new structural economics offers a clear rationale for having a proactive, facilitating state in the process of economic development" (Lin 2010).

In one crucial respect, however, Lin's approach retains a central neoclassical premise. It is that "a country's comparative advantages and thus its optimal industrial structure are determined by its factor endowments" (Lin 2012, p. 5). Consequently, industrial policy should only be used to facilitate the upgrading of industries which are consistent with the country's comparative advantages.

Lin refers to "latent and evolving" comparative advantage, thus introducing a dynamic component often absent in the Bank's past formulations. It would appear that at this point his analysis is in effect essentially the same as the Bank's. In this vein Ajit Singh calls Lin's message "deeply conservative" (Singh 2011, p. 7) and Ha-Joon Chang writes that Lin needs to "free himself from the shackles of neoclassical economics" (Chang 2012, p. 133) in order to accept that a country needs to defy its comparative advantage to upgrade its industry. In this reading, the new structural economics would appear to be a case of *plus ça change, plus c'est la même chose*.

An alternative reading

There is, however, an alternative reading of Lin's proposal. Renowned proponent of industrial policy Dani Rodrik feels that Lin's ideas are, at least potentially, a significant departure from existing Bank approaches. For all the emphasis on conforming to, not defying, comparative advantage, writes Rodrik, "if one believes that externality and coordination problems need to be addressed, as Lin apparently does, one must believe that such problems are preventing firms from investing appropriately. One must believe that markets are sending entrepreneurs the wrong signals – invest here, not there – and that allocating resources according to comparative advantage, as revealed by market prices, would be socially suboptimal" (Rodrik 2012, p. 54).

In Rodrik's view it is clear that if Lin thinks governments must step in to address those market failures, he is in effect asking them to defy comparative advantage as revealed by market prices. The approach leads inexorably to a more activist role for the state, despite Lin's reluctance to admit it.

What next for the Bank?

It is an open question which of the readings of Lin's analysis, the conservative or the activist, is the right one. The important issue is which of the two is more likely to be adopted by the World Bank. Lin was replaced at the Bank in July by Kaushik Basu of Cornell University, who at the time was chief economic adviser to the government of India. His views on the issue and more generally his approach to economic development policy will obviously have a major influence on the Bank's position.

Basu is definitely a free-market man, although not a market fundamentalist; in a 2006 article in *The Times of India* he had this to say about the opening up of the Indian economy: "For over 40 years, we in India strangled market forces and

individual enterprise in the belief that government could deliver it all, thereby creating a system where those with greater propensity to corruption were rewarded. Today, when we hear from the other extremity that it should all be left to the market, we must remember our propensity to extreme views and tenacity to hold on to them despite contrary evidence. We must not err the next 40 years with another flawed ideology" (Basu 2006).

His preference for a restricted role for the state, however, is apparent when he goes on to summarize what its role in the economy should be: "government is needed to redistribute to the poor (the market has no natural propensity for this), provide public goods and enforce contracts. On the other hand, an economy cannot be run by government alone" (ibid.).

This view, which he has elaborated upon in some detail elsewhere (Basu and Maertens 2007; Basu 2010; Basu 2011), does not differ fundamentally from the approach presented in the already cited 1997 *WDR*, and would suggest that no major departure from the established Bank view on industrial policy should be expected.

Perhaps more decisive for trying to predict the line the Bank may take on industrial policy is observing what developed- and developing-country governments – which are, after all, the Bank's shareholders – are doing in this field. Here, as Rodrik (2010) has pointed out, it seems clear that industrial policy is back, whether in Britain, France, China or, interestingly, in the United States, despite the fact that the notion is still anathema in the public debate there. Rodrik observes that the US Department of Energy alone is planning to spend more than \$40 billion in loans and grants to encourage private firms to develop green technologies, such as electric cars, new batteries, wind turbines and solar panels, a clear case of environmentally oriented industrial policy.

The Bank would therefore do well to reflect on Rodrik's perceptive summing up: "The standard rap against industrial policy is that governments cannot pick winners. Of course they can't, but that is largely irrelevant. What determines success in industrial policy is not the ability to pick winners, but the capacity to let the losers go – a much less demanding requirement ... A government that makes no mistakes when promoting industry is one that makes the bigger mistake of not trying hard enough." □

Carlos Fortin, a former Deputy Secretary-General of the United Nations Conference on Trade and Development (UNCTAD), is a research associate with the Institute of Development Studies in the UK. This article is reproduced from the website of the Bretton Woods Project (www.brettonwoodsproject.org).

Endnote

1. Stiglitz's own view, as is well known, is quite the opposite; the argument against industrial policies, he went on to say, "is based on a naive reading of economic theory and a misreading of economic history" (Stiglitz 2002, p. 15).

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(continued from page 8)

policymakers are holding interest rates low, but this is trashing other countries' attempts to hold down the appreciation of their own currencies. Brazil is perhaps the most prominent example in this regard."

Brazil has been at the forefront in pushing up its foreign reserves, continuing to increase this cushion as the world economy has continued to roil.

While Griesgraber suggests that powerful countries such as China and Brazil will increasingly get away with flouting IMF diktat, she warns that smaller countries continue to get squeezed by overlapping responsibilities imposed by the World Trade Organization and various bilateral treaties – responsibilities often, and still, demanded by Washington.

Meanwhile, with the largest trove of international reserves in the world, estimated at some \$3 trillion, China is given special attention in the IEO report. Washington has long accused Beijing of holding down the yuan's exchange rate in order to keep exports cheaper. (Significant reserves can be one result of an artificially low exchange rate.)

The exchange-rate issue even became a central point during the recent presidential election here, with President Barack Obama's Republican opponent, Mitt Romney, pledging that he would formally declare China a "currency manipulator" on his first day in office.

And while many analysts have suggested that Beijing's currency manipulation isn't really much of a factor anymore, the 2012 presidential election saw both candidates trying to take a harder line on the issue.

IMF managers, meanwhile, have rejected several of the audit's findings, warning that the IEO investigators have understated the potential disturbances caused by excessive reserves and have misconstrued the breadth of the Fund's response in dealing with the global economic downturn.

While IMF staff did not respond specifically to any broader accusation of politicization, others have urged caution in this regard.

"Reserves have multiple purposes," Dev Kar, lead economist with Global Financial Integrity, a Washington-based watchdog, and a former senior economist at the IMF, told IPS in an e-mail. "While a large accumulation serves the insurance purpose ... such an accumulation can impose a cost on other countries (for example, inhibiting corrective action on the exchange rate)."

He continued: "So research cannot be seen as kowtowing before any country's economic or political agenda.

The facts are what they are. The interpretation lies in the eyes of the beholder."

On the other hand, Griesgraber emphasizes that the fact that countries are feeling the urge to build up the cushion of significant reserves in the first place underscores a broader problem facing the IMF, which was originally created to offer just this type of insurance for economies facing uncertainty.

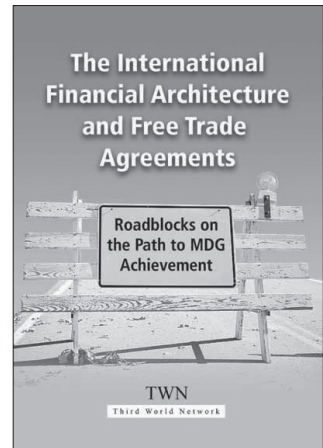
"If the IMF is not fulfilling the purpose for which it's designed, it makes sense to have some form of self-insurance," she says. "At the same time, we can't forget that this has a high opportunity cost for many countries, which are forced to use their own money for interest payments rather than using it to build roads, strengthen health systems, and other social expenditures." (IPS) □

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