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Rethinking Global Economic Governance: Towards Trade and Financial Reforms for Enhancing Development

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Abstract

This paper highlights that origin and cause of the financial crisis that originated from the US. It further links the crisis to issues of weak governance and the economic tenets that have shaped global trade and financial exchange. With the linkage drawn it further examines the economic impact of the financial crisis on developing countries and Africa in particular. The paper concludes by providing recommendations that would assist African countries mitigate against such adverse external shocks.

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**RESPONDING TO GLOBAL CRISES: NEW
DEVELOPMENT PATHS**

**RETHINKING GLOBAL ECONOMIC GOVERNANCE:
TOWARDS TRADE AND FINANCIAL REFORMS FOR
ENHANCING DEVELOPMENT**



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1.0 BACKGROUND TO THE FINANCIAL AND WIDER ECONOMIC CRISIS

The debate on global economic governance has taken the centre stage in economic debates all over the globe. While this debate has been ongoing for decades, it has gained momentum after the 2008 financial crisis that emanated from the United States and spread to other countries with strong links with the US Economy. The financial crisis has its origin in US subprime mortgage market, which collapsed due to issues related to moral hazard and adverse selection. The ripple effect from the subprime lending market quickly spread to other sectors of the economy and other parts of the world. The securitization process in the subprime mortgage market has largely been blamed for the financial crisis and the wider economic crisis. The loans in the subprime market which were very risky were turned into securities ‘mortgage backed securities’ and sold in various financial markets. This form of securitization was considered very innovative by bankers and investors and not only a good way of managing risk but also transferring risks to others. Given that the subprime loans were given to individuals with a high risk of default, and the interlinked nature of investment, investors started offloading these securities as they were not bringing the returns that were initially envisaged. And as a result several large investment banks experienced bank runs:

- 1) On September 7, 2008: Two United States Government sponsored enterprises, Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) went into conservatorship run by FHFA (Federal Housing Finance Agency).
- 2) On September 14, 2008, Lehman Brothers filed for bankruptcy, the Sale of Merrill Lynch to Bank of America.
- 3) On September 16, 2008, AIG faced severe liquidity crunch defaulters.

The issue of economic governance strongly featured in the US financial crisis debate because the securitization market was not regulated. There was no regulation to guard against excessive risk taking in the financial system. Secondly, while lack of regulation is a factor to consider, the economic tenets that have shaped trade and financial transactions play an important role. In the late 20th century and early 21st century, the free market theory has largely shaped economic exchange in all sectors. The theory of free market has largely been advocated for by the Breton Woods Institutions: World Bank and IMF, the World Trade Organization among other key players that shape the global economic landscape.

2.0 THE TENETS OF ECONOMIC GOVERNANCE FOR DEVELOPMENT AND THE RESULTING GLOBAL ECONOMIC CRISIS

A set of rules that govern the daily interactions of human beings form an institution. Institutions in turn govern production and exchange which could be in the form of a law, an organization or a political government. Economic governance focuses on sound economic management of an economy that ensures sustainable development overtime. Economic governance creates, protects and enforces property rights that then facilitate economic activities. Global trade and international finance has been largely governed by international agreements ratified by member countries that then adhere to the rules. The end of World War II saw the creation of the International Monetary Fund (IMF), whose role was to bring stability to the international monetary system, and the World Bank, whose function was to channel investment into development and reconstruction projects. These two Breton Woods institutions: i.e. The World Bank and the IMF strongly advocated for free market economies where there was little interference from the government. This saw the privatization of government owned enterprises in many developing countries. It was argued that with competition

and free markets, the forces of demand and supply would determine prices, and furthermore, the neoclassical theory of international trade argued that with trade, incomes and wages would be raising leaving trading partners better off, and hence the rationale for free trade, and the strong emphasis by the Breton Woods Institutions.

The unregulated free market was a major determinant of the financial crisis. Mortgage brokers in the subprime market did not follow the rules in determining who got the loans, the brokers then absolved themselves from the risk by selling these loans to other investors as mortgage backed securities, since undeserving people were able to get the loans, more low income people were able to purchase houses, others even went ahead to speculate, where they would buy a house and later sell it at a profit, and then leverage it to buy another investment. The high rate of default caused a slump in the housing sector, this affected the financial sector and the ripple effect resulted in massive loss of job, lack of effective demand in the US and other developed countries such as Germany, France and the UK. This weak governance of the financial sub-sector has had severe effects in developing and least developing countries as will be discussed in the next section.

3.0 THE ECONOMIC CRISIS AND ITS IMPACT ON AFRICAN COUNTRIES

The outward cascading of the financial crisis to other sectors that were previously unaffected and to the global economy has raised serious concerns on the impact of the financial crisis on developing countries. The magnitude of the crisis largely depends on developing countries economic relationship with advanced countries that were greatly affected such as US, the European Union and the UK among others. Given that Africa largely consists of least developed countries and a few developing countries, which have weak links with developed countries financial markets, most African countries experienced 'second round' effects.

- 1) India and China experienced a financial contagion where there were serious drops in the stock markets; these equally affected other sectors of these emerging markets. Given that China and India are major trading partners of African countries, the impact of the financial crisis on both the Chinese and Indian economy resulted in lower exports and trading prices of natural resources. Given that most African countries are commodity dependent, the incomes of rural households which are largely from agriculture reduced substantially.
- 2) There is a large African economic immigrant community in the US and EU, the increase in unemployment due to closure of businesses resulted in a decrease in remittances from immigrants to their native countries. This in turn affected the exchange rate and current account balances.
- 3) There was a reduction in the official flows and donor aid to African countries since the major donors are the US and the EU. There was even pressure to further reduce already committed aid and other official flows in an effort to deal with the wider economic crisis.
- 4) There was a reduction in foreign direct investments and equity finance was also on a downward trend. However, this occurrence was greater South Africa which is more integrated with the global economy as compared to other African counterparts.
- 5) Given that most African countries experience large current account deficits, and with reduced exports and therefore weaker currencies, most countries would have to increase prices to correct for these imbalances leading to inflation.

The above effects as highlighted vary from country to country, however, the economic impact tends to remain the same, and these include:

- 1) Weaker revenues emanating from exports which are dominantly commodities.
- 2) Greater imbalanced on the current accounts and balance of payments
- 3) Lower investment due to a reduction in foreign direct investments and even lower growth rates.

- 4) Loss of employment due to decrease in demand for commodities
- 5) Reduced remittances to native homes

Lower growth rates therefore translate to higher incidence of poverty, more crime, and weaker social protection systems that cushion citizens against such calamities. As a result, African countries will still face a lot of difficulties in meeting the millennium development goals within the given time frame.

4.0 CONCLUSION AND RECOMMENDATIONS

It can be concluded that the ability of African countries to cushion themselves against the crisis largely depends on their commodity export demand, external financing such as development assistance, foreign direct investments and their ability to undertake stabilization or expansionary fiscal and monetary policies. The only way in which losses from the financial and wider economic crisis can be mitigated in Africa is through strong counter –cyclical policies that offer safety nets to its citizenry, however, such policies will not be reached with the traditional World Bank and IMF prescriptions such as the “Washington Consensus’ but these require keen surgery of an economy in order to be able to provide effective stimulus packages that restores and economy to an effective growth path. Some of the recommendations that would bring such results include:

At International Level

- 1) A paradigm shift by key players in international trade from the neoclassical theory of free markets to a balanced notion of including government in effective economic governance and in particular regulation of laws that facilitate trade and exchange.
- 2) Cost adjustment funds should be put in place by multilateral organizations that shape global trade and financial transactions, to assist member countries adversely affected by external shocks protect their economies. These funds would assist countries effectively adjust to the external shocks that may arise such as the financial and economy wide crisis.

At Country Level

- 3) Fight against corruption is paramount if any African economy is to achieve sustainable development. In fighting corruption, resources are freed that can be used to achieve development and poverty reduction and more so provide a cushion against external shock such as the financial crisis. Furthermore issues of equity which are a source of civil conflicts will also be dealt with simultaneously.
- 4) Strong and accountable institutions will ensure proper economic governance and citizens and investors will also be guaranteed their property rights which is an important factor in achieving sustainable growth.
- 5) Move from commodity dependence to service production. Different economies should endeavor to move to manufacturing with high added value that drives away commodity dependence and vulnerability to external market shocks.
- 6) Move from aid dependency to better fiscal management, with better fiscal management, most countries will be able to finance both their development and recurrent budgets. Less reliance on donor aid is important as governments are able to chart development paths that benefit the citizens.
- 7) Social protection and safety nets mechanisms should be put in place to protect individuals who have to bear the adjustment costs of any external shocks, which may arise such as the financial and economy wide crisis.
- 8) African countries rich in commodities also tend to be rich in genetic resources. These resources through innovations and intellectual property initiatives can be turned to income through patenting. Royalties (returns due to patent protection) if well used would result in development. Countries should invest in legal and institutional frameworks that protect intellectual property emanating from the same resources used for commodity production.