

Crisis Mitigation by and for Developing Countries
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Introduction

The report of the Growth Commission, published in 2008, was chiefly concerned with steps that developing countries can take to achieve and maintain high economic growth and improve the quality of life in those countries. Although the first signs of an economic slowdown were already apparent in some developed countries, the authors of *The Growth Report* could not have anticipated the onset of the deep global recession that has reduced the exports of developing countries and, in combination with net capital outflows, led to large depreciations of some countries' currencies. The prices and volume of both manufactured and commodity exports have fallen dramatically from the high levels reached earlier in this decade.

This paper will ask what developing countries' governments can do individually to ameliorate the impact of the global economic contraction and what the international community can do collectively. The paper will undoubtedly repeat recommendations made by other papers written for this meeting, but it may reinforce some of those recommendations.

The title of the paper is meant to convey obliquely the main message of the paper. The developing countries can neither fend off nor resolve the global economic crisis, although there are steps they can take to mitigate the painful effects of the crisis, as well as steps that can be taken internationally to foster the recovery of the global economy on which all countries depend for the rapid revival of their own economies.

Manifestations of the Crisis

Despite the remarkable progress that many developing countries have made in recent years, diversifying their economies and raising living standards, many are still very vulnerable to a deep, long-lasting recession in the major developed countries. In recent months, moreover, several developing countries have experienced large capital outflows reflecting domestic and foreign concerns about their economic prospects and the stability of their banking systems; some countries' banks have large foreign-currency debts and others have taken large losses on their foreign-currency assets.

As a result of those capital outflows, the currencies of several developing countries have depreciated sharply *vis-à-vis* the US dollar, and some countries, large and small, have run down their foreign-exchange reserves. The International Monetary Fund, which had been shedding staff to cope with an impending budget deficit, began again to lend on a large scale, and it opened a new window, the Short-Term Liquidity Facility (SLF), to provide quick-disbursing credit to countries with strong macroeconomic conditions and policies but subject nevertheless to sudden short-term pressures. When the SLF failed to attract customers, presumably because drawings on the SLF had to be repaid too quickly, the IMF announced a comprehensive overhaul of its credit facilities, extending more liberal access to emerging-market and developing countries, while relying more heavily on *ex ante* tests of eligibility for access to

IMF credit rather than traditional *ex post* conditionality.¹ The Fund is also seeking to supplement its financial resources by borrowing from individual members. Having obtained an offer of \$100 billion from Japan and €75 billion from the European Union, it seeks to borrow another \$150 billion in order to raise its readily available resources to \$500 billion. Looking ahead, it has been suggested that the IMF enlarge and activate the New Arrangements to Borrow (NAB) to provide the Fund with even more resources.

The main aim of this paper, however, is not to rehearse at length the evolution of the global crisis. It will propose ways in which developing countries can reduce their own vulnerability to international financial crises and cope more effectively with such crises when they occur. The paper has three main parts. The first, following this introduction, will suggest ways in which developing countries, lacking comprehensive social safety nets, may still be able to reduce the hardships suffered by their people when their countries are caught up in a major economic crisis – lessons we might draw from the current crisis even before it has ended. The second part will examine ways in which international arrangements and institutions, especially the IMF, can contribute more effectively to crisis prevention and crisis resolution. The third part will examine more radical proposals for reforming the international monetary system, including proposals by other participants in this meeting.

What Developing Countries Can Do for Themselves

Unfortunately, there is little that a developing country can do to ward off the effects of a major economic contraction in the industrial countries. At one time, most textbooks told us that a country could insulate itself from external shocks by allowing the price of its currency to float freely. As its trade balance worsened because of a fall in the foreign demand for the country's exports, the country's currency would depreciate sufficiently to rebalance its foreign trade – to raise the foreign demand for its exports and reduce its domestic demand for imports.

That proposition was rather simplistic, however, because it paid insufficient attention to the role of international capital flows in the propagation of macroeconomic shocks, and its validity is surely open to question when a country's main trade partners are suffering a similar fall in demand for their exports or when, as in East Asia, some of the countries' main export industries are integrated into multicountry supply chains. An improvement in a country's trade balance has then to be achieved mainly by raising the domestic-currency prices of the country's imports, so as to reduce the domestic demand for those imports and stimulate the domestic production of import-competing goods. That may take time, however, and for the effect to be long-lasting, the country's monetary and fiscal policies must be sufficiently austere to prevent higher import prices from triggering a wage-price spiral.

In many developing countries, moreover, the domestic economy is heavily dependent on the export of a single commodity, be it petroleum, copper, or rice, that has no close substitute at home or abroad, nor can the domestic output of that commodity be raised rapidly in response to the stimulus of a higher domestic-currency price. Other developing countries are heavily dependent on imports of grain and other staples for which no close substitutes are produced

¹ These changes are concisely summarized in the Background Note issued by the IMF on March 24 2009.

domestically. Some of these countries have large foreign-exchange reserves and may not need financial assistance from the International Monetary Fund, even if the demand for their main export products do not revive quickly. Others may deplete their foreign-currency reserves and need help from the IMF. Fortunately, the changes made recently by the IMF in the form and substance of the policy commitments it will extract from its clientele should make it easier economically and politically for governments to seek assistance from the Fund.

As the global economic crisis evolved and spread to countries far from its epicenter, very large numbers of workers lost their jobs, notably in China, and many moved back to the countryside. The same thing is apt to occur on a smaller scale in some of the Gulf Emirates, where huge office towers are being left unfinished, and the workers who were building them have been discharged with no new jobs on offer. They may have to return to their home countries to seek food and shelter. Their plight is evocative of an earlier era, when unemployed workers in the industrial countries depended on private charities for food and shelter – conditions that led to social and political upheavals.

Today, of course, the major industrial countries have fairly comprehensive social safety nets and the ability to undertake large-scale, labor-intensive projects to put people back to work. There is room for thoughtful disagreement about the size and quality of some such projects, as well as the time it will take to get them under way. The projects themselves may be “shovel ready” but the bureaucratic processes involved in bringing shovels and workers together may take much time, especially in the case of large-scale projects.

Developing countries, however, can ill afford long delays in bringing shovels and workers together. Few of them have social insurance programs comprehensive enough to mitigate the suffering of workers and their families when jobs disappear, nor the financial and real resources required to initiate large job-creating projects as soon as economic activity slows down. It might therefore be best for them to rely on large numbers of small projects – literally, not figuratively, shovel ready – along with stockpiles of basic foodstuffs and of the materials needed to provide temporary shelter for unemployed workers and their families. There is surely no shortage of roads to repair nor schools and clinics to build, and well as other labor-intensive projects. In many low-income developing countries, of course, there are too few nurses to staff new clinics and too few teachers to staff new schools. Those that are available may have therefore to serve as mentors, teaching others how to teach basic skills and how to provide basic health care.

Finally, governments in developing countries should seek out and punish severely employers who have shut down their plants without paying their workers the wages those workers have already earned. Outrageous instances of this sort have been reported in places as far apart as China and the Congo.

Looking ahead, it is time for developing countries to start weaving their *own* social safety nets, including at the very least unemployment insurance programs wholly or partly financed by private and public employers. We have lived through a rather long period of prosperity, not only in the major industrial countries but also in many developing countries. We may face more

turbulent times, even if we successfully tame and harness the financial sector to serve the real economy more benignly.

Finally, governments in countries that have sovereign wealth funds might require those funds to set aside some of their earnings to help their countries' governments finance a social safety net, rather than retain and reinvest all of their earnings to resolve more distant problems. Taking a longer view, economic diversification, not the accumulation of financial assets, may offer the best protection against a future loss of export earnings from an exhaustible resource.

In a number of countries, moreover, especially in East Asia, domestic policies should be redirected to reduce the export dependence of their economies, and this should be done not only by countries like China, that export finished manufactured goods, but also by the several countries that produce and export key components for those manufactured goods. All such countries should stimulate domestic consumption, however difficult that may be when unemployment and economic insecurity are rising. Radical innovations in fiscal policies may be needed for this purpose, including, for example, government sponsorship and insurance of new financial institutions specialized in the provision of consumer credit, ranging from car loans to home loans. Under present conditions, those financial institutions may have high loan-loss rates, but the cost to the government of providing insurance against their losses would be lower than the cost of large capital-intensive projects, which may do less to generate the income and employment required to offset the loss of jobs in the private sector.

Similar innovations may be helpful in other developing countries, such as middle-income countries in Latin America, but they will not be very helpful in low-income countries. There, multilateral lenders, especially the World Bank and the regional development banks, may have to play a major role by focusing on large numbers of relatively small infrastructural projects that can create employment and income quickly. Ideally, the gathering and vetting of proposals for those projects should take place in prosperous times, and some of the projects should surely be undertaken as soon as they have been identified, rather than being shelved until economic conditions deteriorate. Otherwise, those who manage the transition from project design to implementation will not gain experience, while those who proposed the projects initially may lose faith in the whole process. But that is a problem for the future. The immediate need in many developing countries is for a large number of relatively small, labor-intensive projects that can be started quickly, to foster economic and social stability.

These suggestions are consistent with a point stressed in *The Growth Report*, that industrialization and urbanization go together:

It is extremely rare to achieve per capita incomes above \$10,000 (in purchasing power parity terms) before half of the population lives in the cities. Urbanization is thus the geographic corollary of industrialization: as workers leave the farms for factories, they leave the fields for the cities. (*Growth Report*, p. 58)

Nevertheless, big cities can benefit hugely from small-scale projects such as the building of neighborhood schools and clinics. I commend them for three reasons. First, they can be started rather quickly if they are planned in advance, thus reducing the long lags in implementation that

may help to explain why fiscal policies in developing countries are often found to be procyclical. Second, they readily accommodate local involvement in planning and subsequent implementation, thus helping to create durable urban communities to substitute for the rural communities that migrants from the countryside have left behind. Third, they contribute to the quality of urban life by providing an unending stream of social services, especially health care and education.

A large inventory of small-scale projects cannot contribute greatly to macroeconomic stability unless financing for the execution of those projects is made available as soon as there are signs of an economic slowdown or outright contraction of economic activity. It would therefore be prudent to set aside receipts from a particular tax or use charge, to be released if and only if there is verifiable evidence of an incipient economic slowdown – a decline, for example, in revenue from a cyclically sensitive source, even a decline in the growth rate of that revenue. It might indeed be prudent to appoint *two* officials as guardians of the accumulated revenue, one from the national government and one from the local government, each one with a ‘key’ to the figurative lockbox but joint responsibility for the prompt and proper use of the accumulated revenue.

Reforming Global Financial Governance

Let me now turn to a very different question. What have we learned from the current financial crisis about the governance and supervision of large financial institutions? Surely, it has taught us how little we know – and how much more we need to know – about the governance and wide-ranging activities of those institutions, let alone the complex financial instruments they created and sold to their customers around the world. I have been greatly impressed by two recent studies of these issues: *The Report of the High-Level Group on Financial Supervision in the EU*, chaired by Jacques de Larosière, and *The Turner Review* (which is focused more narrowly but not exclusively on recent British experience). Both of them and other recent studies concentrate on three complex issues: (1) How best to supervise transnational financial institutions? (2) How best to assess the quality of the instruments they issue? (3) How to prevent the failure or likely failure of one such institution from impairing the viability of other institutions, including those in other countries?

I have no satisfactory answer to the first question. Although I have no personal experience of banking supervision, I find it hard to believe that a “college” of supervisors coming from countries with different laws, regulations, and practices, can assist substantially in the supervision of a large multinational bank with the frequency and rigor required to protect the bank’s investors, depositors, and other counterparties. They may be quite useful within the European Union, but I am more skeptical about the contribution they are likely to make to the safety and soundness of global financial institutions, which must answer to several sets of national laws and regulations. I am also concerned by the amounts of time that may be required to prepare for meetings of the colleges, which cannot be very useful unless they are well prepared, with adequate documentation and appropriate attention to differences in national laws and regulations.

I also wonder about the amount of information that may be lost in the consolidation of bank supervision, with the far-flung operations of a global bank being examined chiefly at the bank's head office. An astute examiner might have questions about a bank's activities in a particular foreign country. Would anyone at the bank's head office be able to answer those questions definitively? How long might it take to extract meaningful answers from the bank's foreign affiliate? Similar problems may, of course, arise with regard to a bank that has many domestic branches, but I am more confident of an examiner's ability to obtain adequate information about a domestic branch than about a foreign branch or subsidiary.

In the end, I come down reluctantly in favor of the colleges, with one important reservation – that the need for well-prepared meetings of those colleges may have to be met by increasing the number of skilled supervisors, so that the time taken by meetings of the colleges does not reduce the time available for the actual supervision of financial institutions. The usefulness of the colleges, after all, will depend on the quality of the information that the supervisors bring to the meetings of the colleges.

Recent events in the United States, raise questions about another matter – the supervision of financial conglomerates, such as AIG, that are major if not dominant players in the markets for certain financial instruments (in the case of AIG, credit default swaps) and have therefore become too big to fail. In this particular instance, failure could have called into question the solvency of the institutions that were the counterparties to the contractual commitments made by AIG, as well as the insurance coverage provided by AIG and its far flung subsidiaries. I know of no way to prohibit a financial institution from becoming too big to fail, yet ways must be found to protect its counterparties without burdening the taxpayer with the bill for the firm's bad bets. We might also be thinking of new ways in which the counterparties of a large financial institution can insure their claims against the insolvency of that institution, and do so at an affordable price. (This is, of course, what credit default swaps were supposed to do, but they became a vehicle for gambling on near-term insolvency rather than purchasing long-term insurance against it.)

Reforming the International Monetary System

Several years ago, I attended at conference at the Mount Washington Hotel at Bretton Woods, convened to commemorate a more memorable conference held there in 1944. As I stood in the lobby of the hotel, two men who looked to be somewhat older than am now greeted each other enthusiastically. One of them exclaimed "It's good to see you. I thought we were both dead." Both of them, of course, had attended the Bretton Woods Conference of 1944.

Although those two gentlemen are no longer with us, the institutions born at Bretton Woods are very much alive. Like the Mount Washington Hotel, however, they need periodic renovation. So too, do the policies and practices of the governments that bear the main responsibility for the functioning of the international monetary system. It is, to be sure, a more heterogeneous system than the one adopted in 1944, but some rather odd features remain. One of the very odd features is the role played by the Congress of the United States. As some of you probably know, the United States did not adhere to the Articles of Agreement of the IMF in the

usual way – by a two-thirds vote of the U.S. Senate, which is way it ratifies a treaty. Instead, it adopted legislation, the Bretton Woods Agreement Act, which governs the participation of the United States in the IMF. The good news is that the White House does not have to obtain a two-thirds vote of the US Senate to approve an amendment to the Articles of Agreement of the IMF, which is what is needed to adopt or amend a treaty. The bad news is that it has to obtain approval by the House of Representatives as well as the Senate, which means that the White House must convince majorities in both the Senate and the House that a proposed amendment to the Articles of Agreement of the IMF is consonant with the national interest of the United States.

I dwell on these peculiar arrangements because of the problems they pose whenever the United States is called upon to endorse a change in the Articles of Agreement of the IMF. First, the US Treasury must persuade the President’s advisors in the White House that the change at issue is important enough to warrant an expenditure of political capital, a precious commodity in this country even when, as now, the President enjoys widespread support in the country and the Congress. Second, it must persuade the relevant committees of the Congress to approve the requisite legislation without the inclusion of extraneous or damaging amendments, and then to obtain the approval of the House and Senate.

That is why I feel sadly safe in saying that it would be nearly impossible to make a major, discontinuous change in the governance of the IMF – to eliminate or even reduce substantially the number of cases in which 85 percent of the votes in the Fund must be cast in favor of a decision or, for that matter, adopt a significant change in the Fund’s Articles of Agreement that was not strongly favored by the United States. Let me be clear. I am not defending the hegemonic influence of the United States in the IMF, nor am I defending the leading role of the US dollar in the international monetary system. I am trying merely to explain how voting in the Fund came to be what it is and why it would be very hard to change substantially. As for the role of the dollar in the international monetary and financial system, that too may be hard to change, although a significant change has already taken place with the advent of the euro, and a further change may well take place when the renminbi has become fully convertible for capital as well as current transactions.

In a recent speech, Governor Zhou of the People’s Bank of China called for a fundamental reform of the international monetary system, one that would introduce “an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies.”²

In principle, the SDR comes close to meeting Governor Zhou’s objective, as he acknowledged in his recent speech. Its value is defined by a weighed basket of four major currencies (the dollar, euro, pound, and yen) which are, of course, widely used in the invoicing of world trade and the issuance of international securities, and the quantity of SDRs is governed by the IMF, in which, I have said, the United States has disproportionate influence but cannot always command sufficient support for its own policy preferences. I would also draw attention

² Zhou Xiaochuan, “Reform the International Monetary System,” The People’s Bank of China, Beijing, March 26, 2009.

to the recent *Report* of the Committee on IMF Governance Reform chaired by Trevor Manuel, which made far-reaching recommendations.³

In his recent speech, however, Governor Zhou skirted an issue that others are bound to raise – one that has proved fatal to earlier proposals aimed at enhancing the role of the SDR as a reserve asset. He proposed the creation of an open-ended fund which, he said, would allow subscriptions and redemptions of existing reserve currencies in exchange for SDR-denominated claims. This proposal resembles one made several years ago – the proposal for a so-called substitution account into which official holders of dollars could deposit them with the IMF in exchange for SDR denominated claims. That proposal foundered when official holders insisted that the United States maintain the SDR value of the dollars held by the account by topping up its dollar holdings whenever the dollar depreciated *vis-à-vis* the SDR. If the SDR-denominated fund proposed by Governor Zhou imposed the same maintenance-of-value obligation on the US Treasury, it would be unacceptable not only to the Treasury but also to the US Congress, as it would impose an open-ended financial obligation on the United States.

We've been here before, and we'll be here again. Happily, these episodes are few and far between. On a more serious note, however, the time may soon come to consider very carefully proposals like those made by Governor Zhou. At the moment, governments have a great deal of work to do stabilizing the world economy. Once that is done, they can and should turn their attention to longer-term issues rather than lose interest after the crisis has passed.

³ Committee on IMF Governance Reform, *Final Report*, March 24, 2009.

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