FINANCIAL AND MONETARY REFORM FOR SUSTAINABLE DEVELOPMENT

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The 2008 global financial crisis

hit harder Rich countries than developing ones

- The ones that suffered less were the ones that got less indebted,

either in domestic or in foreign markets.

Rich countries suffered more

Because it was in the US that the crisis broke up.

Because it was a banking crisis not a currency crisis (which a typical of developing countries).

Because their banks were more involved into speculation and fraud through financial “innovations” based on derivatives and securitization.

The developing countries that suffered less

were the ones that limited current account deficits and foreign indebtedness,

either by <u>design</u> (Asian countries), or by <u>luck</u> (Latin American countries benefited by high commodity prices in the 2000s.

From the crisis we all learned that

- - financial regulation is highly necessary,
- - banks should have much higher capital requirements,
- - the “too big to fail” condition must be tackled,
- - asset prices bubbles matter more than inflation if we hope either to avoid or to limit the scope of future financial crises

But the response has not be proportional to what we learned

- Financial regulation and increase in capital requirements advanced, but modestly
- No solution was offered to the “too big to fail” condition
- Policymakers continue to look more to inflation than to asset bubbles.

But we fail to learn

- - that private indebtedness is more frequent than public financial lack of responsability
- (certainly, in rich countries; increasingly, in the developing countries)
- - that for developing countries current account deficits and foreign indebtedness in foreign money are highly undesirable: they rather cause successively, (a) subtituon of foreign for domestic savings; (b) financial fragility, and (c) currency crisis.

In other words, we learned that neo-liberal and neoclassical assumptions are wrong

- 1. Financial markets are not self-regulated and efficient
- 2. Mathematical risk calculations based on the general equilibrium model are not a substitute for higher capital requirements.
- 3. Big banks are indeed too big to fail, and markets do not offer a solution for that major problem.
- 4. Credit and other asset bubbles are at least as bad as inflation.
- 5. The “Lawson doctrine” (private markets are always in equilibrium; the problem is with the state) is just wrong.
- 6. Growth with “foreign savings” is a mistaken growth policy.

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Two proposals

- On the “too big to fail” problem
- (that interest everybody)

- On current account deficits and the exchange rate
- (that interest developing countries <u>and</u> US.

On the too big to fail issue

1. In order to o desistimulate risky practices on the part of big banks.
2. If it requires bailing out:

a. stockholders will fully lose their values

b. major managers will be required to return to the bank two-thirds of what they won in the previous three years.

(The protection of small depositors so as to turn unnecessary bailing out medium banks poorly managed was already undertaken)

On the current account issue

- 1. A cap should be established to c.a. deficits and surpluses.
- The US proposed 4%
- There is no possible reason why to limit budget deficits and not current account deficits.
- 2. Dutch disease countries should have not deficit but surplus current account
- They don’t need foreign capitals except to finance the beginning of the production of the Dutch disease commodity

Dutch disease countries

- Are countries that are benefited from Ricardian rents originated from
- - abundant and cheap natural resources
- - cheap labor combined with large wage differences,
- and, for that reason, display a permanently overvalued currency that is consistent with the

1. current exchange rate equilibrium (that balances the current account), not with the

2. industrial equilibrium – the exchange rate required to make competitive tradable industries utilizing technology in the world state of the art.

Thus, most developing countries (including China) suffer and benefit from the Dutch disease.

The exchange rate is in the core of development economics, because

it <u>tends</u> cyclically to the overvaluation, to booms and sudden stops, and <u>is</u> permanently overvalued (thus, not just a macroeconomic problem)

- Due to:
- A. the Dutch disease
- B. excessive capital inflows wrongly justified by
- 1. growth with foreign savings policy
- 2. use of the exchange rate as nominal anchor against inflation
- 3. high interest rates to fight inflation and to attract foreign capitals
- 4. exchange rate populism

When the country neutralizes the Dutch disease,

it will display a current account surplus,

because

it will have shifted from

- the current-account equilibrium exchange rate
- to the industrial equilibrium exchange rate

which is, by definition, consistent with current account surplus,

in so far as it is more depreciated than the current equilibrium, when there is Dutch disease.

Thus, a cap on current account deficits and surpluses

1. is an advertence to <u>incompetent</u> policymakers in countries that accept without restrictions current account deficits financed by capital inflows.

-This is dangerous for non-Dutch disease countries (as the present case of Spain underlines),

and absurd for Dutch disease countries (like Brazil).

2. It imposes a limit to <u>competent</u> policymakers that, in order to neutralize the Dutch disease, manage their exchange rate to the point of achieving very high, non-cooperative, current account surpluses (case of China and other fast growing Asian countries).