

The morning after the night before

The impact of the financial crisis on the developing world

A Christian Aid report
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We believe in life before death

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Introduction

What a night! A bender of epic proportions! Above-trend economic growth for 15 years, fuelled by a heady cocktail of apparently stable low unemployment and low inflation, looked to the more intoxicated as though it would never end. The world, it seemed, had discovered a new investment system in which financial-market wizardry would lead to ever-greater heights of economic performance.

In the cold light of day, it's easy to see how misplaced the exuberance was. The stimulants that made it a night to remember now stand exposed for what they really were: regulatory weakness that allowed credit to balloon out of control and a lack of transparency that enabled businesses to hide the true state of their finances – at least until the music stopped.

Chastened taxpayers in the western world are now footing the bill for the excesses of the night before in the form of multi-billion-pound payouts to keep afloat the banks that triggered the crisis in the first place. At the same time, many people's main assets – their pension funds and their houses – are losing value.

World stock markets, where most pension funds are heavily invested, lost around a third of their value in the year to September 2008, wiping US\$20 trillion off the value of listed companies.¹

In the United Kingdom, the London stock exchange lost almost 30 per cent over the same period.² At the same time, the price of a 'typical' house in the UK dropped by 14.6 per cent³ while in the second quarter of 2008 housing repossessions soared by 70 per cent.⁴

Those in richer countries who are feeling the pinch have every right to complain. The regulators who were supposed to protect society from institutional financial recklessness were seduced by the zeitgeist

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United Nations Secretary-General Ban Ki-moon

and went partying instead.

With the morning-after recriminations now underway in earnest, one salient fact should resonate: however bad it is for richer nations, **it is the poor and vulnerable in developing countries who will suffer most from this financial crisis**, which is not of their making.

Already hard-hit by soaring food and energy prices that pushed up inflation, causing food shortages and widespread hunger, poor countries can only look on helplessly as demand for their exports drops and vital remittances sent back by family members working in the industrialised world rapidly dwindle.

To cap it all, richer countries, in a desperate bid to shore up their economies, are failing to honour aid commitments.

Some analysts are already predicting cuts in official development assistance (ODA) of up to a third or more. 'We are deeply concerned about the prospects for ODA,' Brett House, senior economist at the United Nations Development Programme (UNDP), said in November 2008.⁵

'In past periods of market turmoil and recession, global ODA has on occasion fallen up to 40 per cent from established trends.'

United Nations Secretary-General Ban Ki-moon is similarly alarmed. The world financial crisis, he warns, 'could be the final blow that many of the poorest of the world's poor simply cannot survive'.⁶

So how have we come to this? The bitter irony, as we show in this report, is that the turmoil now engulfing the world's wealthier economies can be traced directly back to the same factors that have undermined the developing world for years, condemning poor countries to a cycle of poverty.

For two decades or more, the international community has resolutely looked the other way while big business has exploited inadequate global financial regulations and the lack of transparency afforded by 'secrecy jurisdictions', more usually known as 'tax havens', to the detriment of the world's poorer countries.

Many transnational corporations (TNCs) and other major concerns have aimed to minimise, avoid, or even illegally evade altogether, their obligation to pay tax in many of the countries where they operate.

It was lax regulation, coupled with banking secrecy, that also accounted for the massive problems in the United States' sub-prime mortgage market – the trigger of the present crisis.

Christian Aid estimates that in the developing world, tax evasion by international business currently amounts to some

US\$160bn a year.⁷ If allocated according to present spending patterns, that sum would be enough to save the lives of 350,000 children under the age of five a year.

As world leaders now struggle to control their economies in today's market mayhem, it is imperative that they seize what is emerging as the rarest of opportunities to institute root-and-branch reform to global financial systems for the benefit of all – rich and poor alike.

Christian Aid has prepared this report for the International Conference on Financing for Development, which finance and development ministers from around the world will attend in Doha, Qatar, in November 2008.

The conference will examine the impact of the financial crisis on poorer countries, and it will assess the progress made towards realising the 2002 Monterrey Consensus on Financing for Development, which signposted how public and private funds could be used to help poor countries.

The Consensus was reached in 2002 in Monterrey, Mexico, between more than 50 heads of state and 200 ministers of finance, foreign affairs, development and trade, as well as heads of UN organisations, the International Monetary Fund (IMF), the World Bank and the World Trade Organisation (WTO).

Christian Aid has examined the impact of different income streams on poorer countries. In this report we conclude that nations struggling to find a way out of poverty benefit far more from revenues from taxes that they themselves impose and collect than from any other source of income.

Tax revenues (compared to natural-resource wealth or to aid) are not only a sustainable form of finance, they also strengthen the democratic process, ultimately improving governance and ensuring that money is well spent according to the needs of a country's citizens.

Efforts to counter today's financial meltdown must include a tightening of regulations and the removal of the secrecy that tax havens at present offer, in order to protect wealthier economies and enable poorer countries to collect money that is rightfully theirs. There is growing international support for clamping down on such secrecy, with US President Elect Barack Obama sponsoring a 'Stop Tax Haven Abuse Act' in the US and France and Germany demanding reform. However the UK government has until recently resisted such calls, potentially undermining the very fight against poverty that UK Prime Minister Gordon Brown, then Chancellor, spearheaded three years ago at the G8 in Gleneagles.

In recent weeks, Secretary-General Ban Ki-moon has

repeatedly stressed the need to keep long-term objectives for the developing world, such as the Millennium Development Goals (MDGs), at the centre of the global agenda.⁸

Eight MDGs to tackle global poverty were agreed in 2000 during the UN Millennium Summit. They include halving by 2015 the number of people living on less than one dollar a day and the number suffering from hunger; promoting gender equality; achieving 'full and productive' employment for all; making primary education universal; and achieving dramatic cuts in child and maternal mortality rates.

Before the present crisis struck, experts were already warning that while significant progress towards meeting the MDGs was being made, 'urgent and increased efforts'⁹ were needed, particularly in sub-Saharan Africa. Reforming the global financial system would help answer that rallying cry.

The need for that effort is now more urgent than ever. Two giant steps forward would be:

- **to introduce a requirement that businesses that operate transnationally must reveal publicly what they pay in tax in every country where they do business. That way abuses can be quickly identified**
- **to reach a global agreement that will lift the cloak of secrecy that tax havens offer, forcing them to share information with tax authorities in other countries.**

With those two measures in place, future crises can be averted and the battle against poverty can take on a new momentum.

In October 2008, the United Nations Food and Agriculture Organisation's Director-General, Jacques Diouf, reported that only ten per cent of the US\$22bn pledged to help ease food shortages had so far been handed over.

The cost to the developing world

The financial crisis began in the developed world, but because economies there are interlinked with poorer nations, the crisis is now global. As the UN Secretary-General, Ban Ki-moon, put it recently, it's not just Wall Street and Main Street that are hurting; people with 'no streets' are suffering too.¹⁰

Some developing countries are more vulnerable than others, depending on their reliance on different types of finance: aid, income from commodity and other exports, foreign investment and flows of remittances from expatriate workers.

Most, however, will face a growing struggle as remittances decline, aid commitments in all likelihood fall short, export earnings fall and panicking foreign financiers withdraw their money.

Growth rates are expected to fall, although whether countries in the developing world tip over into recession remains to be seen. The full impact of the crisis remains unknown, but damage is already apparent.

The threat to aid

Rich governments have found hundreds of billions of dollars to shore up their financial systems but poor countries don't have such huge resources. They need foreign aid more than ever now, at a time when wealthy nations are more preoccupied than for many years with their own economic woes.

At best aid revenues seem likely to stall, and may well fall as financial pressure mounts on donor governments and they look for politically easy spending cuts. Long-held pledges that donor countries will scale up their giving to 0.7 per cent of their gross national product (GNP) now look increasingly unlikely to be realised.

The threat of cuts is sufficiently serious to have prompted a chorus of recent calls, from institutions such as the IMF, World Bank and UN, for governments to maintain aid flows.

In a statement on 12 October 2008, the development committee of the World Bank and IMF urged: 'Poorer countries, with their limited sources of fiscal revenue, will be especially dependent on timely and predictable flows of official

development assistance (ODA). In this regard, we emphasise the enhanced importance, in the current context, of donors meeting their ODA commitments.'¹¹

UN Secretary-General Ban Ki-moon went further, warning that the financial crisis could undo progress towards eradicating poverty, hunger and disease, fighting climate change and promoting development. The world financial crisis 'could be the final blow than many of the poorest of the world's poor simply cannot survive', he said.¹²

The evidence shows that aid flows are already drying up. On World Food Day in October 2008, the United Nations' Food and Agriculture Organisation's Director-General, Jacques Diouf, reported that only ten per cent of the US\$22bn pledged earlier this year to help ease food shortages had so far been handed over.¹³

This shortfall augurs ill for the new pledges of US\$16bn made in September 2008 at a UN summit on the MDGs.

Remittances are falling

Across the world, families are noticing a fall in the amount of money being sent home by relatives in developed countries who may be struggling to make ends meet, worrying about their futures or have already lost their jobs.

In many parts of the world, remittances are hugely important, making up more than 20 per cent of the gross domestic product (GDP) of some poor countries.

In Kenya, remittances, which make up five per cent of GDP, plunged by more than one-third to \$36.5m in the year to August 2008, according to the Central Bank of Kenya.

The fall in remittances, in turn, is reducing demand in the shops. It has also caused a drop in the value of the Kenyan shilling, which means that imported goods cost more.¹⁴

A sustained fall of this size effectively knocks two per cent off the country's GDP at a stroke – and potentially much more when the multiplier effects of money no longer being spent are taken into account.

In the Philippines, the government is alarmed at the

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Philippines Presidential spokesman Jesus Dureza

prospect of some of the millions of Filipinos who work overseas losing their jobs. At present, their remittances supply some ten per cent of the country’s GDP.

Presidential spokesman Jesus Dureza said: ‘We should be prepared for a worst-case scenario, because our country is part of what we call a global village. If their stomach aches, we will also feel it.’¹⁵

It is a similar story in the Caribbean and Latin America, where in El Salvador and Guatemala remittances contribute 18 per cent and 12 per cent of GDP respectively.¹⁶

The Inter-American Development Bank (IDB) forecasts that in 2008, the real contribution of remittances to households in Latin America and the Caribbean (that is, after adjusting for inflation) will fall for the first time on record.

In making that prediction, it emphasises that remittances are not used for luxury purchases, but for vital goods and for long-term development. ‘In countries such as Mexico, remittances are a key poverty-reduction tool, as more than 57 per cent of remittances are used to purchase daily necessities such as food, clothing and shelter,’ said a recent IDB report. ‘The remainder of the money is saved, invested in housing, small businesses or education.’¹⁷

World Bank researchers have found that a ten per cent increase in remittances to a country is associated with a 3.5 per cent fall in the proportion of people living in monetary poverty, so that ‘dollar for dollar the income remitted by migrants from abroad reduces poverty by much more than income generated by domestic economic activity.’¹⁸

Export orders tumble

The fall in consumer demand that is leading the US and Europe into recession is also hitting demand for developing countries’ exports. The credit crunch, meanwhile, is making the short-term loans that finance roughly 90 per cent of trade both expensive and hard to obtain. The lubricant of world trade is drying up.

One startling sign of the slowdown in trade is the plunge in the cost of shipping bulk products such as iron ore, grain, coal and bauxite. The Baltic Dry Index, a composite of shipping prices for dry bulk products, has plummeted 92 per cent from 11,793 points in May 2008 to just 891 in early November, according to the United Nations Conference on Trade and Development (UNCTAD).¹⁹

This may be of some small consolation to exporters, who will have to pay less to ship their products, but it is also powerful evidence that export volumes are slumping

and expected to fall further.

Announcing the new figures in early November, UNCTAD commented: ‘This shows that the unfolding financial crisis has spread to international trade with negative implications for developing countries, especially those dependent on commodities.’²⁰

In fact, most developing countries’ exports are still heavily based on commodities.²¹ Excluding the newly emerging industrial economies of east and south Asia, primary commodities accounted for about 51 per cent of developing countries’ exports in 2003-6, and 79 per cent of African countries’ exports over that period.

As UNCTAD has commented: ‘Commodity-dependent economies are exposed to considerable external shocks stemming from price booms and busts in international commodity markets... For metals and minerals, industrial raw materials and energy, price movements are strongly determined by demand, and are closely linked to global industrial and economic activity.’²²

This is evident in the prices of industrial metals over the course of 2008, which have tumbled back from their recent record highs. Copper, for instance, reached \$8,454 per tonne in the second quarter of 2008 but by mid-October it was down to \$6,198.²³ Nickel has plunged by more than half, from a peak in 2007 of \$37,136 per tonne to \$15,494 in mid-October 2008. Aluminium, tin, zinc and lead are also all substantially less valuable now than earlier this year.²⁴

Demand for some manufactured products – especially luxury items – also seems certain to fall as US and EU consumers lose confidence.

Some observers have suggested that China could be an alternative market for east Asian manufacturer. However, economist Jayati Ghosh, professor of economics at India’s Jawaharlal Nehru University, argues that China is ‘highly unlikely’ to become an alternative engine of economic growth for the world economy, because China’s growth has itself been export-led.²⁵

Indeed, China is suffering a fall in demand for its own products. In early November 2008, one index of new orders, exports and other factors sunk to its lowest level since the index began in 2005, as export orders fell and demand dwindled for industrial goods such as steel and machinery.²⁶

Demand in a very different sector of the global economy – tourism – is also suffering as financially stressed consumers from rich countries stay at home or take short-haul holidays.

The Caribbean – the world’s most tourism-dependent region – is already seeing a fall in demand from the US and Europe, according to the IMF.²⁷

Indeed, tourist industries across the world, which are growing most rapidly in developing countries, have been feeling the effects of the financial crisis since the summer, according to the United Nations World Tourism Organisation (UNWTO). Both business and leisure travel are affected and UNWTO expects the situation to deteriorate further.²⁸

Falling employment and tax revenues

As demand for poor countries’ goods and services falls, the industries affected will lay off workers or cut their hours, adding to unemployment or under-employment and poverty.

That falling demand, as well as the fall in commodity prices, will also cut developing countries’ tax revenues, with knock-on effects on their governments’ ability to provide education, health services and other spending aimed at reducing poverty.²⁹

However, although economic growth is expected to slow in developing countries, they will not necessarily experience recession. If they do manage to avoid it, tax revenues could remain relatively steady while other sources of development finance drop off. Recession would imply a much bleaker prognosis.

Finance flees developing economies

In 1998 the bursting of the property bubble in Thailand prompted foreign investors to rush for the exit in countries across the region and ultimately even in Latin America and Russia.

This time, outflows of foreign capital from developing countries seem to have been triggered by the realisation that since the richest countries in the world have struggled to bail out their financial systems, smaller economies might well prove unable to do so.

John Lipsky, the IMF first deputy managing director, told New York financiers at the end of October 2008 that developing countries’ stock markets had suffered even more than their own.

‘Emerging equity markets already have absorbed greater losses than mature markets, reflecting investors’ flight to safety in the face of high uncertainty and risk aversion,’ he said. ‘Anticipating a significant growth slowdown, emerging equity markets have declined around 50 per cent year-to-date.’ The flight of foreign capital could ‘seriously harm’ growth in emerging economies, he added.

During October, capital reversals – in which foreign investors withdrew their money from the stock markets, government bonds and currencies – hit countries that had played little, if any, role in the financial crisis, forcing many to seek outside support.

Developing countries that had recently received much foreign investment in local stock markets are now seeing sudden reversals, according to IMF data.³⁰ India, for example, enjoyed inflows of around US\$12bn a year on average for 2005-2007. In 2008, it has already seen outflows of more than US\$9bn.

Asia as a whole has seen average inflows of more than US\$13bn a year over the past three years turn in 2008 into an outflow of more than US\$15bn – and counting. Average inflows of more than US\$4bn a year to Latin America over a similar period have in 2008 become an outflow of more than US\$4bn so far.

The sudden withdrawals matter because they hit the value of stock market-quoted companies and lower the value of developing countries’ currencies, making their exports cheaper but their imports more expensive.

This makes it much harder for the private sector – including banks – to repay loans or obtain additional borrowing in foreign currency. This in turn threatens the stability of banks and reduces lending to businesses and individuals.

‘Even countries that have excellent track records of implementing strong macroeconomic policies have been caught up in the global financial market crisis,’ the IMF’s managing director, Dominique Strauss-Kahn, has warned. On October 29 the IMF responded with a new Short-Term Liquidity Facility, aimed at helping developing countries survive foreign investors’ withdrawals of vast sums.³¹

Foreign direct investment which involves taking physical control of a business or establishing a new one is also likely to suffer more gradually as global investment retrenches.

Food prices are stoking inflation

High food prices are not a result of the financial crisis. They reflect other factors such as higher fuel prices, misplaced trade liberalisation policies, under-investment in food production and the impact of climate change. Nonetheless, they make it harder for poor people to cope, making it more expensive to get enough to eat, at a time when people’s incomes may be falling as growth rates slow, remittances fall and unemployment rises.

‘With food accounting for a major part of household expenditure, the resulting loss in the purchasing power of the poor is a serious concern. . . In these circumstances, maintaining, if not increasing, aid remains of paramount importance.’

Antoinette Sayeh, director of the International Monetary Fund’s African Department

The prices of many staple foodstuffs hit record highs on world markets early in 2008, with the dramatic hikes triggering riots in many countries. By September, they had fallen back from their peak, as buyers’ expectations of economic slowdown reduced demand.

Risk of riots and instability

In November, however, the United Nations’ FAO warned that the world might face a repeat of the food security crisis as the credit crunch encroached on agricultural markets.³²

‘Riots and instability could again capture the headlines,’ said an FAO report. The price of corn, wheat and rice was said to have fallen 40-60 per cent, but that should not lead to a ‘false sense of security’.

‘Under the current gloomy prospects for agricultural prices, high input costs and more difficult access to credit, farmers may cut their plantings, which might again result in a tightening of world food supplies,’ the report said.

IMF figures in October 2008 showed that many important foods remained well above the prices in the last quarter of 2007, stoking double-digit inflation in some countries and meaning that food remains painfully expensive for poor people.

For instance, in September 2008, the price of rice – a staple food in many developing countries – remained double what it was in the last quarter of 2007.³³ Maize and sugar were well above their 2007 (fourth quarter) levels, and the prices of soya and rapeseed oil were also higher. The price of oil, which influences food prices, was also still above its 2007 (fourth quarter) level in September 2008.

In sub-Saharan Africa, high prices are fuelling inflation. The IMF forecasts that inflation will have hit 12 per cent this year and that it will still be running at ten per cent next year.

Antoinette Sayeh, director of the IMF’s African Department, said in October: ‘The challenge for policymakers is to adjust to the food- and fuel-price shock, preserve economic stability in the face of global financial turbulence and shield the poor.’³⁴

‘With food and fuel prices substantially off recent peaks, it should be easier to fully pass through higher prices to the economy to encourage adjustment,’ she argued.

However, she added: ‘With food accounting for a major part of household expenditure, the resulting loss in the purchasing power of the poor is a serious concern. . . In these circumstances, maintaining, if not increasing, aid remains of paramount importance.’

The IMF has sounded a similar warning about the situation

of poor people in Latin America, saying that some may be forced to cut back on food. ‘The pick-up in food inflation puts at risk the gains on poverty reduction from the sustained reduction of inflation across the region through 2006,’ it said. ‘The rise in food prices since end-2006 may have lowered real consumption of poor urban households, all other factors being equal, by 16 per cent in Nicaragua and three per cent in Mexico in this period.’³⁵

While Christian Aid welcomes the fact that the IMF is monitoring the development impact of the crisis, there are serious questions over the IMF’s ability to play a more positive role. Christian Aid believes the IMF would be of more benefit to poorer countries if its efforts were concentrated on ensuring stability in international financial markets, instead of, for example, providing small amounts of expensive financing to low-income countries, where the IMF has little obvious expertise.³⁶

As we explore later in this report, the IMF’s role in previous crises has been controversial at best and, for many countries, clearly damaging. Moreover, there are doubts as to whether the IMF now has sufficient funds to make a significant difference if the crisis takes on greater proportions in developing countries.³⁷

How lack of information helped create a crisis

The roots of the grave problems now facing developing countries lie thousands of miles away from most of their borders, in the fever that surrounded the United States' sub-prime mortgage market and in the plush boardrooms of what were, until recently, the most powerful financial institutions in the world.

Information and the customer

It has long been recognised that financial markets are different from others, in that they are more highly dependent on information. If you sell me a banana, you care only that I have the money to pay for it immediately. If you make me a loan, however, you will usually want to know whether I have the means to pay you back. That will require information about how solvent I am, as well as my probity.

If you know that I have assets (a house), a steady income (a sound job) and a reputation for repaying my debts (good credit history), you will probably make the loan. If you cannot find out any of these things, you probably won't.

If, however, you have an incentive for making the loan, regardless of whether or not I can keep up the repayments, you may well decide to lend to me anyway. This is the story of the US sub-prime mortgage crisis that triggered the present financial maelstrom.

In recent years, mortgage brokers in the US were systematically engaged in obtaining customers by whatever means they could, knowing that they would be paid on the basis of every loan made, regardless of the customer's subsequent ability to repay the borrowed money.

This behaviour, which in retrospect appears almost criminally negligent, was encouraged by banks keen to extend credit in the full confidence that the loans made could then be shifted along the chain and sold *en bloc* on the international market for collateralised debt.

Those who ultimately owned the mortgages were in no position to judge their true value, for they knew nothing of the mortgagees' ability to pay. As customer after customer defaulted, mortgage after mortgage turned out to be worthless, leaving serious question-marks over the value of the mortgage 'bundles' that had been sold on.

The credit-rating agencies, which should have been assessing the risk factor, merely exacerbated matters. They helped design, often for large consultancy fees, the financial instruments through which the mortgages were passed down the chain and sold on.

Arthur Levitt, former chairman of the Securities and Exchange Commission, which protects investors in the US, has argued that 'the credit-rating agencies suffer from a conflict of interest — perceived and apparent — that may have distorted their judgement.'³⁸

Whether faced with a conflict of interest or not, the agencies seem to have fundamentally failed in their role of ensuring efficient risk evaluation across the market.

Information and the banks: the role of trust

Just as a financial market needs information to function efficiently, so banks also require information about other banks if they are to do business with them. It's a world in which reputation is all.

The nature of standard banking is to accept savings deposits (to borrow from customers) and use that money to make loans to the other customers, either individuals or businesses, loans which are then repaid by the customer with interest. The interest rate paid by borrowers is higher than that given by the bank to depositors. This is the bank's margin.

The difficulty is the 'maturity mismatch': customers may wish to access their savings quickly, while banks cannot retrieve the loans they have made at the same speed because

‘The credit-rating agencies suffer from a conflict of interest – perceived and apparent – that may have distorted their judgement.’

Arthur Levitt, former chairman of the Securities and Exchange Commission

invariably the money will have been invested, in housing in the case of many individual borrowers, or in business enterprises.

Any bank in the world would face closure if enough customers demanded their money back at once, as no bank holds all the customers’ savings in cash. It is critical then that withdrawals remain within normal parameters. A panic-stricken run on a bank will take down even the soundest institution.

For this reason, banking regulations demand that there are strict limits on the amount of loans a bank can make (or other financial assets it can create or acquire) in proportion to its equity.

As the current financial crisis unfolded, while depositors largely kept faith, the banks (and other financial institutions) effectively did not; they stopped lending to each other.

Even the shortest-term markets (such as overnight loans) seized up, and the lending that did take place incurred interest rates far higher than the central banks’ policy rates.

Put simply, the banks had stopped trusting each other. As mortgage bundles turned out to be potentially worthless, the banks became aware they did not know the value of each others’ assets or likely future income streams, and nobody wanted to be left holding loans that could not be repaid.

Part of this uncertainty stemmed from factors outside the banks’ control, such as the likely future performance of the housing market and the economy, which determine, respectively, the value of mortgage and business-loan books.

A far greater part of the problem, however, was a direct result of the way in which banks and other financial institutions has been operating in recent years, in particular the lack of transparency surrounding their assets and liabilities.

This lack of transparency is partly the result of the complex way in which banks exploit the difference in banking regulations between countries where they do business in a process known as ‘regulatory arbitrage’. In effect, without wanting to draw attention to their activities, they seek out the legal jurisdictions that will put the least restriction on their activities and charge the least tax on their profits.

Opacity is also the result of the sheer complexity of the new derivatives – for instance, collateralised debt obligations (CDOs) and credit default swaps (CDSs) – that were created to ‘slice and dice’ the sub-prime debt, and the dangerously small number of people within financial institutions or regulatory agencies who fully understood how these new financial instruments worked.

As long as the markets were going up, few people

questioned the true value of such derivatives, but plummeting prices and rocketing defaults in the US housing market eventually forced a reassessment as investors tried to work out who was really hurting.

As bank share prices fell, reassessment also took place in the money markets. Banks started to question the wisdom of lending to each other, knowing what their own assets and liabilities looked like and so naturally questioning the position of others.

The problem was often one of perception. Bank A may have considered Bank B a sound institution. However, if no one else in the market was prepared to lend to Bank B, then Bank A wouldn’t either, to minimise the risk of default.

Once the crisis broke, the banks compounded the lack of trust by refusing to come clean about what they were really worth. This refusal may have arisen in part from a genuine inability to value their assets, but it had every appearance of being a pretence that there was no real problem.

This perceived bluff served only to unnerve investors further, delaying the resumption of normal business and prolonging the crisis.

In short, the massive bail-out operations that have been necessary are the result of the disappearance of trust between banks and other financial institutions. Only the power of state support has proved able to restore that trust; hence nationalisation as a solution.

As we write, in early November 2008, banks are beginning to lend to each other on more normal terms, but there remains some uncertainty about the ultimate success of the bail-outs that have taken place.

Information and regulation

There is a further reason for lack of transparency in the banking sector: banking secrecy. Previous large-scale corporate bankruptcies – such as those of Enron and WorldCom – exposed nests of hidden transactions and liabilities, primarily located in tax havens.

These structures misled investors about the true value of the companies’ assets and liabilities, whether intentionally or not.

The current wave of bankruptcies is no different. The UK parliament saw a session on the nationalisation of Northern Rock bank descend into farce, as it became clear that the government – the new owner – did not know either who owned the Rock’s Jersey-based offshore vehicle, Granite,

or what, if anything, it was worth.³⁹ The run on the bank may have been more about panic than fully informed judgement by customers, but that run seems quite reasonable in the light of the subsequent balance-sheet revelations.

In fact, this was part of a wider process – the development of what the Basel-based Bank for International Settlements (the ‘bank for central banks’) has referred to as the ‘shadow banking system’.⁴⁰

This is the setting-up of banks, bank-like institutions and funds, including hedge funds, private equity operations and structured investment vehicles – conduits used by mainstream investment banks and others – in jurisdictions (tax havens) outside the main financial centres and outside their regulatory reach.

The growth of opacity

The aims are to escape the type of regulation that banking activities usually face and to reduce the tax bill – even if most actual activity remains in the financial centres and not in the havens. One result is greater opacity, keeping the detail of arrangements largely out of sight (and out of mind) of more stringent regulators.

The regulations these institutions are trying to avoid are those that aim to ensure the solvency of banks and similar institutions by requiring that they maintain some minimum level of capital to guard against adverse scenarios. In recent years institutions have made increasing efforts to avoid this fundamental check on systemic solvency.

One well-developed example of the key part that regulation (or lack of it) played in this crisis relates to Ireland, although over time many more examples will emerge in many different jurisdictions. Jim Stewart, senior lecturer in finance at Trinity College, Dublin, has highlighted the role of that city’s International Financial Services Centre (IFSC) in the crisis.⁴¹

As he notes, Ireland ‘streamlined’ its regulation on setting up funds so that ‘if the relevant documents are provided to the regulator by 3pm, the fund will be authorised the next day.’

This is in spite of the fact that ‘a prospectus for a quoted instrument is a complex legal and financial document (a debt instrument issued by Sachsen Bank ran to 245 pages) so it is unlikely it could be adequately assessed between 3pm and the normal close of business (5 pm).’⁴²

Ireland was by no means alone in this – there has been a ‘race to the bottom’ in the regulation of such activity. In Luxembourg, for example, it is possible to set up a hedge fund

with ‘pre-authorisation approval’ as long as the regulator is informed within a month. Moreover, the regulator will not make any checks on elements such as the capitalisation of the fund promoter, unlike in Ireland.

The *Financial Times* noted in April 2008: ‘Historically, European asset managers’ default option was to look to the Cayman Islands, Bermuda or the British Virgin Islands. But more recently European jurisdictions (chiefly the Channel Islands, Ireland and Luxembourg) have been streamlining regulation and beefing up services to get a piece of the ever-growing hedge-fund action. On the margins, the Isle of Man offers a cost-effective solution and Malta is seen as a domicile for the future.’⁴³

By July 2008, 19 funds facing problems had been identified as located at the IFSC, according to Stewart. In addition to four German banks with problems at IFSC-located funds, which required almost €17bn of German state aid, Stewart notes that Bear Stearns, one of the largest banking collapses earlier in the crisis, had ‘two investment funds and six debt securities listed on the Irish Stock Exchange, and it also operates three subsidiaries in the Dublin IFSC through a holding company’ – a holding company which managed to finance \$11,900 of assets for every \$100 of equity.

Compared to the international consensus that banks should not exceed \$1,250 of risk-weighted assets for each \$100 of shareholder capital (that is, they should have shareholder capital equal to at least eight per cent of their risk-weighted assets, as a cushion to absorb losses without hurting depositors)⁴⁴, that ratio is a striking indication of the extent to which the shadow banking system is responsible for the enormous growth of credit in recent years.

The type of assets that such a bank would finance would include loans, and the purchase of shares, bonds, related options and derivatives. In this way, regulatory arbitrage led directly to greater credit creation and higher asset prices – and so was at the very heart of the long boom that is ending so badly.

Stewart goes on to note that the Irish regulator, the Financial Services Regulatory Authority, appears to consider itself responsible only for ‘Irish banks’ – those with headquarters in Ireland – and hence to question whether anyone had ultimate regulatory responsibility for oversight of investment structures of banks headquartered elsewhere. The German regulator appears to have had at best minimal oversight of the Irish operations of German banks.

Financial markets can only function well with good information and strong regulation. This has been forgotten or ignored by policymakers for too long.

This is one example of a potential loophole in global regulations covering holding companies located outside the jurisdiction in which their headquarters are registered.

Far from being a problem only for Ireland, it is a common theme in analyses of the shadow banking sector. The *Financial Times* argued in an October 2007 editorial that ‘the supervision of so-called “conduits”, off-balance sheet vehicles which borrow money, finance loans and generally behave just like banks’, was of great concern. ‘Most of this activity is regulatory arbitrage – it exists to avoid the restrictions placed on banks – and supervisors appear to have ignored it.’⁴⁵ Indeed, the paper continued: ‘If there is to be reform then this is the place to start.’

Who pays?

In the present crisis, when banks have got into trouble the costs have been borne by national governments (that is, the taxpayers) and the bank shareholders – neither of which groups appears to have had sufficient information to discipline company behaviour effectively.

There can surely be no better argument for stronger regulation and greater transparency.

Shareholders require information so they can value businesses accurately. National governments require information to ensure that they can regulate business, in order to protect themselves – or rather, to protect taxpayers – from bearing the costs of activities in which they do not share the returns.

Needless to say, the banks do not appear to have repatriated the profits from their shadow activities in order to contribute to the societies that have ended up covering their risk, through paying taxes.

In the financial sector, more or less the full risk remains in the original economies. Meanwhile, the tax haven increases its own revenues at the expense of jurisdictions that tolerate its behaviour.

Competing businesses that do not take advantage of this international avoidance mechanism are put at a competitive disadvantage. Those too scrupulous or too small to mimic this behaviour will face a higher level of tax and regulatory scrutiny, and hence are likely to obtain lower levels of post-tax profit – at least until the bubble bursts.

Not that everyone in a tax haven benefits. As havens from Panama to Jersey have experienced, the top-line economic benefits – even in the good times – have not

always been enjoyed by the poorest in those societies.⁴⁶ The current reversal is, sadly, likely to see poverty in tax havens worsening considerably.

The need for transparency

Financial markets are fundamentally driven by the efficient use of information to price assets and liabilities appropriately. For more than a decade, new asset structures were allowed to develop where no one – not investors nor regulators, nor even market players themselves – could clearly see the underlying value. This complexity was made still more opaque by the deliberate use of tax havens – be it to hide from regulators, tax authorities, investors or competitors.

The underlying lack of transparency combined with a weakening US property market to cause panic, because it wasn’t clear which banks were being damaged, and by how much, by falling property prices and rising default rates.

In effect nobody really understood who owned that risk. This led in turn to market players in tax havens, particularly hedge funds, speculating with what, in effect, were large bets on which banks, and by extension which currencies, would be next to suffer.

With the amount of borrowed money that these players could bring to bear, many of these bets turned out to be self-fulfilling prophecies.

Financial markets should be the best way to price assets according to the best information available. However, assets were instead being priced on the basis of a complete lack of information about the nature and ownership of the risk involved. In addition, information was also lacking about who exactly was speculating on market prices.

Well-functioning markets have a crucial role to play in facilitating economic progress, but financial markets can only function well with good information and strong regulation. This has been forgotten or ignored by policymakers for too long.

That is why global financial regulation is necessary, and it is hard to disagree with UK Prime Minister Gordon Brown’s pronouncement in New York, as discussions over the US bailout became increasingly heated, that what is needed is ‘a new global financial order, founding it on transparency, not opacity’.⁴⁷ But some specifics are required.

First and foremost, the response must be based on recognition that the extent of global economic and financial integration has surpassed the ability of national regulatory systems to cope alone.

Some have suggested, however, that the UK may be the last great defender of tax havens now that Barack Obama – a sponsor of the ‘Stop Tax Haven Abuse Act’ – has been elected President of the United States.

This does not mean that the creation of a supranational authority is necessarily warranted, but it does mean – at a minimum – that a new degree of cooperation between jurisdictions is required. Such will be (and are already) the costs to nation states of failed (or absent) regulation elsewhere that it seems unlikely that the present situation can be tolerated for much longer.

Tax havens have not only leeches tax revenues from countries both rich and poor, but they have also cost taxpayers in a number of countries dearly as governments have been forced to respond to the crisis.

The leading economies are far from blameless; they have tolerated, if not actively encouraged, this situation for most of the past 30 years. They too should be held to account for their role in the ‘age of irresponsibility’, to use Gordon Brown’s memorable description.

Some have suggested, however, that the UK may be the last great defender of tax havens now that Barack Obama – a sponsor of the ‘Stop Tax Haven Abuse Act’ – has been elected President of the United States.

Of the 70-plus havens around the world, no fewer than 30 are in Commonwealth countries, Crown Dependencies or British Overseas Territories, while IMF research recently implied that the UK itself is a tax haven.

Such has been the UK’s commitment to the network of havens that when it signed the UN Convention against Corruption in 2006, it exempted all of its Overseas Territories and Crown Dependencies.⁴⁸

This decision was made in spite of the widespread recognition that tax havens, apart from their role in undermining financial regulation, are also a key part of the chain of corruption. As the World Bank has noted: ‘While the traditional focus of the international development community has been on addressing corruption and weak governance within the developing countries themselves, this approach ignores the “other side of the equation”: stolen assets are often hidden in the financial centres of developed countries.’⁴⁹

It is perhaps understandable that bankers sought to maximise short-term net profits without considering the social costs of tax minimisation or regulatory arbitrage or the longer-term profit implications. But national governments and regulators had a duty to consider these factors. This they neglected, in favour of letting the good times roll.

The new ‘global financial order’ cannot be based on transparency alone. Certainly, that is a prerequisite – information

provision by financial market players to investors and regulators, and information exchange between jurisdictions, is necessary to ensure the application of appropriate tax and other regulation.

But there must also be a new approach to responsibilities and rights. The costs that the leading economies now face are those of allowing market participants and tax havens the right to participate in global financial markets without meeting minimum responsibilities in return.

A framework of international cooperation is needed to ensure that there are no deliberately created regulatory gaps to be exploited, and that participants are held to a duty not to exploit those they may uncover. The social costs of this exploitation are becoming increasingly clear.

On 1 October 2008, as the Sigma fund based in the Cayman Islands closed down, the *Financial Times* reported ‘the end of 25 years of development of the shadow banking sector...’. The wind-down of ‘the oldest and once the single largest structured investment vehicle, marks the final chapter in an extraordinary project to create a credit industry outside the world of traditional banking’, said the paper.⁵⁰

There are now fewer vested interests in tax havens left to pander to: much of the shadow banking sector has gone, and won’t be back in a hurry, so neither banks nor havens can realistically claim that they will suffer further by the elimination of economic opportunities. In the medium to long term, the international community will need to take steps to provide alternative development paths for poorer havens.

The citizens of tax havens should not be made scapegoats. The international community must recognise that, for the poorest in such societies, there have been social and economic costs even at the best of times. Now the international community must help create alternative development paths for havens that are less damaging to the global economy.

This is the end of an era. The only appropriate ‘celebration’ would be to push through international agreements on information exchange and regulatory cooperation to ensure that there is no chance of a repeat of the systematic abuse of secrecy that has led us here.

Developing countries and their citizens are now paying for a crisis for which they bear no responsibility.

The case for tax

Today's crisis must spark considerable efforts by the policymakers of leading economies to tighten up global financial regulation. The cost to their citizens requires nothing less. But, as will become increasingly clear in the months and years ahead, the crisis has also imposed significant costs on developing countries and their citizens.

As the nations of the world gather for the Doha conference on Financing for Development, it is crucial that the international community recognises that several of the factors that have brought about the present crisis – inadequate regulation, lack of transparency and banking secrecy – have been costing the developing world dear for years.

It is crucial too that they recognise that developing countries and their citizens are now paying for a crisis for which they bear no responsibility. It is essential that the interests of those developing countries are represented in the way in which global financial regulations are reformed.

Tax dodging on a massive scale

The gravest impact the present global financial system has had on the developing world is the manner in which regulatory failings, lack of transparency and the growth of tax havens, with the deliberate connivance of richer countries such as the UK, has facilitated tax dodging by international business on a massive scale, thereby exacerbating poverty.

The World Bank quotes figures showing that illicit outflows of capital from developing or transitional economies amount to between \$500-\$800bn a year, of which 60-65 per cent is commercial tax evasion.

One of the most common forms of corporate tax evasion is 'transfer mispricing', where different parts of the same transnational corporation sell goods and services to each other from the developing world through tax havens at prices manipulated to lower the tax liability.

For example, if a multinational sells diamonds mined in one country, with a value of \$100, to a subsidiary in a tax haven for \$50, it has shifted \$50 of profit out of the first country. If it can

then show that the diamond cost \$50 to extract, it will declare no profit in the country where the diamond was mined – and so pay no corporate income tax.

Another common form of evasion is 'false invoicing', where similar transactions take place between unrelated companies working in collusion with each other. Importers in the developing world will inflate the price they say they have to pay the foreign supplier so they can report lower profits and hence pay less tax.

The reverse can also happen. A person exporting goods from a developing country will deliberately undervalue what is being sold, on paper at least, so the profits are, on paper, once again depleted. Falsified invoicing is difficult to detect in official statistics as it is often based purely on verbal agreements between the buyer and seller.

Christian Aid calculates that these two activities alone cost the developing world US\$160bn a year in lost corporate taxes. That is more than one-and-a-half times the annual global aid budget.

If used in developing countries according to current spending patterns, the amount going into health services would save the lives of 350,000 children under the age of five every year, to say nothing of other benefits in areas such as sanitation and education.

As other sources of development finance are curtailed by the crisis, the importance of tax to poor countries becomes ever more obvious. International policymakers must now seize the opportunity, ensuring that the changes to global financial regulation that they deliver are not simply a limited effort to prevent the worst abuses, but instead lead to a transparent and well-governed global system which delivers benefits for all – including the poorest.

Taxation is important as a source of development finance, but also – and perhaps more importantly – it is a key process that nurtures a healthy relationship between a state and its citizens, and strengthens channels of political representation. Tax revenues not only finance development;

The empirical evidence provides substantial support for the existence of a systematic general relationship between taxation and democracy, with states with a higher ratio of tax revenue to expenditure more likely to be democratic.

the process of their collection and use is at the heart of building good governance.

To eradicate poverty, a state must have the necessary revenues to provide for the basic needs of its citizens, and to create and support the physical, legal and administrative infrastructure that makes economic growth possible and allows equitable development.

There are three main sources of public finance in developing countries. First and foremost is the mobilisation of domestic revenues: taxation. Second is aid, which retains its public character whether flowing directly to states or not. Finally, a number of states are highly reliant for their revenues on rents from natural-resource wealth.

Finance streams in poor countries

Tax revenues in low-income countries average around ten per cent of gross domestic product (GDP), increasing to around 20 per cent in upper-middle income countries and around 40 per cent in high-income countries such as the UK. These figures hide a great diversity, however, from conflict and post-conflict states with minimal revenues to relatively successful tax-based low-income states such as Kenya with around 20 per cent of GDP.

Aid inflows average around three per cent of GDP in low-income countries, but less than half a per cent in middle-income countries. Again, however, this hides a diversity in range that includes countries such as Mozambique, which has received grant aid often in excess of ten per cent of GDP since the end of its civil war in the early 1990s, and others with alternative revenue sources such as Botswana, which has received less than one per cent of GDP in grant aid each year since the mid-1990s.

Consistent data on natural-resource revenues is less readily available, but IMF researchers have prepared a data set for sub-Saharan Africa which shows the full range. Of 40 countries in their data set, they provide data for resource revenues for 11.⁵¹

Of these, three (Cote d'Ivoire, Namibia and South Africa) have resource revenues of between two and three per cent of total tax revenues for 2005 (the most recent year reported); for three (Guinea, Cameroon and Chad) the equivalent figure rises to between 20 and 50 per cent; for two more (Botswana and Gabon), it is 50 to 70 per cent; and for three others (Democratic Republic of Congo, Nigeria and Equatorial Guinea), it is from 83 to 94 per cent of total tax revenues.

With tax revenues often so low in the poorest countries,

many are highly dependent on either foreign aid or on natural-resource revenues. One academic who examined data for the period 2000-04 found the following:

'Data is available for 116 countries, of which 11 collect less than half of total revenue from taxes, 21 collect less than two-thirds of revenue from taxes and 58 collect at least five per cent of GDP in non-tax revenue. Because aid revenue generally does not fully enter the budget, these countries are primarily resource-dependent nations, though three countries for which data is available, Democratic Republic of the Congo, Ethiopia and Sierra Leone, received more than one-third of their core budget from aid.'⁵²

Sixteen additional countries received total aid flows that were equal to at least 50 per cent of total tax revenue, while 11 received aid exceeding the amount of total tax collected. Finally, it is worth remembering that these totals exclude a large number of notably resource- or aid-dependent countries including Iraq, Libya, Qatar, Saudi Arabia, United Arab Emirates, Yemen, Angola, Botswana, Cameroon, Equatorial Guinea, Gabon, Liberia, Mauritania, Nigeria, Sudan, Zambia and Ecuador. On balance, this provides strong evidence of the central importance of non-tax revenues to a very large share of developing nations.

For a great many developing-country governments, then, the concept of the state is far from that pertaining in rich countries. They are not the largest actor in the national economy and they are not financed predominantly by taxation of their own citizens.

The quantity of public finance is of great importance to the development process – but so too is the *quality*. Analysis of financing for development cannot be blind to the now well-established fact that tax, aid and natural-resource revenues have sharply different impacts on the processes of democratisation and the standards of governance.

In broad terms, there exists a spectrum of sources of public finance, from natural-resource wealth at one pole, which tends systematically to undermine governance and to weaken state responsiveness to citizens, to taxation at the other pole, which tends to strengthen governance and channels of political representation. Aid lies somewhere between the two extremes.

Natural resources can be divided into two classes: 'lootable', those which can be easily exploited by individual citizens; and 'non-lootable', requiring large-scale investment that can only be mobilised by government.

'Lootable' resources are likely to be geographically dispersed, easy to reach and relatively inexpensive to exploit, with the most common example being alluvial diamonds. In such cases the existence of resource wealth increases the incentive to attempt to seize the state, though not to the extent large centralised resources would, while the ease with which rebel groups can seize those resources means they have ready access to the finances needed to wage a protracted military struggle.

The prototypical cases of this kind of conflict are Angola, Sierra Leone and Liberia, all of which saw rebel groups seize control of diamond resources and wage long-lasting civil conflicts.⁵³

'Non-lootable' resources, such as oil, can give rise to two main contrasting outcomes. One possibility is of a strong and stable but also relatively autocratic and unaccountable government, using its resources to buy off discontents and to stifle protest.⁵⁴ Alternatively, conflict may arise as groups compete to control the state and its resources to corner this power for themselves.

Why tax works

One major problem facing many countries in the developing world with both 'lootable' and 'non-lootable' natural resources is the lack of transparency that frequently characterises the extraction deals that mining and drilling companies strike with government ministers and officials. In numerous instances these deals are hugely to the disadvantage of the countries in question, as tax and royalty rates are set too low.

The region(s) in which resources are located can see the rise of secessionist movements, in response to a narrative that depicts central government as exploiting the resources without concomitant benefit to those living where the resources are found.⁵⁵

There is no suggestion that developing countries should simply turn their backs on their natural-resource wealth. It is important, however, that this revenue source is as transparent, and indeed as 'tax-like', as possible.

Above all, the value of resources being extracted, and the resultant payments to government, must be absolutely transparent. Christian Aid works with partners in a range of countries to support them in achieving this end.

States that rely on tax revenues, in stark contrast, are much more likely over time to see the development of more responsive governments; hence not only are development

prospects improved but the chances of conflict are also reduced. A number of arguments have been advanced to explain this phenomenon.

First, historical experience suggests that bargaining over taxation is the basis for growing accountability of a state to its citizens. It is argued that much of the development of political institutions throughout Europe has roots in this basic fiscal relationship: governments that needed to raise tax revenues were frequently inclined to make reciprocal concessions to taxpayers and build corresponding state capacity.⁵⁶

These are the two key strands of the tax-governance relationship: that those citizens who are taxed will be more inclined to hold governments to account, and that those governments that tax must necessarily develop bureaucratic capacity to do so. This in turn has broader implications for the development of effective states.

Governments can of course raise taxes in coercive rather than compromising ways⁵⁷, however, or target only certain groups and hence develop imbalanced accountability mechanisms.⁵⁸

And in many poorer countries, broad-based and pro-poor economic growth supported by development finance is necessary in the first place to create the jobs and enterprises that can then be taxed.

The empirical evidence provides substantial support for the existence of a systematic general relationship between taxation and democracy, with states with a higher ratio of tax revenue to expenditure more likely to be democratic.⁵⁹ Direct taxation (of income and corporate profits) in particular has been identified as the driver of the relationship.⁶⁰

Research has found that government spending tends to reflect the underlying tax structure⁶¹: governments that rely more on a narrow group of large taxpayers tend to provide a greater share of services that are desirable to that group, and likewise for governments reliant on broad tax bases.

At the sub-national level, the empirical results are, if anything, stronger. States in Argentina that depend more heavily on taxation are more democratic⁶², while local governments in Tanzania and Zambia that receive higher levels of foreign aid tend to spend a smaller share of their budget on development and more on consumption.⁶³

Finally, the question of where exactly aid fits on the spectrum between natural resources and taxation is still open. On the one hand, a body of research questions the benefits of aid, but where this was once put down

Few people enjoy paying tax; but the act of doing so is a social act, a contribution to society, and confers on people the right and the incentive to hold their governments to account for their expenditures and policies.

to the absence of 'good' policies⁶⁴, more recent research has rejected that explanation.⁶⁵

In recent years it has been widely accepted that increased aid reduces reliance on taxes, and may further erode the incentive to maximise potential tax revenue, thus reducing the need for a government to be accountable to its citizens.⁶⁶

However, the most recent (and statistically advanced) work finds that the relationship between aid and tax collection is either ambivalent or slightly positive, depending on the specification.⁶⁷ This alone is evidence that the extent to which foreign aid substitutes for taxation, and thus is likely to erode public accountability, is likely to be more limited than has sometimes been claimed.

In no sense, it is clear, does aid cause the damage that natural-resource wealth can to the development of effective and responsive states. There is no doubt that aid still has a crucial role to play, and especially for shorter-term assistance to states facing special conditions.

However, long-term aid dependence is likely, eventually, to undermine governance. Both recipients and donors must focus on building exit strategies from aid to independent development. That means prioritising the emergence of effective taxation systems. The quality of development finance is important – and the highest quality source, by far, is taxation.

Effective taxation can deliver two key things for developing countries. First, it can provide the revenues so that states can play their crucial role in delivering for citizens – not least the MDGs – and creating the conditions for the private sector to blossom. Second, taxation has a strong link to political representation: so that governments reliant on other sources of finance tend not to respond to their citizens, and standards of governance are undermined, while governments that must rely on their citizens for revenues are much more likely to be responsive to their citizens, and to be held to account by their citizens.

Few people enjoy paying tax; but the act of doing so is a social act, a contribution to society, and confers on people the right and the incentive to hold their governments to account for their expenditures and policies. In this way, effective taxation systems support the emergence of genuine political representation. The combination of increasing (domestic) revenues and greater political responsiveness supports the emergence of states that can play a crucial role in poverty eradication for their people.

Measures to avoid

The financial crisis has had a number of effects in rich countries. In particular, part-nationalisation of banking systems has required large increases in public debt. In addition, the unwillingness of banks to return to previous levels of business and mortgage lending is threatening economic activity (and employment) and the value of houses, most people's biggest single asset.

Governments are financially restricted, just as economies are beginning to feel the strongest effects of the dislocation in financial markets. The downturn is likely to be deep and long in many of the directly affected economies.

As detailed earlier in this report, developing countries are feeling the impact too. The effect on development finance is a particular concern. While the need for revenues to support the state is clear, private sources of finance also have an important role to play in the development process.

Globalisation offers great potential to tap into markets for goods, services and capital. The resulting sources of finance range from the proceeds of international trade to flows of foreign direct investment (FDI) or (typically shorter-term) portfolio investment in bonds and equities, along with private debt. Finally, remittance income from expatriate workers is increasingly important in poorer economies – more than 20 per cent of gross domestic product (GDP) in many, and as much as 50 per cent of GDP in Tajikistan, for example.⁶⁸

Each source of finance has implications for the economic development of countries. In international finance, the consensus has shifted towards increasingly open capital markets in an era that arguably began with the removal of the UK's last capital controls by Margaret Thatcher shortly after she was first elected Prime Minister in 1979. In the 1990s this was aggressively promoted by the IMF in particular.

This culminated in an attempt – which overlapped with the beginning of the 1997-98 east Asian crisis – to change the

IMF's articles to give it a statutory duty to advise countries on capital account liberalisation (opening up their economies to international financial flows). This was surprising, not least because every significant episode of capital account liberalisation (CAL) had been followed by a painful bust.⁶⁹ Moreover, then as now, there was no serious evidence for any economic growth benefits of CAL – and a number of reasons to be concerned about the likely impact on poverty and inequality.⁷⁰

Over time this came to be accepted even by the more rigid supporters of liberalisation, as testified to by the research output of successive departing IMF chief economists.⁷¹ Most recently, this culminated in a finding from Raghuram Rajan, a former IMF economic counsellor and director of research, that 'foreign capital usage seems to be negatively correlated with growth'. Specifically, 'countries that had high investment ratios and lower reliance on foreign savings (lower current account deficits) grew faster – on average, by about one per cent a year – compared with countries that had high investment but also a greater degree of reliance on foreign capital'.⁷²

The strength of the domestic financial sector appears to be key to an additional finding. Rajan's more detailed analysis finds that, where the domestic financial sector is weaker, and so one might expect foreign finance to be especially valuable, above all for those industries with most need of finance: 'Foreign capital seems to hurt rather than help the relative growth of industries dependent on finance in those countries'.⁷³

By implication, while reliance on foreign finance is in general bad for growth in developing countries, it is particularly detrimental to private-sector development when it is expected to substitute for a well-functioning domestic financial sector. The latter remains of fundamental importance for development.

Arguably, the international consensus has pushed developing countries into premature capital account

The presumption in favour of international financial liberalisation, regardless of the lack of evidence of any benefits, and with clear evidence of grave costs, must surely end.

liberalisation, creating opportunities for financial market players but undermining countries' prospects for growth. The foreign capital boom in emerging market economies from the early 1990s was followed, perhaps inevitably, by the east Asian crisis, which generated a sharp setback to development in most of the affected countries.

In many cases, the story is surprisingly similar. Opening up an economy to international financial flows tends to lead to an increase in the availability of credit, as domestic banks can access international debt markets, and a boom in national stock markets as the potential pool of investors is dramatically expanded.

Rather than feed investment in productive assets and an increase in the trend rate of economic growth, however, two less benevolent outcomes typically emerge – the majority of the investment goes into unproductive assets and the growth of credit fuels a consumption boom. The former tends to result primarily in a property price bubble, including in housing, while the latter feeds general inflation. This is typically supported by exchange-rate appreciation as foreign capital enters.

The subsequent crash sees external investors reassess their view of the country, triggering a rapid reversal of flows. Asset valuations collapse while the financial system is dramatically restricted. Having over-extended credit in the belief that the new sources of finance were permanent, banks respond to the loss of finance by sharply reducing the credit they provide – both mortgages and business loans.

This in turn exacerbates both the property price collapse and the economic downturn, as businesses see credit withdrawn just when they need it most (consumption is also falling sharply) and respond by laying off staff and/or entering bankruptcy. Both reinforce the other processes at work, raising unemployment and further reducing consumption and asset prices.

This presents grave problems for policymakers. In the east Asian crisis, a major policy split developed between the World Bank, under chief economist Joseph Stiglitz, and the IMF. Stiglitz argued that these real effects on businesses and employment had to be the primary concern, so countries should be advised to cut interest rates and prop up their financial sectors to ensure that lending continued.

The IMF, then at the peak of its insistence on capital account liberalisation, argued that the key was instead to push up interest rates in order to make the country attractive to short-term investors and so maintain some foreign finance. Where this was pursued, which in each case was where the IMF

had power over governments due to their indebtedness, the result was – more or less as Stiglitz had predicted – a much sharper recession.⁷⁴

In spite of the interest-rate hikes, foreign finance was not generally forthcoming – who would lend to such a damaged economy? – but banks were now forced to pay higher interest rates for their own borrowing and they were denied anything like the support that has been offered in the major economies since last August. Many banks went out of business, faced with growing loan defaults and tighter borrowing conditions.

Businesses that could borrow faced higher costs when they could least afford it and bankruptcies soared. Unemployment followed, slashing consumption further and undermining the prospects of those businesses with relatively strong financial positions.

Countries with substantial sovereign wealth funds can be split into two groups: those with natural-resource wealth and those who had close experience of the east Asian crisis. The latter group does not exist by coincidence – a clear decision was taken to build up vast reserves of foreign exchange so that, no matter what came to pass, they would not suffer such dictated terms again.

For once meltdown was reached in that crisis, it became clear that protecting economies required careful, extended support for their financial sectors. Countries able to follow that course – that is, those that did not have to rely on the IMF to bail them out in return for policy control – did so as far as they could.

Wall Street or Main Street?

It is therefore foolish to suggest, as strands of political discourse have done during the current crisis, that there exists a stark choice between helping 'Wall Street' or helping 'Main Street' – the financial markets or the real economy. The reality is that abandoning the former at the very moment of their greatest weakness would have devastating effects for the latter.

It does not necessarily follow that support is warranted for the specific multi-billion-dollar bail-outs across Europe and the US. But there is no doubt serious action was needed, as banks had become almost completely unwilling to lend to each other, and then only at interest rates much higher than the policy rate – in effect, creating the conditions of the IMF bail-out during the east Asian crisis.

Part-nationalisation may have offered the best chance of restoring trust among banks and ensuring that some lending

continued. What is critical is that these steps are followed up with others to ensure that business lending (to small and medium-sized enterprises in particular) is sufficiently protected, so that balance-sheet consolidation in the banking sector does not provoke more of a spike in unemployment than is absolutely necessary.

The other lesson from the east Asian crisis is that policymakers should be particularly focused on the longer-term path of inequality, which is likely to have been increased by both the boom and the bust – with implications for poverty, especially now. Greater costs of social welfare systems are guaranteed, but in addition greater redistribution during the downturn would reduce the long-term costs for social stability and the damage to the lives of the least well-off.

It is a sad fact that such crises, even if rapidly reversed, cause long-term damage through, for example, periods of malnutrition during infancy and childhood. Higher inequality is also often identified as a barrier to future economic growth.⁷⁵

For both instrumental and direct reasons, then, policymakers should take care to control the extent of both poverty and inequality. The inevitable constraints on fiscal policy (given levels of public debt) should not mean that the poorest in societies pick up the tab for financial-market excesses.

The presumption in favour of international financial liberalisation, regardless of the lack of evidence of any benefits and with clear evidence of grave costs, must surely end. But the role of trade regulation is also relevant, as the Director-General of the WTO, Pascal Lamy, has pointed out: 'Trade in goods and services represents only about two per cent of international transactions but it takes place in one of the most internationally regulated environments ever created. No such regulations exist for international finance...'

Yet current trade negotiations include a powerful process aimed at liberalising services. In this context, the new obligations on the movement of European Union capital and entry of EU service-providers – including, most obviously, *financial* services – being demanded by the European Commission in negotiations over Economic Partnership Agreements with African, Caribbean and Pacific nations, might weaken the strength and undermine the stability of the financial sector in developing countries.

Just as rich countries are currently doing, developing countries need to review their financial regulation and conduct impact assessments to determine the type of regulation and liberalisation that will benefit development – and not allow

themselves to be forced into liberalisation through trade deals.

Finally, it must be absolutely certain that where support is given to countries facing problematic capital reversals, the IMF in particular must not hypocritically return to its policy stance of the late-1990s, which it has already acknowledged was flawed.

Sadly, the early evidence is not promising – for example Iceland, a relatively wealthy country but dramatically weakened by the crisis, in accepting IMF support, was required to raise its interest rate to 18 per cent 'in order to attract foreign capital'.⁷⁶ It seems that as in other areas of its functioning – tax policy is one clear example⁷⁷ – the policy thinking at the IMF runs well ahead of its approach in practice.

Turning to public finance, aid revenues seem likely to stall, at best, and may well fall as financial pressure mounts on donor governments and they look for easy cuts to expenditure. The history of unfulfilled aid commitments looks set to be extended, with pledges to scale up to 0.7 per cent of donor country GNP looking increasingly shaky.

Finally, tax revenues will also come under pressure. Rich countries will see government finances stretched as they attempt to shore up their financial sectors but also cope with the welfare implications of higher unemployment. Poorer countries will face similar pressures.

Tax revenues fall naturally as the economy turns down and profits and income drop, along with sales. However, while economic growth is predicted to fall in developing countries, they will not necessarily experience recession but simply moderation of growth rates. This would be the most benign outcome and would allow taxation to remain relatively steady while other sources of development finance dropped off.

Today's financial turmoil provides the perfect opportunity for overhauling the system and ending abuses that have hit both rich and poor alike.

The silver lining?

In the long run, tax is the only sustainable source of finance for independent development. For that reason, the Doha conference must put tax at the top of its agenda – and it must also be given serious attention by international policymakers considering global financial regulation in the wake of the crisis.

Today's financial turmoil provides the perfect opportunity for overhauling the system and ending abuses that have hit both rich and poor alike.

In a report published earlier this year, Christian Aid analysed the main obstacles to effective taxation for development. They are three-fold. First, tax authorities typically lack the capacity to tax effectively and transparently. We strongly support the work of the UK's Department for International Development, and others, to build this capacity.

The second potential weakness relates to the ability and willingness of civil society to hold governments to account for their taxation policies and practices. Here, we are working with partners in many countries to support them in this area.

In Zambia, civil-society organisations are preparing to monitor the government's expenditure of its additional income as a result of tightening its tax regime on copper-mining companies earlier this year. In Tanzania, a government-appointed review committee is recommending changes to increase the transparency of Tanzania's mining-tax regime after pressure from faith groups and other civil-society organisations. In Sierra Leone, civil-society organisations are actively pushing for more transparency in the country's mining-tax regime.

The remaining obstacle to effective taxation is international. Without international measures imposed to ensure greater transparency, tax authorities simply do not have the capacity to challenge the rampant abuse of their systems. So far, the international community has shown no will to enact the necessary measures. There are simple steps (listed below) that would go a long way to ending this problem.

Happily, there are core common interests between richer countries and the developing world over this. Preventing

another crisis will require the closing of the regulatory gaps that result from globalisation having galloped ahead of national regulation, in finance above all but also in trade. That solution must involve alignment of national systems, specifically the sharing of information and of responsibility, to prevent exploitation of gaps.

For investors, it requires much more information about the activities of companies in different jurisdictions. To give one example, an investor supplying funds in the Cayman Islands to one of the largest investment banks to collapse in the present crisis may have been aware of the risks being run. An investor doing the same in New York would almost certainly have assumed that any risks were regulated in and by the US, and so would not necessarily have appreciated the precarious nature of the institution. Company accounts must provide information on a country-by-country basis, so that investors are able to judge the risk accordingly.

For developing countries too, the key changes required are a joining up of regulation and transparency about corporate activity. An international accounting standard requiring country-by-country reporting of economic activity, including tax paid, is the most powerful indicative tool that tax authorities could receive to guide them as to which companies and transactions to investigate with their limited resources.

The joining up of regulation, in the form of automatic tax-information exchange between jurisdictions, would not only bolster the tax revenues of rich countries (except of abusive secrecy jurisdictions) but would also make it possible for developing countries to uncover the necessary information on abuses of their tax system taking place via international trade and financial flows.

Christian Aid is calling for two key measures of global financial regulation:

- **an international accounting standard on country-by-country reporting** to provide investors, regulators and tax authorities with a powerful indicative tool to assess risks and highlights abuses
- **automatic tax-information exchange between jurisdictions** based on a global agreement including all countries, instead of a piecemeal approach involving bilateral treaties, which have been shown to have limited impact and which tend to exclude developing countries.

The Financing for Development conference in Doha cannot alone deliver either of these two key asks, but the policymakers of the leading economies can – and must.

From the Doha outcome report, Christian Aid is seeking the following:

- a clear statement of the pre-eminence of tax as the only sustainable source of public finance for independent development
- that the UN Committee of Experts on International Cooperation on Tax Matters (the UN Tax Committee) be upgraded into an intergovernmental body, tasked with enhancing international cooperation on tax issues and promoting the goal of effective tax-information exchange (not least between developing countries and others)
- that the UN Tax Committee adopt a 'UN Code of Conduct on Cooperation in Combating International Tax Evasion and Avoidance', of which

a draft has already been discussed and which sets minimum standards for countries' cooperation

- from the broader process of global financial regulation (the 'Bretton Woods II' process), Christian Aid demands that the interests of all stakeholders in the financial system be taken into account – including, explicitly, those at lower levels of income. Those who are bearing the costs of the crisis must be involved in the discussion and design of the regulatory solution
- finally, the conference must commit to funding and carrying out a full analysis of the scale and nature of illicit financial flows from developing countries.

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Glossary

Balance of payments: this measures the economic transactions between a particular country and the rest of the world. Examples of economic transactions are exports and imports of goods such as oil, machinery, clothes and computers, exports and imports of services such as travel and banking services, inflows and outflows of income such as interest and dividends, and financial flows such as investments and loans.

Capital account liberalisation: the relaxation of restrictions on the flow of finance (for instance, loans, investments in shares and in physical assets) both into and out of a country.

Capital reversal: a sudden, large-scale outflow of money which has previously entered a country from abroad, for instance via purchases of shares, government bonds and the provision of bank loans.

Collateralised debt obligations: investments that pay income generated by a pool of loans backed by assets such as houses. This type of investment became notorious in 2008, when it emerged that the mortgage-backed securities held by many major banks could be worth far less than had been thought, leading to multi-billion-dollar write-downs of banks' assets and to the credit crunch itself.

Commodities: products that are grown or extracted from the earth and traded in large quantities on international markets. Examples include coffee, gold, oil, oranges, coal, soya beans, nickel, wool, logs and rubber.

Country-by-country reporting: financial accounts in which a firm's activities, results and taxes paid are shown separately for each country in which it operates.

Credit default swap: two parties make an agreement under which the first party pays the second a fixed, periodic sum for the life of the agreement. The second party pays nothing unless there is a 'credit event', such as a default on a loan or a bankruptcy, in relation to a loan made by the first party and which is covered by the agreement. If this happens, then the second party makes a payment to the first and the swap ends.

Debt instrument: a contract between a person or organisation that has lent money and a person or organisation that has borrowed it. Examples of debt instruments are mortgages, bonds and more complex bundles of mortgages and loans.

Derivatives: financial contracts whose value depends on the value of another variable, such as the price of oil, the price of shares in a particular company, the inflation rate of a particular country, or the return on a particular debt instrument.

Fiscal: relates to government finances, taxation and spending.

Foreign direct investment (FDI): this happens when a person or company in one country invests money in a project in another country and gains control over the project concerned.

Governance: to do with the institutions that have power, how they use it and the rules they observe.

Gross domestic product (GDP): a measure of the total economic activity in a country. It reflects a country's total income, production or spending.

Hedge fund: private investment funds, open only to wealthy individuals and other investment companies, which typically take high risks in pursuit of large, rapid returns. They pursue a wide variety of strategies in order to achieve this goal.

Holding company: a company that owns all or most of another company or companies, which are called its subsidiaries.

Millennium Development Goals (MDGs): goals set in 2000 by world leaders at a United Nations conference in New York. There are eight goals, including halving the extent of extreme poverty and providing universal primary education. All are to be achieved by 2015.

Net public debt: the total financial liabilities of a government, minus its financial assets.

Off-balance-sheet vehicle: a financial entity deemed sufficiently independent of a company that its assets and liabilities need not be included in that company's accounts. However, such entities are controversial in that some companies use them to hide assets or liabilities from investors, regulators and tax authorities.

Remittances: money sent by people working outside their home country back to family and friends still living in their home country.

Risk-weighted assets: this idea is used to assess whether a bank has sufficient assets relative to its liabilities. Assets (for example, loans made by the bank) are weighted according to how likely they are to default (not be repaid properly).

Secrecy jurisdiction: a country or other territory providing secrecy to non-residents, who channel financial or other business through it. While these jurisdictions are commonly referred to as tax havens, this is somewhat misleading – the low tax aspect is often an added attraction, but the key to their operation is the secrecy, which prevents regulators (including but not limited to tax authorities) from other countries halting abuse.

Shareholder capital: the finance a firm has obtained from its shareholders, typically but not necessarily when it is in its early stages.

Sovereign wealth funds: government-owned investment funds, usually consisting of assets denominated in foreign exchange.

Structured investment vehicles: investment funds that typically borrow money for short periods at low interest rates and make longer-term investments (including in securitised mortgages, a type of collateralised debt obligations, see above) which pay higher interest rates, making money on the difference. Many ran into severe trouble or collapsed during the credit crunch of 2007-8. Many were set up by banks but not included on banks' books.

Sub-prime debt: loans made to borrowers who are considered more likely than typical borrowers to break the terms of their loan agreement.

Tax haven: see 'secrecy jurisdiction'.

Sources of information used to compile this glossary: National Statistics (UK), IMF, OECD, World Bank, Tax Justice Network, US Commodities Futures Trading Association, *Accountancy Age* magazine, riskglossary.com

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The turmoil now engulfing the world's wealthier economies can be traced directly back to the same factors that have undermined the developing world for years, condemning poor countries to a cycle of poverty.

In rich countries, lax banking and accounting regulations, and tax havens offering banking secrecy, led to a massive credit boom that has now ended in disaster.

In poor countries, the same factors have for years enabled many transnational corporations and other businesses to minimise, avoid or even illegally evade altogether paying the tax revenues that the developing world so badly needs.

The present market mayhem provides the rarest of opportunities for the international community to institute root-and-branch reform to global financial systems for the benefit of all – rich and poor alike. It is imperative, says Christian Aid, that the moment is not lost.

London: PO Box 100, SE1 7RT **Belfast:** PO Box 150, BT9 6AE
Cardiff: PO Box 6055, CF15 5AA **Edinburgh:** PO Box 11, EH1 0BR
Dublin: 17 Clanwilliam Terrace, Dublin 2
Website: www.christianaid.org.uk

UK registered charity number 1105851 Company number 5171525
Scotland charity number SC039150
Republic of Ireland charity number CHY 6998 Company number 426928
Northern Ireland charity number XR94639 Company number NI059154