Statement by Finance and Trade Issues Cluster

Addressed to the UN Open Working Group on Sustainable Development Goals

Session 5 of the Open Working Group: "Sustained inclusive economic growth, macroeconomic policy questions (including international trade, international financial system and external debt sustainability), and infrastructure development, and energy

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Preface

We want to start with a preliminary note of caution: trying to merely turn the issues of macroeconomic policies, trade, debt and others that are the topic of this session into goals is a risky oversimplification that will breed failure in the overall framework. The recommendations we make below in the domain of economic policy constitute an essential part of the enabling environment to achieve sustainable development goals –alongside methodological and qualitative factors. For that, they should be compiled into a Plan of Action, which includes an analysis of key issues and means of implementation to carry them out, and become an inextricable component of the post-2015 development agenda, together with the sustainable development goals. Such a structure would recognize from the outset that sustainable development requires, as a precedent, adequate policy space for human rights-based development and a development- and environmentally-friendly global economic environment.

Financial regulation

The share of financial activity in the total turnover in the global economy has greatly increased and, accordingly, holds more sway on the functioning of the real economy. A McKinsey report shows that just one fourth of financial market profits gained in the 12 years before the crisis was used to finance the real economy and households. As the dominance of finance has grown, the share of investment into the real economy decreased.

Achieving sustainable development goals requires a reversal of this trend, a shift to a model where finance serves a real economy that is based on universal human rights, reduces inequality and embraces our responsibility as stewards of creation. That cannot be achieved if finance (markets, institutions, elites) is the main force driving the economy. Financial re-regulation is required to operate that shift.

Efforts to re-regulate finance should start with countries having the freedom to use capital controls to regulate cross-border capital movements when necessary. The IMF has endorsed the use of such measures lately but with too many macroeconomic prerequisites (such as low fiscal deficits and adequate foreign reserves) that, if applied in a draconian way, would diminish the practicality and effectiveness of such measures.

Even though the IMF's Articles of Agreement deny its authority to restrict capital controls,[1] the Fund's programs and surveillance display a bias toward requiring countries to meet such preconditions before applying measures to manage capital flows. Thus, the IMF should refrain from advising or requiring compliance with preconditions that limit or restrict member countries' choices and ability to regulate capital flows.

Financial markets should be regulated at the national level with participation of all those who have a stake in the sector's performance. Appropriate levels and types of re-regulation should reach all financial markets and financial actors, rather than exempt some actors or instruments. The rationale behind de-regulation is that it permits investors to test higher risk strategies and spur innovation, however, that strategy ultimately risks imposing unacceptable costs on the formal banking sector (and eventually the public budget).

No financial institution should be allowed to grow too big or complex that in case of failure it cannot be safely wound down without risk to the economy and vital banking services. The Financial Stability Board has begun to take steps to enable the orderly resolution of Too Big To Fail banks.[2] *Systemically Important financial Institutions* (SIFIs)[3] should be downsized and simplified. A first step would be the separation between investment and commercial banking. Enabling legislation for cross-border resolution of firms operating in more than one country, the requirement to file orderly wind-down plans and capital surcharges to dis-incentivize institutions from becoming too big, are complementary (not substitute) steps.

The Basel Agreement on capital requirements should emphasize the leverage ratio and risk-weighted capital buffers should complement it. Banks should not be allowed to establish their

[1] Article VI states "Members may exercise such controls as are necessary to regulate international capital movements."
[2] http://www.financialstabilityboard.org/publications/r_130902.pdf
[3] http://www.bis.org/publ/bcbs255.htm

own risk weighting. The leverage ratio and all risk-weighted capital requirements ratios, as well as the additional ratios for SIFIs, should be increased. Full implementation should be brought forward to 2015.

All derivatives must be traded in public exchanges and centrally cleared, in addition to being reported to trade registers. Particularly risky products such as *Credit Default Swaps,* and dangerous speculative practices like *Naked Short Selling* should be banned. Central clearing houses should have adequate capital buffers and require collateral for each transaction. In order to prevent food and fuel price volatility, regulators should set ex-ante position limits. Banks should not be allowed to use government insured deposits to engage in trading on their own behalf (proprietary trading).

The regulation of derivatives markets has particular bearing for many developing countries that are dependent on commodities trade revenues. For such countries, instability in those markets leads to unmanageable import costs and unpredictable export revenues. The resulting terms of trade reduces developing country capacity for diversifying into other sectors. Financial firms should be banned from speculating through physical holdings of commodities, particularly when those firms also trade derivatives contracts in those commodities, and thus are in a position to manipulate the prices of the underlying assets of the derivatives contracts.

Shadow banking vehicles should be subject to strict reporting requirements to ensure proper and monitoring and give the basis for more effective regulation.[4] Innovative products must go through a clearance procedure to ascertain that they are consumer friendly and not harmful to the stability of the system.

Credit Rating Agencies should be subject to strong governance requirements to suppress conflicts of interest and ensure integrity and accountability. Governments should hasten moves towards limiting regulatory reliance on credit rating agencies and reform legal regimes to ensure that the agencies are liable for negligent behavior. They should implement alternatives to the “issuer-pays” model, including by ensuring that there are competing public agencies with independent rating processes.

The International Monetary System and macroeconomic stability

Macroeconomic policy and social policy cannot continue to be incoherently disconnected, as though they are in separate, unrelated categories. Macroeconomic stability built on the back of growing income inequality, under-employment and an erosion of the social fabric is not

[4] http://www.financialstabilityboard.org/publications/r_131114.htm

sustainable. Thus, the policies to recognize unpaid and non-monetized work, tackle unemployment, inequality and exclusion (e.g. a social protection floor) and factor in environmental limits to linear growth, are integral components of a solid macroeconomic policy framework.[5]

This calls for the reversal of austerity measures, which in most cases have proved self-defeating in achieving fiscal and debt sustainability.[6] Counter-cyclical, rather than pro-cyclical, macroeconomic policies—subject to *ex ante* and *ex post facto* gender, human rights and environmental impact assessments and matched with people's needs—are the best safeguard against disproportionate human rights backsliding and economic and social instability.

Indeed, there is a problematic paradox between the fixation with economic growth, on the one hand, and the global consensus on austerity, particularly in the form of public spending cuts and regressive tax policies, on the other. Excessive levels of austerity will render the Post-2015 agenda illusive. Both developed and developing countries have prioritized deflationary macroeconomic policies over expansionary policies that could stimulate public investment, create urgently needed jobs and re-orient tax policies toward wealth redistribution for greater socio-economic equality.

Increased levels of exchange rate volatility have a strong impact on trade performance by constricting levels of domestic investment, destabilizing relative prices of export products (which, in turn, affect competitiveness of the economies), increasing the price of access to finance for production and shifting the value of market access concessions. By affecting the prices of essential imports such as food and energy, they also carry consequences for food security and the balance of trade (in creating or exacerbating current account deficits). Without a reformed international financial and monetary system that can counter these trends, developing countries will continue to be disadvantaged in global trade, even while dealing with a disproportionate share of environmental impacts.

The growing consensus around the shortcomings of the current international monetary system has not been accompanied by concerted and coordinated action for reform. While the dangers inherent to a continuation of the status quo – based on the domestic currency of one country as the main international trading and reserve currency – are evident, there is no shared vision for reform.

There are four key challenges that a reform of the monetary system must address:

1. Rebalancing and achieving coordination among trade deficit and surplus countries;

[5] http://www.levyinstitute.org/publications/?docid=1699
[6] E.g. http://www.ase.tufts.edu/gdae/Pubs/rp/PB13-01_EUAusterity.pdf

2. Ensuring adjustments are non-recessionary;

3. Limiting exchange rate volatility; and,

4. Promoting innovative mechanisms to enable the generation of development and climate finance.

These can be achieved through the following pillars:

1. A credible system for coordination among deficit and surplus countries;

2. A transition path towards a revamped system with a supranational currency as the cornerstone –revamped Special Drawing Rights can serve as a proxy leading towards such currency; and,

3. Support for countries to use capital flows management measures (as described above).

A more resilient monetary system requires greater diversity and regional-sensitivity of approaches. So such efforts at the global level should be complemented and counter-balanced by regional financial and monetary architectures, namely: 1) establishing regional monetary funds that would pool foreign currency reserves to combat speculative attacks and to compensate for economic asymmetries within the region; 2) extending intra-regional trade through payments with domestic or regional currencies; 3) establishing or consolidating regional development banks that are oriented to finance transformative objectives and are aligned with the realization of human rights and environmental renewal and, 4) creating democratic regional forums for discussing coordination on capital flow regulations.

Reform of governance of International Financial Institutions

We call for all IMF members to implement expeditiously the already agreed, though insufficient, reforms to the voting system, including the transfer of two Board chairs from European countries to developing countries. One of these chairs should go to African countries, who have the largest number of countries in their constituencies on the IMF Executive Board.

The deadline to reform the quota formula should not be missed (again). Such reform must give adequate and fair voice to borrowing countries, especially the poorer ones, by adopting and applying a more balanced approach to variables relating to the "demand for" and "supply of" finance. It should also provide greater weight to Purchasing Power Parity and the size of populations of member countries and should introduce a "double majority system", i.e.

decisions must carry the requisite support according to both the quota distribution and the number of countries supporting the decision. The reform must also continue to reduce the number of European seats on the boards of IFIs and introduce democratic accountability for each Executive Director. The process of selecting leaders of all global financial institutions must be open, gender-balanced, transparent, merit-based, and reflective of the composition of membership.

Both the World Bank and the IMF should implement transparent accountability mechanisms beyond the existing ones.

The membership of financial standard-setting bodies should also be broadened to give participation (voice and vote) to all countries which are affected by their policies (e.g., by experiencing positive or negative spill-overs).

Mobilization of domestic resources

Progressive, transparent and accountable taxation systems should be central to any sustainable development strategy. Billions are lost each year in developing countries through tax evasion and tax avoidance due to systemic and deliberate minimization of the tax share of companies and wealthy individuals. Conservative estimates put the figure at around USD 800 billion,[7] while one estimate based on transfer mispricing figures alone says that developing countries are denied USD 100 billion a year in tax revenue.[8] Mobilizing domestic revenue is all the more critical in the light of dwindling ODA trends.

While each country is responsible for their revenue-raising systems, industrialized countries play a key role in curbing international tax competition between companies and countries that negatively impacts on a country's ability to meet their human rights obligations. For example, the link between tax and fiscal losses and human rights is that in order to offset the losses, the governments resort to heavily taxing the poor through regressive taxes like value-added taxes (VAT).

As indispensable measures to prevent tax evasion and avoidance, and to enable progressive redistributive taxes, countries should:

1. Increase international cooperation and reform international tax governance to close tax havens, secrecy jurisdictions and guarantee tax transparency;

[7] Kar, Dev and Sarah Freitas 2011. Illicit Financial Flows from Developing Countries Over the Decade Ending 2009. Global Financial Integrity, Washington DC. December.
[8] Available at http://www.gfip.org/storage/gfip/documents/reports/implied%20tax%20revenue%20loss%20report_final.pdf

2. Strengthen the role of the UN in promoting international cooperation on tax matters, including upgrading the UN Committee of Experts on International Cooperation in Tax Matters to an intergovernmental body subsidiary to the ECOSOC. Join relevant international bodies including the "Global Forum on Transparency and Exchange of Information" and the "Multilateral Convention on Tax Exchange Information";

3. Implement financial transactions taxes (FTTs). In addition to their potential to keep sustainable resource flows towards human and environmental development initiatives, FTTs a) limit the incentives for damaging short-term speculation in financial markets, b) reduce systemic risks the capital market and curb money laundering and flows to tax havens.

4. Agree internationally to public automatic exchange of information and public registries of disclosure of beneficial ownership of companies; and,

5. In particular, measures to prevent transfer mispricing are necessary. The "arm's length" principle's application to all countries has inequitable impacts on developing ones. Alternatives should be agreed (e.g. unitary taxation). The multilateral adoption of country-by-country reporting of transnational corporations (TNCs) could help mitigate transfer pricing losses, in addition to bringing welcome transparency to ill-gained corporate revenue.

The current Action Plan on "*Base Erosion and Profit Shifting*" by the OECD is a promising initiative but suffers from some structural weaknesses particularly linked to the lack of developing countries' involvement in, and ownership of, the process. There is a risk of undesirable effects if the result is the use of principles and practices that harm, rather than help, revenue-gathering efforts by developing countries. (One such example is the potential consolidation of the residence rather than the source principle as basis for taxation) Thus, broad participation by developing countries in the exercise is critical.

Debt

In spite of successive debt cancellation initiatives and the implementation of the IMF/World Bank Debt Sustainability Framework since 2005, four countries are in debt distress, 13 are at high risk and 27 at moderate risk (IMF 2012). Moreover, 6 of the high risk countries and 15 of the moderate risk countries reached "Completion Point" under HIPC, that is, they received all the stock and flow cancellation available through this program.

This raises questions about the effectiveness of the Initiative's ability to make debt "sustainable in the long term," even for the limited sphere of its beneficiary countries. Several countries in the Caribbean and Pacific regions are also at high risk or in debt distress. Last year was the third consecutive year that debt in developing countries increased by more than 10 %.

The anticipated rolling back of quantitative easing is expected to put further pressure on the debt situation of developing countries, particularly through the currency depreciation that occurs during capital flight. At the same time, the bailouts of European countries such as Greece is evidence that debt distress is no longer confined to the developing world.

The now universal problem of unsustainable debt should be addressed by: reviewing onerous debts and cancelling illegitimate debts, especially in least developed countries; and revising Debt Sustainability parameters to make them more objective and accountable to the prioritization of financial needs for meeting development goals above debt repayments.

An independent and fair public debt workout mechanism should be established as a way to avoid the phenomenon of "too little, too late" that prevails in the current ad hoc, case-by-case patchwork of mechanisms to address debt crises. Ex –ante rules for fair burden-sharing would be the best way to promote responsible lending and prevent buildup of unsustainable debt. The UN should lead in design and implementation of such a mechanism. It should build on the features of any orderly insolvency regime in adherence to rule of law: 1) One single "insolvency" process that involves all creditors, 2) Impartiality in decision-making over terms and conditions of a restructuring, 3) Impartial assessment of individual claims' validity, of the sovereign's sustainable debt level and hence eventually necessary debt relief.

From an economic and social rights perspective, reduced debt burdens and increased fiscal capacity contribute to the creation of the conditions necessary for the realization of all human rights, particularly economic, social and cultural rights.

The *UN Guiding Principles on Foreign Debt and Human Rights*, endorsed by the UN's Human Rights Council in June 2012, underscores that States, international financial institutions and private companies have the duty to refrain from formulating, adopting, funding and implementing policies and programmes that directly or indirectly contravene the enjoyment of human rights.

Infrastructure financing

The post-2015 agenda should close the infrastructure gap faced by all countries and make it a pre-condition for implementation of the new development agenda. For that purpose, measures to support the financing of all categories of infrastructure are required.

In terms of financing techniques, form should follow function. It is true that the poorest and most disadvantaged communities are most affected by the infrastructure deficits. But their needs are more likely to be served through appropriate scale infrastructure, that can be built in a short time horizon and with robust safeguards that are aligned with the Rio Conference principles (e.g. the precautionary principle), rather than large infrastructure projects. Such infrastructure should be embedded in sustainable industrial policy that enables secondary and tertiary processing of raw commodities. There is a range of financing forms from the public to the private, including a diversity of forms of association and partnership that are available for building and financing infrastructure. We call for all of these forms to be openly discussed with participation by the affected communities and groups, and their distributional consequences debated in transparent and open ways.

We are concerned that these consultations are being bypassed by the advocacy vested interests make in favor of large infrastructure projects financed through public-private partnerships (PPPs). While the advantages of PPP-type arrangements are predicated on availability of private finance and the lack of public funding, the fiscal costs and risks of PPPs are often hidden. Such costs and risks, in the form of (explicit and implicit) contingent liabilities, tax incentives, failure to deliver on commitments to expanded investment (especially to the un- or under-served), are compounded in environments of low institutional quality. PPPs can socialize the costs while privatizing the benefits of infrastructure thus worsening inequality in income and access. Therefore, full transparency of PPP arrangements, including contract transparency, should be required.

We demand that fiscal and public debt risks of PPPs be properly accounted for and placed under public scrutiny through mechanisms for organized social participation and monitoring. Institutional and capacity pre-requirements for the success and effective functioning of PPPs, including social participation and provision of free prior and informed consent (FPIC) from affected communities, should be in place prior to project design and implementation.

International Trade

We call for a review of international trade and investment agreements. Among other things they restrict the ability of governments to regulate foreign investments in the public interest, promote investor rights at the expense of human rights in State Parties, impose barriers to technology transfer, productive capacity and industrial transformation, prevent fair taxation, and narrow the policy space countries need to achieve objectives of sustainable development.

Beginning with the World Trade Organization, there is a need to close the democratic deficit in all trade agreements. Subject to such conditions, in order to better address interlinkages between trade and finance, the WTO Working Group on Debt, Trade and Finance should be strengthened.

Countries' space and capacity to alleviate crises has been greatly compromised by bilateral, regional and multilateral trade and investment agreements as well as the WTO-GATS "request-offer" negotiations on liberalization of trade in financial services. In line with the general consensus on the need for an overhaul of financial deregulation paradigm, a process for the immediate revision of the rules on liberalization of financial services should be established at all levels, including negotiations on financial services in the WTO.

To address trade asymmetries between regions and countries, there is a need to guarantee meaningfulness, weight, operationalization and legal status of Special and Differential treatment principle for developing countries, the removal of subsidies in developed countries, especially in agriculture and the flexibilization of Intellectual Property Rights rules in order to protect, *inter alia*, public health, environment, natural resources.

Regional coordination should be strengthened to facilitate reorientation of economies towards protecting and building local industries and productive capacities driven largely by domestic demand while ensuring greater regional trading and productive complementarity in sustainable sectors.

All States should respect, protect and fulfill, in the realm of trade and investment agreements, their obligations under the Maastricht Principles on Extraterritorial Obligations of States in the area of Economic, Social and Cultural Rights. Additionally they should monitor gender differential impacts of trade policies and take protective measures where impacts are expected to be harmful.

- END -