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The Global Financial Crisis and Development

Implications for the Entrepreneurial Economy

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Abstract

This paper provides an evaluation of the state of global development two years after the global financial crisis of 2008. It argues that in the wake of the crisis a number of re-assessments of global development has taken place, especially with respect to (i) the surprising origins of the crisis, (ii) the surprising resilience of the developing world, and (iii) the shortcomings of the global financial architecture (GFA). Despite these re-assessments, progress in dealing with the deep causes of the crisis has been slow, and there are strong vested interests against reform of the GFA due to the incentives that many years of deregulation and regulatory capture has created. These incentives influences entrepreneurial and managerial behaviour in ways that may frustrate reform and re-regulation and leave global development vulnerable to further financial (and other) crises. The paper draws out some implications for the entrepreneurial economy.

Keywords: Global financial crisis, international trade, finance, developing countries, entrepreneurship

JEL classification: F33, O11,M13

Acronyms

AfDB	African Development Bank
BCBS	Basel Committee on Banking Supervision
CDO	Collateralized Debt Obligation
CDS	Credit Default Swaps
CFPA	Consumer Financial Protection Agency
CRA	Credit Rating Agencies
DAC	Development Assistance Committee
ESA	European Supervisory Authorities
ESRB	European Systemic Risk Board
EU	European Union
FATF	Financial Action Task Force
FDIC	Federal Deposit Insurance Corporation
FCL	Flexible Credit Lines
FSB	Financial Stability Board
FSF	Financial Stability Forum
FTT	Financial Transactions Tax
GDP	Gross Domestic Product
GFA	Global Financial Architecture
GFC	Global Financial Crisis
GNI	Gross National Income
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation

ILO	International Labour Organization
INV	International New Ventures
IMF	International Monetary Fund
NSE	Non-state ‘sovereign’ entrepreneurs
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
OFC	Offshore Financial Centers
TBTF	Too Big To Fail
UK	United Kingdom
UN	United Nations
UNCAC	United Nations Convention against Corruption
USA	United States of America

1. Introduction

The history and significance of the global financial and economic crisis of 2008 is yet to be written and determined. After two years, in spite of a re-assessment of global development, not much progress has been made in dealing with the deep causes of the crisis. While we understand better now why and how the crisis occurred, we are still some way from a sustainable recovery, and even perhaps a longer way from preventing financial crises to derail global development in future. The culprits have been identified but not dealt with yet. Now, two years after the crisis, developing countries face sluggish international demand, food prices are yet again spiraling upwards, many advanced countries face the specter of fiscal constraints and even debt crises, and currency 'wars' have become a possibility as countries vie for a reduced global market. Even if there are 'green shoots' in some advanced economies, and even if developing and emerging countries have been less dramatically affected than was perhaps first anticipated, many challenges remain.

The purpose of this paper is to provide an evaluation of global development two years after the crisis and to link the unaddressed issues to the incentive or reward structure that has been come into being in the 'entrepreneurial economies' of advanced countries. Section two will sketch a brief history of the crisis. Section three will set out various re-assessments of global development that is now taking place. Section four warns against strong resistance against reform of the GFA outlining some of the vested interests, while section 5 argues for the need to take the incentive structure of the entrepreneurial economy into consideration if the GFA is to be successfully reformed or revolutionized. Section 6 concludes.

2. A Brief History of the Crisis

Although it is a myth that the crisis was completely unforeseen[1], it did come as a surprise to many because it happened after almost a decade of very good global growth (Naudé, 2009;2010a). Developing countries and emerging markets especially did well, and many countries in Africa seemed to have cut the corner, their growth rates boosted by high demand

[1] Bezemer (2009) contains a list of economists who did foresee a crisis.

for commodities. Accompanied by reductions in violent conflicts and improvements in governance and macro-economic management there was widespread optimism that global poverty was in retreat. The countries that were most embracing globalization were seemingly growing the fastest (Dollar and Kraay, 2004). World income inequality[2], which seems to have peaked in 1970s, was also slowly, but surely, declining (Crafts, 2004).

Hence the shock and disappointment when during 2007 it was realized that growing mortgage loan defaults in US and the failure of Northern Rock in the UK were harbingers of a crisis. In the USA a combination of cheap money, aggressive lending practices, rising house prices, and weak prudential regulation had since the start of the century facilitated the extension of mortgage finance to the tune of more than a trillion US dollars, largely to households who had little prospects of ever repaying. Banks 'covered up' the risk by securitizing the expected income streams from these bad loans, packaging them in with other securities such as Collateralized Debt Obligations (CDOs). These were sold onwards throughout the world as they were given favourable (AAA) ratings by Credit Rating Agencies (CRA) – who were in many cases paid by the investment banks for which they were providing the rating. Moral hazards and conflicts of interests were rife throughout the financial system.

Problems started when mortgage defaults started rising, foreclosures on houses increased, and short-term interest rates started rising. In March 2007, the US's New Century Financial Corporation stopped issuing subprime mortgages. In July 2007 the Federal Deposit Insurance Corporation (FDIC) took over the IndyMac Bank. On 7 September 2008 the US Treasury had to rescue (nationalize) the largest mortgage lenders, Fannie Mae and Freddie Mac. By mid 2008 around 40 per cent of all sub-prime mortgages issued in 2006 in the USA were non-performing.

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[2] Global disparities in incomes and wealth remain staggering. Almost one and a half billion people are extremely poor in terms of incomes (Chen and Ravallion, 2008). Global income inequality between countries is high with the world Gini-coefficient according to all estimates exceeding 0.6 (Hillebrand, 2008). Wealth is even more unequally distributed, with almost half of the richest 10 percent of adults in the world (owing 85 percent of its wealth), living in only two countries, the US and Japan (Davies, 2008).

The global knock-on effects were immediately felt. The deflation of the house price bubble shook confidence in the US dollar and became an important factor in rising energy and food prices. The price of oil jumped from US$ 90 per barrel in January 2008 to US$147 per barrel in July 2008. Oil and maize prices peaked in July 2008 at record levels, putting enormous economic strain on energy and food importing developing countries[3]. Around 40 poor countries were thrown into an acute food crisis.

On 15 September 2008 investment banking firm Lehman Brothers declared bankruptcy – at that time the largest in the history of the USA. This caused widespread panic in financial markets. Declining stock markets tumbled further. Uncertainties about bank solvencies lead to a global credit contraction. Losses in wealth, consumer confidence and dwindling trade finance were followed by the news that the US, and most other advanced economies, were in recession. For the first time since the Second World War global trade contracted. Both the initial destruction of financial wealth as well as the psychological shock of seeing many elite Wall Street firms on their knees prompted many to compare what was now a global financial and economic crisis with the Great Depression (1929-33).

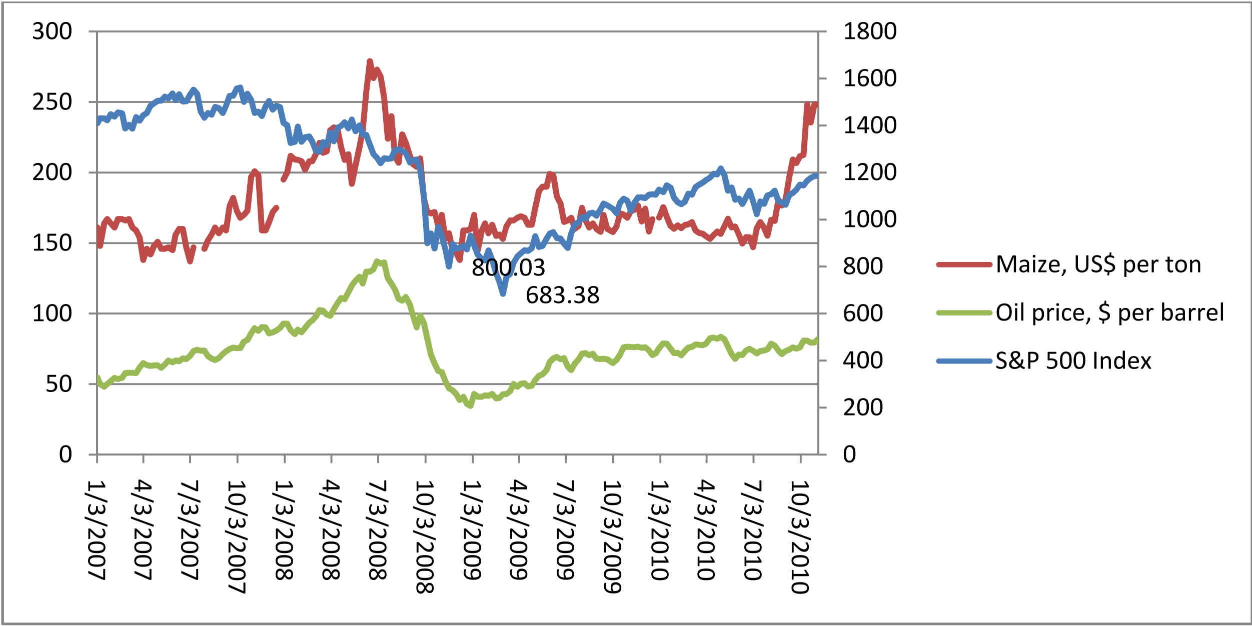
Another Great Depression fortunately never happened – for reasons that will be discussed in the next section. Nevertheless, world output did contract, and world trade contracted to an even greater extent. All regions of the world were affected – some regions such as Europe and the transition economies more directly by contagion in financial markets – and other regions, such as Asia, Africa and Latin America, more by the decline in global demand.

The initial expectation of the impact of the crisis on global development also did not materialize. Although all countries were affected, what was surprising was the resilience shown by developing and emerging economies, who recovered sooner than many anticipated. Many avoided their own recessions. Even by mid 2009 the USA, the epicenter of the crisis, was not technically in a recession anymore.

[3] Khan (2009) argues that it was the rapid 'financialization' of oil markets which allowed the speculation which lead to the bubble in oil prices in 2008, when the price of oil jumped from $ 90 per barrel in January 2008 to $147 per barrel in July 2008.

Figure 1 provides a timeline of the crisis in terms of the prices of shares (as per the S&P 500 index), food (as per the price of maize in $) and the oil price (in $ per barrel).

Figure 1: Timeline of the Crisis in Terms of Share and Commodity Prices

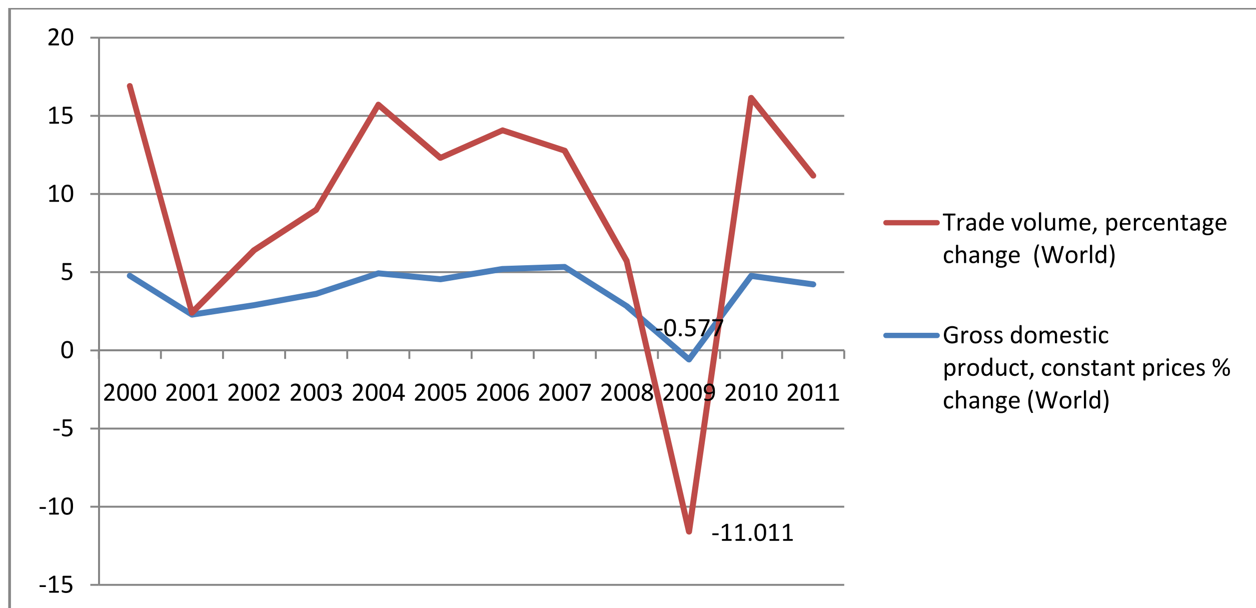


(Source: author's compilation based on data from US Energy Information Administration, the Food and Agricultural Organization and Google Finance)

It can be seen from Figure 1 that prices fell dramatically in September 2008, and then started to slowly recover after February 2009 - about a month after the US government approved its US $ 819 billion fiscal stimulus package (the *American Recovery and Reinvestment Act of 2009*).. Share prices seems to have recovered to levels before than of September 2008 and maize prices are again almost approaching the record highs of early 2008. Oil prices have recovered but not as much and remain at levels comparable to that of 2007.

Figure 2 provides another timeline of the crisis, in terms of GDP and trade volume growth rates for world as a whole.

Figure 2: Timeline of the Crisis: GDP and Trade Volume Changes (World) in %

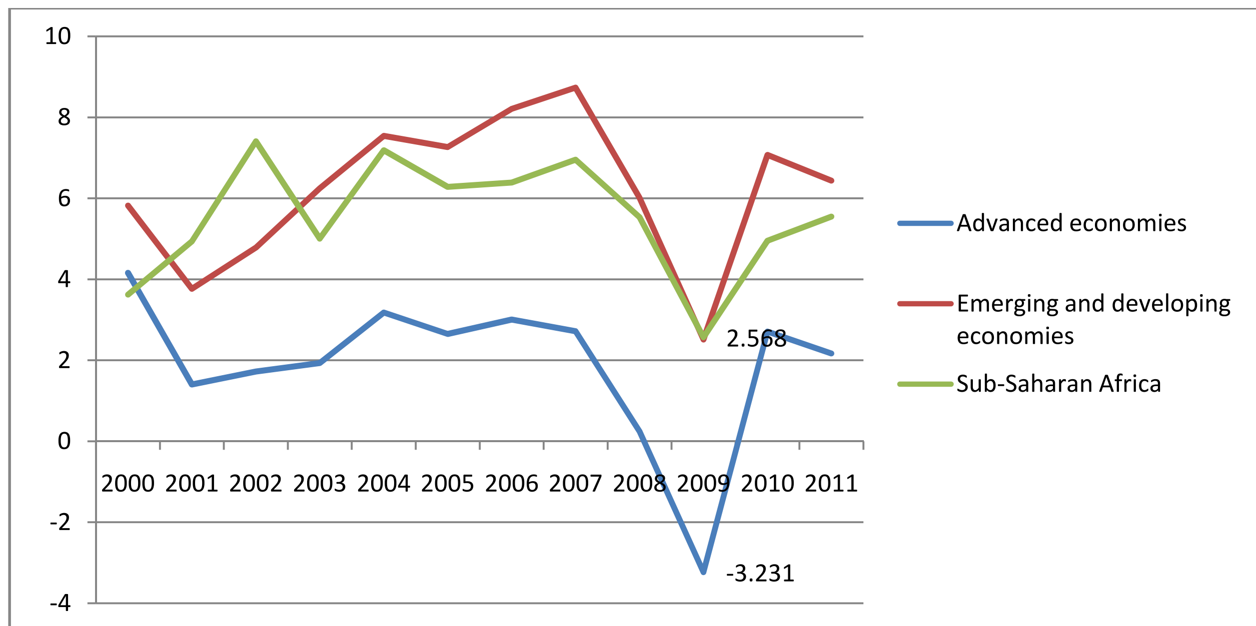


(Source: Author's compilation based on data obtained from the IMF's World Economic Outlook, October 2010)

As Figure 2 shows, volumes of trade contracted sharply during 2009 – by 11 per cent. This is substantially more than the contraction in GDP growth – which for the world on average was a mere -0.57 per cent. The sharp drop in trade, as against the more modest drop in growth, is ascribed to the drying up of trade credit (with trade being very dependent on trade credit) and the globalization of trade that has seen outsourcing of production (global value chains). The figure nevertheless show that despite the large drop in 2009, trade volumes and growth have rapidly recovered to growth in 2010 comparable to that seen during the high-growth 2004-2007 period.

Finally, Figure 3 shows a timeline of the crisis in terms of the GDP growth rates in the major regions of the world.

Figure 3: Timeline of the Crisis: GDP growth Across the World



(Source: Author's compilation based on data obtained from the IMF's World Economic Outlook, October 2010)

Figure 3 shows that the crisis has affected advanced economies much more. There, GDP contracted in real terms by 3 per cent during 2009, whereas emerging and developing economies, and SSA, continued to achieve positive GDP changes, albeit at reduced rates. Both advanced economies and emerging and developing economies recovered in 2010. The IMF predict positive future growth rates in both areas, although that in advanced economies will be much more sluggish than economic growth in the rest of the world.

Even if emerging and developing countries' economic growth rates did recover surprisingly quick, their development may have been jeopardized to an extent not immediately obvious from aggregate growth figures. One reason is that growth contractions lead to higher unemployment and growth resumptions do not always pick up these unemployed. Preliminary estimates and forecasts suggest that unemployment in developing countries will have increased by 32 million, and that 53 million additional people will be thrown into extreme poverty

(ILO,2009). In these countries entrepreneurial opportunities in the informal sector is likely to be increasingly important as a source of survival for many.

People in developing countries are often more seriously affected by economic slumps and rising unemployment because they lack social safety nets. In advanced economies these safety nets kicks in as 'automatic stabilizers' and provide not only direct support to affected households, but also helps to raise aggregate demand, thereby indirectly cushioning the economy. However these safety nets and automatic stabilizers are largely lacking in many developing countries. Also, most developing countries have small domestic markets, and have been growing on the back of exporting their goods to the rest of the world. With the prospect of continued recession or sluggish growth in the rich world, their engines of growth are under threat. Matters are worsened by the fact that even with the resumption in growth and trade, unemployment will remain higher for a considerably longer period of time – this is an important lesson from previous crises. Much of the recovery growth across the developing (and also developed) world may be 'jobless growth'. Hence many people engage in adverse coping behaviour, e.g. children dropping out of school, parents cutting back on health care, people entering prostitution, engaging in criminal activities, resorting to violence. As such the crisis may make it more difficult to improve global security and secure collaboration on mitigating climate change, and very often the worsening social conditions resulting from adverse coping impact negatively on both the supply and demand of entrepreneurship.

While the history described here provide some answers as to the proximate causes of the crisis, it does not give a clear answer as to the underlying causes. It also does not provide a clear answer as to why growth in advanced economies continue to appear sluggish and why food price are edging upwards again. Answers to these questions have however emerged out of a number of re-assessments of the trajectory of global development that has since taken place. In the next section I visit these re-assessments.

3. Re-assessing Global Development

Although the GFC of 2008-2009 was not as unexpected a crisis as some want to believe, it did result in a number of surprises. It was a surprise in that it struck after a period of high growth in the world economy, at a time when especially emerging and developing countries were doing very well. It was a surprise in that it originated in the USA, the world's largest and richest economy, whom everybody through had a robust and world-class financial system. It was a surprise in that unlike over a hundred other financial crises since the 1970s, it originated in the private sector and not in government – in other words it was primarily an entrepreneurial crisis rather than a bureaucratic one (more on this in section 5). And it was a surprise in that emerging and developing countries were more resilient than was expected and was not as hard hit as many had initially feared.

As a result of these surprises the crisis has ignited a number of re-assessments of the mechanisms and frameworks of global development. Three of the most important re-assessments deal with

- The surprising origins of the crisis;
- The surprising short-term resilience of emerging and developing countries; and
- The need to accordingly reform the GFA.

I will briefly deal with each of these in the remainder of this section.

3.1. The Surprising Origins of the Crisis

Financial crises are nothing new. The IMF documents more than 120 financial crises since 1970 (Laeven and Valencia, 2008), and since 1990 there were at least 13 financial crises with global repercussions. What makes the 2008 financial crisis different, or surprising, were that (i) it originated in the USA, (ii) it was a '19th century type of crisis' in that it originated in the private sector or entrepreneurial economy, and not in the government sector as most late 20th century crises, and that (iii) it lead to an unprecedented contraction in global trade.

The fact that the crisis originated in the USA, and moreover the country's private financial sector, a sector thought for many decades to be well-managed, well-regulated and a world leader, caused much shock. It has lead to a re-evaluation of the global economic leadership role of the USA. Indeed the moral and economic leadership of the USA was seriously undermined by the crisis, coming at a time when the USA was facing mounting concern over raising domestic inequalities[4], lack of adequate health care for its citizens, crumbling public infrastructure, an escalating drug war on its border, and wasteful and divisive wars in Afghanistan and Iraq.

The USA has lost a number of leadership positions. As described by Simon Johnson[5] the situation in the USA in this crisis is more analogous to emerging markets than advanced countries:

> "The crash has laid bare many unpleasant truths about the United States. The finance industry has effectively captured our government—a state of affairs that more typically describes emerging markets, and is at the center of many emerging-market crises."

Why and how did this crisis occur in the USA? The simple reality is that the financial crisis took place in the USA because of the combination of (i) unsustainable consumption leading to global savings-consumption imbalances, and (ii) regulatory capture by the USAs financial sector. These two causes are intertwined and have common underlying incentives: per se global imbalances would not have lead to crisis, and without imbalances the size and scope of the damage done by regulatory capture may not have been as large.

It is useful, for the sake of exposition, to discuss the root causes of the crisis using diagram 1.

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[4] Inequality is one of the most significant challenges facing the US. Even despite the wealth wiped out by the financial crisis, the rich are becoming even richer in the US. As reported by Lieberman (2011:1) "In 2009, the average income of the top five percent of earners went up, while on average everyone else's income went down…The share of total income going to the top one percent has increased from roughly eight percent in the 1960s to more than 20 percent today".

[5] SeeJohnson (2009a).

Global imbalances refer to what has also be described as a global 'savings glut' (Bernanke, 2005). These intensified after the 1997-1998 Asian crisis, when these countries found the assistance of the IMF to be unsatisfactory and started to accumulate foreign exchange reserves as self-insurance. Many other developing countries, and developed countries such as Japan, also started to accumulate foreign reserves. Some, like China, also accumulated reserves as part of its export-led growth strategy to keep its currency undervalued. Developing countries now hold approximately US $ 6 trillion in foreign exchange reserves. China is the largest single holder of USD, having around $ 2 trillion in reserves. The costs of these reserves to China and other developing countries are substantial. In effect developing countries' saving is funding high consumption in developed Western countries, such as the US, which by 2007 accounted for more than 18 per cent of global consumption demand.

Between 2000 and 2007 the fact that the USA was the issuer of the global reserve currency, made it possible for the US Federal Reserve to lower interest rates – by up to 27 times between 2001 and 2003 – after the dot-com crisis. In effect, as it is now clear with hindsight, the Federal Reserve responded to the bursting of the dot-com bubble by inflating another bubble – this time in house prices. This further fuelled household consumption in the USA – which rose to exceed 70 percent of GDP, the highest level ever in the USA. As a result, global imbalances continued to widen.

But global imbalances cannot alone carry the blame for the crisis – and neither should it be used to point the fingers for the cause of the crisis at developing countries. After all, the USA was under no obligation to expand household consumption and inflate house prices in the manner that it happened. The reason why it did, and why the rise in house price fed the growth of the subprime mortgage sector, is to be found in perverse incentives that resulted from what could be described as regulatory capture in the US – as depicted in row three of Diagram 1.

Regulatory capture refers to the undue influence of the financial sector in the US economy, to the extent that it was able to influence the weakening of underwriting standards, regulation, supervision – all of which resulted in moral hazards, inappropriate and skewed incentives, and

excessive risk taking. Vivid descriptions of the extent of this regulatory capture are contained in Johnson (2009), Stiglitz (2009) and Taibbi (2009).

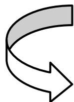
The direct consequences of this regulatory capture is summarized in Diagram 2, rows 4 to 6. In essence, regulatory capture contributed to (i) regulatory failure, (ii) the rise of 'shadow banking' that is of financial intermediation outside the regulated and supervised banking sector, and (iii) incentive failure (or perverse incentives). These three pathologies contributed to the 1997-1998 Asian Crisis, the dot-com crisis, as well as the current crisis, and the resistance against new regulations that is now being experienced. For instance the dot-com crisis was largely caused by relaxed underwriting standards (new high tech firms could list on the stock exchange with very little prospects or reputation) and fraudulent 'laddering' and 'spinning' practices by investment banks.

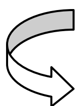
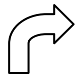
Similarly , between 2000 and 2007 regulatory failure include relaxed underwriting standards with respect to the issuing of mortgage loans (with so-called *Ninja*-loans, applicants were neither required to have proof of income, employment or assets), the shift by banks of poor quality assets off balance sheet, the issuing of inappropriate AAA ratings on securitized mortgage debt by Credit Rating Agencies (CRA) who were paid for by the very investment banks issuing the debt, and the backing of Credit Default Swaps (CDS), which were issued as insurance against mortgage securities, by more CDS.

Although the regulatory capture was lead by the private sector for its own narrow benefit (particularly of the big investment banks) and thus has its origins in the entrepreneurial economy, one cannot blame all entrepreneurs or the entrepreneurial economy as such. In fact as I will set out in greater detail in section 5, entrepreneurs were generally very negatively affected by the financial crisis brought on by the destructive entrepreneurial behaviour of a small section of the economy.

Diagram 1: Main Causes of the Global Economic Crisis and Impact on Developing Countries

	Timeline 1998 - 2000	 2000-2007	 2007-2009
Global-imbalances	• Rise in Petro-dollars (hot money). • Bretton Woods Institutions outdated.	• Forex accumulation. • Bretton Woods Institutions outdated • Dollar as sole reserve currency. • Fed lowering of interest rates. • House price bubble	• Forex accumulation. • Bretton Woods Institutions outdated. • Fed lowering of interest rates. • Fall in US consumption • Oil- price bubble.
Regulatory capture	• Growing financial sector • Financial 'oligarchs'	• 'Growing financial sector • Revolving door' Washington-Wall St. • Growing influence of the 'Goldmanites'.	• Bailouts for insiders. • Bankruptcy for outsiders. • Rise in financial sector concentration. • 'Insiders' value of assets larger.



Regulatory failure	• Directed lending. • Poor supervision. • Relaxed underwriting standards. • 'Laddering' and 'spinning' practices.	• Commodity Futures Modernization Act, 2000 • CDS backed by other CDSs • Relaxed underwriting standards (mortgages). • Mortgage originators not regulated. • Inappropriate ratings by CRAs. • Inappropriate tax laws.	• Reductions in limits on speculative trade in commodities (CFTC). • Inappropriate corporate taxation in US.
Rise of 'shadow' banking 	• Rise of investment banks • Increase in Initial Public Offerings (IPOs)	• Commodity speculation. • Financialization of oil markets • Sub-prime mortgages • Collateralized Debt Obligations (CDO) • Credit Default Swaps(DCS). • Special Investment Vehicles (SIVs) • Offshore banking	• Growth in Sovereign Welfare Funds (SWF).
Perverse Incentive 	• Moral hazards • Herding behaviour • Risk taking	• Moral hazards • Herding behaviour • Risk taking • Excessive leveraging • Bonus structures	• Moral hazards • Herding behaviour • Risk taking • Excessive leveraging • Bonus structures

Consequences for developing countries	• Slumps in world demand: -1997-98 Asia Crisis -2000 Dot.com Crisis • Strangling IMF conditionality • Financial 'flows to safety'. • Exchange rate depreciations and instability. • Rising developing country debt.	• Booms for oil rich and commodity rich countries • Fuelling unsustainable growth through commodity demand and easy finance. • House price bubble. • Growing household indebtedness.	• Slumps in world demand: -Global output falls -Global trade falls -Global credit crunch • Energy crisis • Food price crisis • Reductions in Aid • Financial 'flows to safety'. • Exchange rate depreciations and instability. • Rising developing country debt. • Growing protectionism.

(Source: Author's compilation)

3.2. The Surprising Resilience of Emerging and Developing Countries

As I mentioned in section 2, although it was initially feared, another 'Great Depression' never happened. Partly, thanks to John Maynard Keynes, who taught that the Great Depression was 'great' because governments in the 1930s failed to prop-up aggregate demand. Fearing another Great Depression, advanced countries this time around applied all the lessons learned from that crisis by bailing out banks (most were allowed to fail during the Great Depression) and announcing huge fiscal stimuli (only monetary policy were attempted during the Great Depression). The IMF called for a global stimulus equalling 2 per cent of global GDP – a target that seems to have been achieved, considering preliminary estimates of fiscal stimuli programmes indicates that advanced economies spent around US $ 1.4 trillion (around 2.9 per cent of their GDP) on fiscal stimuli. How effective these will be over the medium term, and how it will contribute to future sovereign debt crises, remains to be seen. Many advanced economies – Greece, Ireland, Portugal and Spain among them - are currently facing worrying debt problems.

In addition to fiscal stimuli, significant resources were thrown at keeping the financial system working and alleviating the credit crunch. According to IMF estimates, the costs of stabilizing

banks, in terms of injections of capital (bailouts), provision of liquidity, standby arrangements, and guarantees of loans and deposits, amounted to around US $ 11 trillion in developed countries, and US $ 1.7 trillion in developing countries. This latter is still a huge sum – about ten times the annual flow of *Official Development Assistance* (ODA) from OECD Development Assistance Committee (DAC) members in 2008. Whether this 'bailout money' as it has been called, and some of the accompanying regulatory changes will be effective in preventing future crises, or whether indeed it will create further moral hazards for banks that have become 'too big to fail' (TBTF) also remains to be seen.

Nevertheless as a result of the above huge injections of money into the global economy, banks were stabilized, and both the financial contagion and economic contraction were dampened. Without these measures, the immediate and short-term impact of the crisis would have been significantly worse. With these measures, most advanced economies, including the USA, were technically out of a recession by mid-2009. Many of the socio-economic and political doomsday prophecies made at the end of 2008 fortunately never materialized.

So one reason emerging and developing countries were not as hard hit was due to the stimulus in advanced economies[6] and the bail-outs provided to stabilize the financial sector. But there were other, perhaps even more important reasons for their resilience. The first is better macro-economic management. Thus we have seen a brave effort to cope in many emerging and developing countries. In the larger and more stronger developing economies, such as China, India and Brazil, recovery was surprisingly swift following implementation of counter-cyclical policies. These countries (particularly Brazil China, India, Mexico and South Africa) spent around US $ 770 billion (around 2.7 per cent of their GDP) on fiscal stimuli. In many African countries, amongst the most fragile, governments have been showing encouraging signs of attempting to shelter their economies. In those where it was possible, such as Mauritius and South Africa

[6] Although there is also some reason to think that fiscal stimuli in advanced countries will not have such an important impact on developing country growth. For instance in some cases these stimuli were accompanied by protective measures. An example is Section 1605 of the $ 787 billion stimulus package approved in the US in February 2009 that commits the US to a 'buy American' condition, i.e. to spend these funds largely on goods manufactured domestically (Hufbauer and Schott, 2009) .

amongst others, governments have been expanding expenditure. Ghana, facing a large budget deficit, had negotiated assistance from the IMF. Kenya and Tanzania benefitted from careful monitoring of their economies. Tanzania for instance, recognized that fiscal stimuli could only be sustained for a short period, and prudently imposed two year limits on government loans and guarantees. The African Development Bank (AfDB) has reacted quickly by identifying the most vulnerable countries and has made emergency finance available. It reported a doubling of its lending during 2009 (from around $ 5 billion to $ 11 billion). The International Finance Corporation (IFC) provided loans to firms and private sector projects in Africa of more than $ 1.8 billion in 2009, increase of more than 32 per cent. Hence many long-term investment projects in Africa, many in critical infrastructure, seemed to have remained in place. As figure 3 shows, the IMF expects African growth to recover to close to 6 per cent in 2010.

A second reason is that many developing countries, particularly in Asia, learned valuable lessons from the 1998 financial crisis which had resulted in their economies now being less vulnerable to financial shocks. Many countries, like South Korea, had accumulated large foreign exchange reserves in order to insure themselves against such crises. While this reflects poorly on the international financial system that it is not trusted by developing countries, it does show that developing countries can and will act in their own best interest.

A third reason is that the improvement in macro-economic management in many developing countries reflects improvements in governance – including improvements in many African countries (Fosu and Naudé, 2009). These improvements, reflected for instance in more robust democracies, more frequent elections, steps to reduce corruption and end conflicts, and to empower women, are largely homegrown. It would be very difficult for anyone to argue that they were the outcome of Western aid or pressure. This means that better governance, which leads to better resilience in the case of financial and economic shocks, have most often been achieved without, or even in spite of, Western aid.

The GFC has shown emerging developing countries that they can and should manage by themselves in collaboration through regional institutions and the UN’s development system (Naudé, 2010a). They still are – and this is another lesson from the crisis – very dependent on

global economic growth, but unlike previous times the extent of the rest of the world, in particular the West's dependence on developing countries is also becoming abundantly clear. Demand in the West will be low and sluggish for years to come. The days of the USA as 'consumer of last resort' is over, and global growth depends now more than ever on the growing demand of developing countries and emerging markets. The role of the private sector, and entrepreneurship specifically, to drive economic growth and consumer demand in developing countries and emerging markets will be critical in years to come.

So the GFC has lead to a re-assessment of the ability and position of emerging and developing countries in global development. In the wake of the crisis this rising status of these countries were confirmed by changes in trade patterns – particularly in the growing economic relations amongst emerging and developing countries and the relative decline of traditional patterns of trade investment. For instance following the crisis China overtook the US as Africa's largest trading partner. Similarly, trade between Africa and India increased ten-fold from $ 7 billion in 1997 to over $ 70 billion in 2007, and trade between Latin America and Africa more than doubled since 1994 and now exceeds $ 26 billion. Entrepreneurs from emerging markets are doing particularly well in other emerging markets and developing countries and the GFC has reinforced this phenomenon. In recent times the press has for instance reported that Indian 'Billionaires Go on Buying Spree in Africa', documenting that in 2010 Indian entrepreneurs invested in at least 79 ventures in African countries (Srivastava and Sharma, 2010).

These cases are examples of the general growth in South-South trade and investment, which had increased from 30 per cent to 50 per cent of global trade over the last three years. The roles of Brazil, China and India in particular stand out. The size of these three economies combined exceeds that of the United States. Unlike the United States, these economies are growing robustly, with predictions of growing household demand as their middle classes grow more prosperous. They will increasingly become less dependent on exports to the USA.

3.3 Improving the Global Financial Architecture

The surprising origin of the crisis as well as the surprising resilience and rise of emerging and developing countries in the global economy has brought to the fore the inappropriateness of the current global financial architecture (GFA). The GFA can be defined as the 'collective governance arrangements at the international level for safeguarding the effective functioning of the global monetary and financial systems' (Elson, 2010:17). The GFA is not a new topic – the inappropriateness of the GFA has been a concern at least since 1971 when the Bretton Woods system of administered exchange rates collapsed, and with that any real international economic and financial coordination. After the last major financial crisis, the Asian crisis of 1997-1998, there was a similar intensification of the debate on how global finance should be managed, and coordinated, in a global economy.

But there was little substantial progress after 1997-98, as the occurrence of the 2008 financial crisis implies. There were incremental changes to the GFA and disparate region efforts to come to grips with the crisis – very much similar to what is now happening. After the 1997-98 Asian Crisis the incremental changes were the creation of the Financial Stability Forum (FSF), the Basel II process on the supervision and regulation of banks, and a re-assessment of international aid leading to a recognition of the need to improve aid effectiveness (for e.g. the Paris and Accra declarations). Each of these areas can now be seen to have resulted basically in failure. There were also, more notably regional efforts in the reaction to the crisis that reflected the continuing absence of global coordination. For instance the Chiang May Initiative was started in Asia (lessons were learned). Furthermore disillusionment with the IMF and World Bank led to a sharp decline in their lending (as the next sub-section will detail). But essentially little else changed; global financial flows continued rising, the shadow banking system and the power of the financial sector continued to expand, and banks became leveraged to unprecedented levels.

Following the 2008 GFC there are in particular five dimensions of the GFA that have been recognized as in need of reform or action[7]:

(i) The World Bank and IMF;

(ii) Global coordination in currency management t avoid global imbalances in saving and consumption, address reserve currency issues and deal with exchange rate misalignment (including that of the Chinese Yuan) and the specter of currency wars.

(iii) Global financial regulation and supervision,

(iv) Illicit financial flows and lack of transparency in financial markets and

(v) International aid (ODA).

In the remainder of this section I will deal with these five dimensions of the international financial architecture.

- *The World Bank and the IMF*

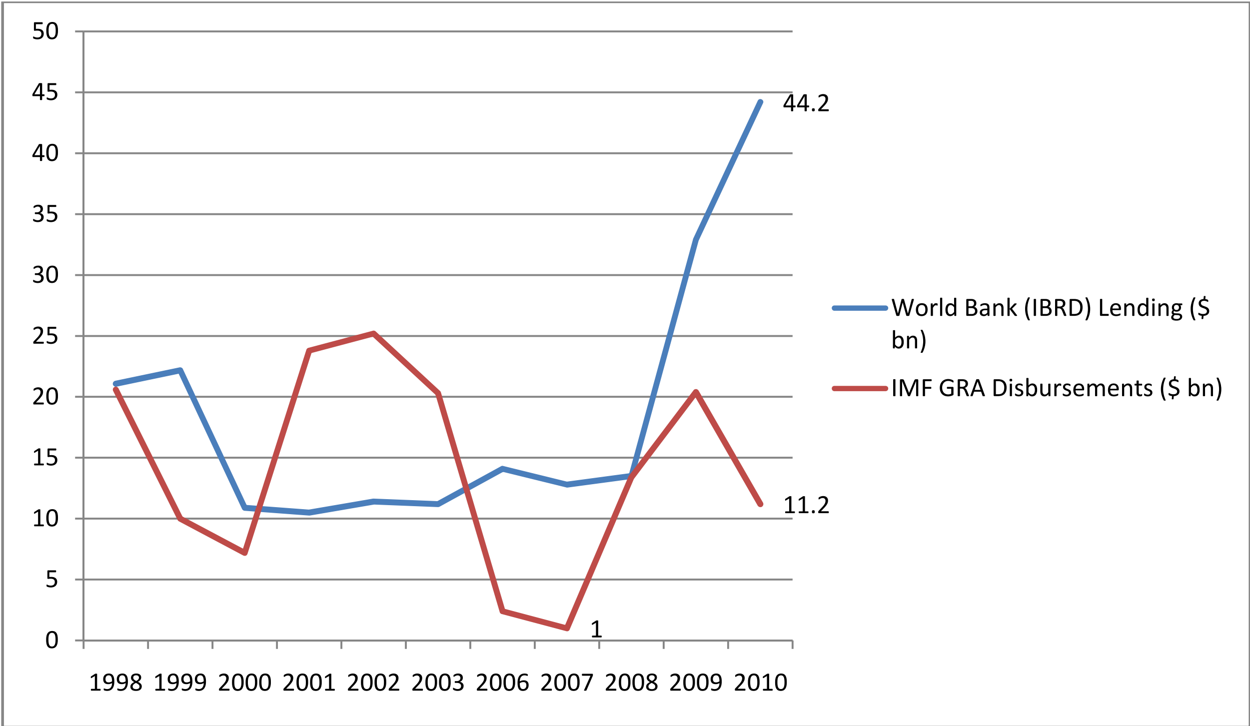
The World Bank and the IMF were created at Bretton Woods in the USA following the Second World War. They were designed by the dominant economic powers of the day, for a world with fixed exchange rates, where the volume of trade and financial flows were many times smaller than today, and where economic crises were only due to inappropriate government policies and/or political stability. Clearly, in a world where economic power is shifting, where exchange rates are floating, where the volume of financial flows dwarfs world output, and where the major financial crisis has been private sector-led, these institutions may seem to be past their sell-by date.

Indeed, before the current crisis the IMF was retrenching staff, and both the lending of the IMF and World Bank had declined to unprecedented low levels. Countries were loath to make use of

[7] The foremost multilateral initiatives to deal in a globally coordinated way with the origins and impacts of the crisis over the past two year were the G-20 meetings in London in April 2009, in Pittsburgh in September 2009, in Toronto in June 2010 and Seoul in November 2010, as well as the United Nations' Conference on the World Financial and Economic Crisis which was held in New York in June 2009.

their funding, and many had purposely paid back any money owed to them. Figure 4 depicts disbursements by the IMF and World Bank (its IBRD arm) since 1998, following the Asian crisis.

Figure 4: Disbursements by the IMF and World Bank, 1998-2010 (US $ billion)



(Source: author's compilation based on data reported in Stein, 2010)

Figure 4 shows that IMF and World Bank disbursements had totaled around US $ 20 billion by 1998. It then dropped significantly: in the case of the IMF lending declined after a temporary surge in 2002 to only US $ 1 billion in 2007, while in case of the World Bank IBRD lending declined to only about two-thirds of the 1990-2000 average. Amidst this global vote of no confidence the IMF was debating its very existence.

What figure 4 also shows, and as is discussed in greater detail by Stein (2010), is that the crisis has given the IMF and World Bank a new lease on life – despite the fact that neither predicted the crisis and that concerns about the impact of the conditionality for their loans still seemed valid. Both institutions' lending shot up during and after the crisis. The IMF got more than 50

new clients – the most recent being Ireland. The resurgence of the Bretton Woods institutions is due to the contagion effects of the crisis as well as to the responses of the G-20.

The G-20 was seen by many as being a positive outcome of the crisis, in that it is ore representative than the G-7 and perhaps faster and more flexible than the United Nations (UN). Before looking at the particular efforts of the G-20 in reforming the World Bank and IMF, and also other initiatives below, it can be mentioned that as an opportunity to act as a more representative forum and promote the plight of the poorest developing countries, the G-20 has not been impressive. A relatively small proportion - only about $ 50 billion - of the G-20's commitments has been directly allocated for the 'poorest' developing countries. This amount pales with the estimated $ 8.4 trillion allocated in total so far for bailing out banks. And although the G-20 is a much more representative body than the G-7, many had hoped that it would become an even more broad-based forum for multilateral co-ordination to address many challenges with public goods characteristics, including climate change, conflicts, international crime, illicit financial flows and so on. These hopes have not yet materialized nor is there any strong evidence that the G-20 is considering its evolution into a more overarching multilateral coordination, or that the developing and emerging country members of the G-20 are serious coordinating and co-operating in ways helpful to the many emerging and developing countries not part of the club.

The G-20 major response to the crisis was to empower the World Bank and IMF. It did this by calling for increasing of the funding of the IMF (by around US $ 750 billion), raising the capital base of the World Bank (by around US $ 86 million) (Stein, 2010), and recommending changes to the way in which the IMF was funded (to make it less depended on being funded from interest on loans). The G-20 also expanded the membership of the Financial Stability Forum (FSF) to include all 20 members (previously it consisted of the members of the G-7), renamed it the Financial Stability Board (FSB), and emphasized the importance of greater co-ordination and harmonization with the IMF.

Both the World Bank and the IMF responded to the crisis and their new lease on life by indicating that they recognized that global economic power has been shifting, and that the way

they performed their operations needed to change. Hence the IMF re-allocated 6 per cent of its voting power[8] towards developing countries (away mainly from Europe, who remains over-represented at the IMF). It should be noted that at present at least a re-allocation of 10 to 15 per cent was needed to reflect the position of developing and emerging economies in the world more fairly. The World Bank also re-allocated 3.13 per cent.

The IMF also acknowledged that it has 'learned from its mistakes and criticisms' (Stein, 2010:1), vowed to do a better job of predicting and preventing future crises, and put forward Flexible Credit Lines (FCL) – essential lending facilities without conditionality. Similarly the World Bank's President indicated that a 'rethink' of development economics was necessary, reportedly declaring that 'we need to democratize and demystify development economics, recognizing that we do not have a monopoly on the answers. We need to throw open the doors, recognizing that others can find and create their own solutions' (Reuters, 2010).

So the World Bank and the IMF is back in business, although with changed voting powers and promises of doing things differently in the past. Does this boil down to an improvement in the GFA?

It is perhaps to early to tell, although many believe that the reforms came too little too late, and that G-20 funding should have been conditional on far-reaching reform. Stein (2010:11) concludes that these reforms seems to signal the '*appearance of change and the reallocation of voting rights to developing countries without a fundamental alteration in the agenda*…'. Third World Network (2009a) points out that the contents of the IMF agreements are still 'business as usual' as strict conditionality is still the basic approach with borrowing countries being required in the midst of a global downturn to implement strong pro-cyclical policies. And at the G-20 meeting in Seoul in November 2010 European countries indicated their resistance to more governance reform of the IMF indicating that they are not willing to relinquish the privilege of appointing the managing director of the IMF. As put by Simon Johnson (2010) former chief

[8] A country's voting power at the IMF is determined by is economic size and role in world trade, according to a particular formula. However this is not regularly updated, and the formula has been shown to be biased in favour of advanced countries, with the US having a veto (Elson, 2010).

economist of the IMF, '*Unless and until an emerging market person gets this position, no one (outside of Europe) will want to rely on the IMF in an emergency. As a result all countries will want to manage their exchange rates to the extent that they can, along Chinese lines, aiming for a significant current account surplus (so as to build up foreign exchange reserves*)'. Finally the IMF is widely seen not to have any influence over the US, nor to have the mandate to address developing countries' concerns that speculation is driving of food and oil price hikes, nor to act and be able to act against China's currency overvaluation, or to be independent in its decision-making.

Perhaps, as far as the IMF and World Bank is concerned, the prediction of Mold et al (2009:30) has been borne out. They predicted that '*A dramatic overhaul of existing institutions may not be on the cards....the crisis may provide the opportunity for pragmatic changes within the existing institutional framework, making it more efficient and inclusive by evolving emerging and developing economies*'. We have certainly seen a number of pragmatic changes that may result in a more efficient and inclusive set of institutions. But with many fundamental governance, mandate and operational issues of the World Bank and IMF remaining controversial, it is to be seen how long these changes will be good enough.

- *Global Imbalances and Currency Wars*

In section 3.1. I pointed out that many developing countries started to accumulate foreign exchange reserves after the 1997-1998 Asian crisis, when these countries found the assistance of the IMF to be unsatisfactory. China's accumulation of foreign exchange reserves, being around US 2 trillion is the result not so much as self-insurance, but of the desire to maintain an undervalued currency to boost export growth. On the other hand, countries such as the USA, who issues the world's reserve currency ever since the 1944 Bretton Woods meeting, has been able to fund over-consumption (hence chronic balance of payments deficits) as a result of the demand for US dollar. By 2007 the USA accounted for more than 18 per cent of global consumption demand, and by November 2010 the Chinese currency was estimated to be 24 per cent undervalued against the dollar (Cline and Williamson, 2010).

For the USA, reducing its consumption and imports necessitates a revaluation of the Chinese Yuan – something which China has until now refused to entertain, at a time when concerns about 'currency wars' have arisen as other developing countries also attempts to keep their exchange rates undervalued as a way to boost competitiveness. Certainly as indicated in the previous section the failure to adequate obtain the buy-in of emerging and developing countries in the IMF may contribute to these currency wars. At the same time there is increasing discussion of replacing or substituting the US dollar as the global reserve currency, perhaps by a basket of currencies or IMF Special Drawing Rights (SDRs) (for a recent discussion of this issue see Williamson, 2010).

These problems in international markets reflects the absence of appropriate co-ordination mechanisms ever since the Bretton Woods system of administrative exchange rates collapsed in 1971. The subsequent system has even been described as a 'non-system'. So far the G-20 and other international processes, including on the level of the UN and of the IMF/World Bank has little progress in tackling these issues apart from the creation of the Financial Stability Board (FSB) out of the previous (ineffective) Financial Stability Forum (FSF) and the minor changes to IMF and World Bank voting rights discussed. Perhaps for the short term the specter of currency wars (trade wars) with the related possibility of rising protectionism is the greatest threat to international trade. Surplus countries, not only China but also Germany and Japan, need to increase consumption (and imports) and deficit countries (such as The US) need to reduce consumption (and imports).

It means that countries such as China, Germany and Japan (and many other export-driven developing countries) should move to greater reliance on domestic market growth (Mayer, 2010) which in turn requires higher levels of employment and rising real wages. It implies that employment creation policies will be vital – and this has to be realized against the fact that unemployment has risen substantially across the world as a result of the crisis, and that unemployment often takes much longer to recover. Hence calls have been made for a re-

emphasis on industrial[9] and fiscal policies that would support domestic market development and in particular the development of entrepreneurial societies that can drive employment and wage growth in developing and emerging economies(Naudé, 2010b).

Also, bearing in mind the rise in IMF lending to developing countries (of more than US $ 160 bn) future debt problems, that will repress demand in the affected developing economies and their partners, need to be planned for. So far there has however been no substantial initiatives to create some sort of sovereign debt work-out mechanism to deal with this in future.

Finally, although important and related to the ability of the US to continue to run current account deficits, the issue of the dollar as a reserve currency is a more longer-term issue, since the dollar is in demand as a reserve currency not because of the economic or political power of the US, but predominantly because of the liquidity of its financial markets. It may take yet some time for other currencies to develop the same measure of liquidity as the dollar in order to become attractive as a reserve currency.

- *Financial Regulation and Supervision*

Improving bank regulation and supervision has been the main focus of financial sector reform after the crisis, as the main cause of the crisis is judged the fact that banks took to much risk due to the extensive deregulation that took place since the 1970s. Hence systemic risk arose because banks were too highly leveraged and engaged in doubtful lending practices. Many proposals for the contents of regulation and supervision have been made, ranging from proposals to break up mega-banks, to prevent banks that are TBTF to exist, to deal with the insolvency of global banks, to a financial transactions tax (FTT), to create and empower consumer protection agencies, to reform credit rating agencies, to regulate sophisticated financial instruments.

[9] In the US, where there has traditionally been significant ideological resistance against industrial policy (see e.g. Ketels, 2007) it is now after the crisis being widely seen as necessary to re-adjust the USA economy away from the dominance of the financial sector (Naudé, 2010b).

Some of the aforementioned proposals have been dealt with, to various degrees of coverage, on a national level in the EU and the USA. In the latter case the *Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010* (covering to 848 pages) was seen as the most significant response to put financial regulation and supervision on a sounder footing. This legislation aims to ‘*To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes’* (p.1 of the Act).

On an international level the main thrusts of bank regulatory reform has been to raise the amount of prudential equity that banks should set aside and how to co-ordinate and harmonise global supervision and monitoring of system risks in the banking system. The former has been started by the G-20, which after its Pittsburgh meeting in 2009 set in motion the Basel III process. This process is lead by the Basel Committee on Banking Supervision (BCBS) and aims to draft new proposals on prudential bank capital requirements. In addition to this initiative it has been realized that in a global world co-ordination and harmonization of financial regulations are necessary. If not, financial firms will take advantage of tax and regulatory arbitrate opportunities (as financial firms and financial transactions are internationally very mobile). Hence the recognized need to return to the pre-1971 multilateralism in international finance. Here, the major initiatives have been the expansion of the G-7 to the G-20, the expansion of the Financial Stability Forum (FSF) into the larger Financial Stability Board (FSB), investigations into tax havens (see the next subsection), and regional co-ordination of supervision, especially in the EU. Here a new oversight structure has been proposed to monitor systemic risk in the banking system. It is to consist of the European Systemic Risk Board (ESRB) and European Supervisory Authorities (ESA).

How successful has these waves of reform been, judging at present? As in the case of reform of the World Bank and IMF, and indeed in a way similar to the incremental reforms seen after the 1997-98 Asian crisis, it would seem that important, and potentially important changes were

made to the way in which banks will be regulated and supervised, but that however these changes do not go far enough. Again the feeling is that too little has been done too late.

For instance as far as the Wall Street Reform and Consumer Protection Act is concerned it is indeed too early to pass a final judgement. To implement that act many rules will have to be made by regulators, who it generally seen to have more discretionary powers than in the past, and hence the extent to which implementation will be successful will have to be seen. Others have criticised the Act for not dealing satisfactory with the 'too big to fail' problem and of diluting the powers of its envisaged Consumer Financial Protection Agency[10] (CFPA).

Also, on an international level, the Basel III agreement, which aims to prescribe acceptable levels of capital to be held by banks, seems to be focusing more on 'micro-prudential' regulation 'aimed at the costly failure of individual financial institutions' (Hanson, et al., 2010:1) rather than macro-prudential regulation aimed at reducing systemic risk. Moreover, it would seem that the Basel III process have been captured by vested interest against too much bank capital requirements, as a result of which the Basel process has been described as a 'disaster' (Johnson, 2010b). In the next section I deal in more detail with the seeming failure of the Basel III process – suffice for now that lack of global coordination and sufficient measures to reduce banks' leverage and risk taking still seem without reach. And also in the EU, initiatives to create a EU wide oversight structure has run into resistance from national regulators, and have so far not yet clarified the tools that the proposed new structures will use to exercise their prudential oversight role (Pooran, 2010).

- *Illicit Financial Flows*

Illicit financial flows refer to '*proceeds from corruption, criminal activities and the proceeds of licit business that becomes illicit when transported across borders in contravention of applicable laws and regulatory frameworks'* (Kar and Cartwright-Smith, 2009:i). These flows are a particularly undesirable dimension or result of the absence of proper global co-ordination and

[10] The Dodd-Frank Act will create within the Federal Reserve System an independent bureau to be known as the Bureau of Consumer Financial Protection**.**

harmonization that has plagued the GFA since 1971. It has been estimated that in 2006 developing countries lost between US $ 858 billion and US $ 1.06 trillion in illicit financial outflows, and that these flows have been growing on average by around 18 per cent over the preceding five years (Kar and Cartwright-Smith, 2009). These amounts dwarfs all forms of aid, and amounts to the amount spent by all developing countries on fiscal stimulus during 2009-2010.

The global financial and economic crisis has raised concerns about these flows to new levels given that such flows are facilitated by tax havens, or ‘offshore financial centers’ (OFCs). These tax havens or OFCs have also been described as ‘secrecy jurisdictions’, as the real attraction is most often seen to lie in the secrecy it provides. Before the crisis substantial amounts of bank liabilities were parked in such offshore centers so as to hide the real extent to which banks were leveraged. Such OFCs also negatively impact on governments’ tax raising abilities as they are also used for tax evasion and avoidance (Murphy, 2010). Following the financial crisis many countries were under much more pressure to increase domestic sources of finance and hence improve tax collection.

Following the crisis in 2008 a number of individual countries as well as the G-20 initiated steps to limit the secrecy surrounding OFCs by improving financial transparency. France’s President Sarkozy wanted to publish a OECD list of tax havens at the April 2009 G-20 meeting – although this was not done after pressure from China. The April 2009 meeting did however issue a warning that tax ‘non-cooperative jurisdictions (such as OFCs) can expect to face sanctions and be placed on a list of countries not in compliance with the international standard for exchange of tax information’ (Neubacher, 2009). What followed is indicative of how far multilateral co-operation and co-ordination still needs to go, for as Nebacher (2009) reports

> ‘The threat promptly produced astonishing results. Less than 120 hours after the close of the London summit, the Organization for Economic Cooperation and Development (OECD) published the shortest blacklist of all time—with exactly zero entries. Apparently not a single country today remains willing to serve as a place of refuge for global capital. The fact that all the world's tax havens seem to have disappeared overnight is primarily

> the result of skillful diplomacy. Even the most notorious offshore financial centers have managed to quickly purge themselves of all suspicions of aiding and abetting tax evaders.'

Hereafter – for instance in the G-20's 2010 Toronto meeting initiatives dealing with tax havens seems to have been subsumed under the broader rubric of corruption, with the G-20 creating a Working Group on corruption. At the follow-up meeting in Seoul in November 2010 The G-20 indicated that it would request all its members to ratify the United Nations Convention against Corruption (UNCAC) and that it would ask the Financial Action Task Force (FATF) to report back to on efforts made to strengthen policies to combat money laundering and terrorist financing. Apart from this however, much still remains to be addresses. As Romero et al (2010) pointed out after the Seoul meeting, '*Nothing was said about global financial transparency, country by country reporting by multinational corporations, automatic tax information exchange, or full disclosure of corporate ownership or beneficiaries of offshore trusts and accounts'*.

- *International Aid*

At the outset of the global economic and financial crisis fears were widespread that advanced countries, who were more affected by the crisis than other regions, would scale down official development assistance (ODA) (aid) significantly. It is known that aid tends to be pro-cyclical (Heady et al., 2009). Many also pointed to the experience of other countries in the past after financial crises- such as Japan and Finland in the 1990s, when aid dropped significantly after these countries ran into financial crises. The EU Institute predicted that aid would decline during 2009 by around US $ 22 billion. These fears lead to calls not only for aid levels to be maintained, but for further reforms to the international aid system, which many had in recent years come to see as a failure (e.g. Moyo, 2008; Easterly, 2006; Rajan and Subramanian, 2008; Chervin and van Wijnbergen, 2010). A large literature has emerged in recent years on proposals to improve aid effectiveness, which include, *inter alia,* finding innovative sources of development finance (such as a carbon tax), increasing the share of multilateral aid (most current aid is bilateral), improving the management of aid, pushing forward with aid for trade

initiatives and facilitating mechanisms for encouraging private sector aid. Despite calls to make progress on these, very little was done since the start of the crisis.

The better than expected performance of the developing countries, the rise in South-South trade and finance, and the growing importance of remittances as source of finance during the crisis, may have lead to a further diminishing of the perceived usefulness and role of aid. Firstly,. Most developing countries recovered quite quickly despite reductions in international aid, showing that aid is not necessary to restart economic growth; second much of the good management and improved governance which made possible greater resilience in the face of the crisis cannot be ascribed to any aid effort; third, non-traditional donors, such as China and the Gulf States who are not members of the OECD DAC, have in recent years risen in prominence; and fourth, the continuing fiscal difficulties / debt crises faced by many advanced economies imply that few countries will achieve the internationally agreed target of allocating 0.7% of GNI to aid[11]. Rather than seeing a continuation of the aid effectiveness agenda that the DAC members recognised as important in 2000, the international aid system is likely to evolve in a different direction after the crisis – those that think the issue is merely one of ensuring that traditional aid flows to developing countries are maintained do not understand the comprehensive re-assessment that the crisis has started. Three aspects of the future 'aid' system will include (i) non-traditional donors playing a greater role, with the benefits and pitfalls that will entail (Grimm et al, 2009) and (ii) the search for and design of forms of aid to buffer vulnerable countries against commodity price shocks and other external shocks and greater development of national insurance markets where these are currently subject to market failure (see e.g. Gunning, 2008) the (iii) transfer of 'climate finance' to developing countries in amounts that would exceed traditional aid (Sumner et al., 2010) and finally making aid a more effective tool to support entrepreneurship. A full discussion of these however fall outside the scope of the present paper.

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[11] The target that aid should rise to 0.7% of GNI was accepted by the Un General Assembly on the 24th of October 1970 – 40 years ago. Then, aid stood at 0.33% of GNI. After 40 years, instead of rising to meet the target, aid stood at 0.31% of GNI in 2009 – less than the level 40 years ago. It seems unlikely, after the events of the 2008 global economic and financial crisis that the world will ever reach the 0.7 % target.

4. The Great Push-Back

While the global financial and economic crisis of 2008 has lead to re-assessments of the global economy in at least three areas, as far as the reform of the GFA is concerned, the progress seems to have been incremental and piece-meal. One reason for this relates to a fundamental cause of the crisis as was discussed in section 3.1. namely the power of the financial sector and its regulatory capture in the US and other advanced economies. In the wake of the crisis these vested interest have mounted what could be called a great push-back in order to resist fundamental changes to the GFA. By briefly discussing this push-back the point needs to be made that even though the crisis powerfully and at great cost illustrated the need to reform the GFA, in particular to reduce the leverage of banks and improve global co-ordination in regulation and supervision, this will not automatically occur. Indeed the danger is that reform of the GFA will end up being inadequate, and as was the case after the 1997-98 Asian crisis, will not prevent a future financial crisis from occurring.

Take the Basel process for instance. It is widely agreed now that Basel II, which was started after the Asian Crisis, was a failure and even contributed to the financial crisis of 2008 by allowing banks themselves to use their own internal risk models to determine the amounts of 'risk-weighted' capital to set aside (Elson, 2010; Lall, 2010). The reason for Basel II's failure was not that it lacked the intention (to limit banks' risk taking) but that it was captured by the international financial sector. Similarly now, with Basel III being tasked by the G20 to reform bank capital requirements with a view of reducing banks' leverage are being captured and influenced by the international financial lobby. Lall et al (2010:2) describes the push-back of banks against the possible imposition of higher capital adequacy requirements[12] as follows:

> 'In April 2010…the BCBS was flooded with protests from large financial institutions warning that Basel III would destroy the economic recovery, potentially triggering a double-dip recession….'

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[12] The Basel III proposal now is for minimum capital to be equal to between 4.5 to 7 per cent of risk-weighted assets (Admati et al, 2010a:1).

According to Lall (2010. 28) the big banks have resisted and diluted Basel III's proposals on capital adequacy through three tactics, namely (i) 'conveying their views to regulators through private meetings'; by(ii) 'spreading internal estimates of the costs of reform for consumers and the wider economy' and (ii) by delaying progress. The banks have gone to great lengths, even before the 2008 crisis, to convince policy makers and the public that they know best, and their opinions are to be trusted to be in the general best interest. As put by Kwak (2010) '*One of the singular victories of the rich has been convincing the rest of us that their disproportionate success has been due to abstract economic forces beyond anyone's control (technology, globalization, etc), not old-fashioned power politics*'.

But it is simply old-fashion power politics that has facilitated the rise of the financial sector, that has brought significant deregulation and increased leverage in the financial system, that has neutralized the Basel II process and that is now pushing back against the Basel III process by arguing that higher capital adequacy (equity) requirements would be detrimental to the economy.

The arguments put forward by the big banks have recently been summarized and have been shown to be without substance by Admati et al (2010a;2010b). As Admati et al (2010b) describes

> 'Bankers warn that increased equity requirements would restrict lending and impede growth. These warnings are misplaced. First, it is easier for better capitalized banks, with fewer prior debt commitments hanging over them, to raise funds for new loans. Second, removing biases created by the current risk-weighting systems that favor marketable securities would increase banks' incentives to fund traditional loans. Third, the recent subprime mortgage experience shows that some lending can be bad for welfare and growth. Lending decisions would be improved by higher and more appropriate equity requirements'.

As banks push back against the re-regulation of the financial sector, they are also simultaneously preparing to find ways around any restricting requirements. As Ely (2009:93) warns

> 'These new regulations will set up the global economy for yet another financial crisis, perhaps worse than the present one…indeed, policymaking that responds to symptoms and consequences of perceived problems, rather than forthrightly addressing the underlying causes of real problems, will introduce greater fragility into the financial system'.

This is why the case for breaking up too big to fail banks have been made – so that if banks to get around regulations, and do end up failing because they take on too much risk, then at least the costs of bailouts will not be as imposing on tax payers, as what would be the case with large banks.

The way in which financial regulation and supervision reform has been handled since the crisis therefore seems to be inadequate, particularly as the largest banks in the US have become even more concentrated after the crisis (Johnson, 2009b, Cho, 2009). Bank of America, J.P. Morgan Chase and Wells Fargo saw asset growth of respectively 138 per cent, 51 per cent and 43 per cent between June 2007 and March 2009. Table 1 shows that their share of total US deposits increased from 2007, just before the crisis, to June 2009.

Table 1 : The Top Four US Banks Getting Bigger

	Market share (of deposits) %	
Bank	**2007**	**Jun-09**
Citigroup	9.1	8.3
JP Morgan Chase	9	10
Bank of America	9.7	11.3
Wells Fargo	4	8.8
Others	68.2	61.6

(source: Based on data from http://blogs.reuters.com/rolfe-winkler/2009/09/15/break-up-the-big-banks/)

The problem of concentration in the banking industry is compounded by the similar concentration in related financial services which should provide checks and balances. Thus 'the analytical foundation for much of the global financial system is now built on the paid-for opinions of just seven firms – the big three Rating Agencies and the Big Four Accounting firms' (Ely, 2009:97).

Financial regulation and supervision without addressing directly the causes of the crisis – the regulatory capture by and influence of the powerful group of entrepreneurs - the financial lobby – is therefore unlikely to reduce the risk of a repeat crisis significantly.

5. Implications for the Entrepreneurial Economy

The potential of continued or repeat crises in financial markets has far reaching implications for global development, as the discussion of the re-assessments taking place in the wake of the recent crisis has made clear. What is also implied from the discussion is that there has so far been relatively less concern about what the inadequacies in the GFA imply for entrepreneurship in general and the entrepreneurial economy specifically. Going forward, and addressing the inadequacies in the GFA it is necessary to understand how entrepreneurship has been affected by the crisis, and how in turn it has affected and even caused the financial crisis. Key is to understand how the global economy, underpinned by the GFA has resulted in incentives which

has lead to the growth and dominance of the financial sector (see also diagram 1) and the resistance against re-regulation that are experienced.

Before proceeding it is necessary to define entrepreneurship and the 'entrepreneurial economy'.

5.1 Entrepreneurship and the Entrepreneurial Economy

Following Schumpeter there is now substantial agreement that there is a subtle difference between entrepreneurship (as process) and the entrepreneur (the agent), and a more substantial difference between the entrepreneur and the manager of a firm[13]. Entrepreneurship as process is about the discovery and exploitation of opportunities (Shane and Venkataraman, 2000). As such entrepreneurship may be found in corporations (e.g. 'corporate entrepreneurship', 'intrapreneurship') and in social, non-profit contexts (e.g. 'public entrepreneurship', 'social entrepreneurship'). Individual entrepreneurs can be defined as 'persons who are ingenious and creative in finding ways that add to their own wealth, power, and prestige' (Baumol, 1990: 987). A large part of the entrepreneurship literature is concerned with the nature and development of entrepreneurial talent or entrepreneurial 'capital' (e.g. Lucas, 1978; Evans and Jovanovic, 1989; Murphy et al. 1991; Banerjee and Newman, 1993; Fonseca et al., 2007).

The 'entrepreneurial economy' (Audretsch and Thurik, 2001;2004) has been described by Thurik (2011:148) as

> 'an economy increasingly dominated by knowledge as the production factor, but also by a different, yet complementary, factor that had been overlooked: entrepreneurship

[13] Both Baumol (1968) and Leibenstein (1968) stress the differences between entrepreneurs and managers, and like Schumpeter sees innovation as the essential distinguishing characteristic or function of the entrepreneur, as opposed to the manager. According to Baumol (1968:65) 'The entrepreneur (whether or not he in fact also doubles as a manager) has a different function. It is his job to locate new ideas and to put them into effect'. In the words of Leibenstein (1968:72) 'at one pole there is routine entrepreneurship, which is really a type of management, and for the rest of the spectrum we have Schumpeterian or "new type" entrepreneurship'.

> capital, or the capacity to engage in and generate entrepreneurial activity. Without new and young firms it is not straightforward that knowledge or R&D always spills over to an environment where it leads to tangible products.'

This is contrasted with the 'managed economy' which refers to the post World War II model where the advanced economies where mainly driven not by smaller entrepreneurial firms, but by large bureaucratic organisations, and where competiveness was obtained through economies of scale and not knowledge. With reference to data from the Global Entrepreneurship Monitor (GEM) Thurik (2011) and Audretsch and Thurik (2001;2004) argue that once an economy make the transition from being a managed to an entrepreneurial economy, that the rate of new firm start-ups will increase. Thurik (2011) also points out that many emerging economies and developing countries have features of both the managed and the entrepreneurial economy.

5.2 Destructive Entrepreneurship and the GFC

Not all entrepreneurship may be beneficial for economic growth and development. This is because entrepreneurial talent may be allocated to activities that may be rewarding for the individual, but may have little, or even negative, consequences for broader society. Thus in many countries many talented entrepreneurs choose not to become entrepreneurs (self-employed) but may take up salaried employment in a state bureaucracy or multinational firm, or may emigrate, while at the same time many less talented entrepreneurs are pushed into informal and survivalist self-employment, especially in developing countries and emerging economies. Entrepreneurial talent may also be channelled into unproductive (e.g. rent-seeking), or even destructive (e.g. illegal) activities. Baumol (1990:895). As put by Silberman (1956:42) more than 50 years ago:

> 'Throughout history there has been a tussle between those who make their way by honest but unimaginative toil and the gamblers, pirates, hucksters of patent medicines and the exploitative mediums of newfangled religions'.

It is argued that the institutional environment in a country (broadly defined as the 'rules of the game') will influence the allocation of entrepreneurial talent (Acs, 2008; Bowen and De Clerq, 2008; Minniti, 2008) and that therefore institutional reform – such as strengthening of property rights and control of corruption - is needed to encourage the right type of entrepreneurship (Douhan and Henrekson, 2009; Bowen and De Clerq, 2008). Thus, while entrepreneurs may provide useful innovations such as bring penicillin to market, they may also provide innovations that retard development, such as inventing and spreading weapons of mass destruction or c*ollateralized mortgage obligations*. Also, while entrepreneurs may contribute to growth by re-allocating production factors to more productive use, they may often re-allocate resources to less-productive use. The GFC is a case in point. Entrepreneurial behaviour in the financial sector lead to massive resource flows into financial assets, creating bubbles and drawing resources from more productive use. Hence it is important to recognize that the global financial crises of 2008-2009 was caused by a perverse incentive structure that favoured predatory lending, excessive risk-taking, and non-productive ('financial') innovation that caused asset-price bubbles. This perverse incentive structure is reflected in the extent of regulatory capture that has occurred in the USA and the rising relative remuneration in the financial services sector. As was shown in the previous section, despite the crisis many USA banks enjoyed greater profits and rising market shares, and inequality in the US continues to widen, suggesting the incentives to take large risks and maintain a 'casino-like' economy is still there.

We also see perverse entrepreneurial incentives making other kinds of disasters worse. For instance natural disasters, such as drought, often wreak more havoc in the form of famine in poor countries, where the incentives are stacked against entrepreneurial farmers to produce and distribute food – these include taxes, to inadequate insurance and infrastructure to exorbitant subsidies enjoyed by farmers in rich countries. Another example is that while many fatalities from earthquakes can be prevented through building standards, these are often not enforced due to the fact that the reward structure allows entrepreneurs in the building industry to bribe officials and thus circumvent regulations. And armed conflicts and corruption are fuelled not as much by poverty as by natural resource abundance ('lootable' resources such as

oil and diamonds), aid and government expenditure programmes, which tempt entrepreneurs to try and expropriate easy rents from these than add new value. Even ass far as climate change is concerned, the global reward structure has been such that rich countries have received the most benefits from carbon-intensive growth; however they are less likely to suffer to the same extent and have the innovative capacity to reduce emissions. As a result climate change-induced crises may exacerbate global disparities.

5.3 Impact of the GFC on Entrepreneurship[14]

The global integration of financial markets, and the increased financial liberalization in which many countries have engaged in over the past decade resulted in a rapid transmission of the US sub-prime crisis across the world -- causing credit contractions all round. Amongst developing and emerging country regions the worst to be affected were the transition countries of Eastern Europe and Central Asia. However even in less integrated economies the US-centred financial crisis had an impact-many banks in Africa realised that the US-crisis was due (partly) to inadequate bank supervision and capital requirements. Subsequently their surveillance and supervision was tightened, reducing the availability of credit in their domestic economies (Naudé, 2010c).

Finance (credit) matter for entrepreneurship. The general contraction in finance accompanying the GFC will therefore, ceteris paribus, lead to a reduction in new firm start-ups, higher rates of firm failure, and slower growth, less investment and employment, and productivity changes for existing firms. Economic theory and empirical evidence support these expected effects of a financial contraction (Banerjee and Newman, 1993; Cagetti and De Nardi, 2005a, 2005b; Evans and Jovanovic, 1989; Gries and Naudé, 2009). These effects have indeed also been documented in the case of the 2008-2009 global economic crisis. For instance in the UK the amount raised by venture capital funds fell from GBP1,010 million in 2006 to GBP179 million in 2008 and in the USA the number of business bankruptcies increased by 54 percent in 2008 (OECD, 2009). Not only will fewer firms be started up as a result of lack of access to finance, but wealth

[14] This section relies on Gries and Naudé (2010).

inequalities will also worsen because only those individuals with access to own wealth (and firms with sufficient internal finance) will be able to obtain start-up finance. Hence the rich will be more able than say middle-class prospective entrepreneurs to start a firm during a financial crisis (Naudé and MacGee, 2009). This itself can worsen wealth inequalities which in turn can further reduce start-ups -- as Mesnard and Ravallion (2005: 3) point out `greater wealth inequality implies that fewer potential entrepreneurs are able to finance start-up capital'. Thus, more binding credit constraints reduce the start-up rate, lead to reductions in the average size of firms, and increase wealth inequalities.

The GFC also reduced the size and access to international markets. The latter - affected by export demand and credit costs and availability -- is an important determinant of international entrepreneurship. International entrepreneurship refers to the `discovery, enactment, evaluation, and exploitation of opportunities-across national borders-to create future goods and services' (Oviatt and McDougall, 2005: 540). An important feature of globalization has been the rise of international new ventures (INV), which are firms that internationalize early after their establishment (Naudé and Rossouw, 2010). These firms have also been described as born-globals (McDougall and Oviatt 2003: 9). To the extent that a global economic crisis disrupts world trade, ignite protectionist measures, and a retreat from globalization, it would be detrimental to international entrepreneurship and specifically INVs. But it is also existing international entrepreneurs that will be particularly hard hit, especially since the fixed or sunk cost to start exporting is high, and in the absence of sustainable markets and trade credit many entrepreneurs will be forced out of international trade. International sources of finance are important for the start-up and growth of entrepreneurial firms in international trade, as this provides funding that may not otherwise be available to produce for the domestic economy. Hence negative shocks to world trade-and world wealth-will be particularly detrimental to international entrepreneurs in developing countries.

The effects of a financial and trade contraction described in the previous paragraphs may be general -- affecting entrepreneurs in both developing and advanced economies. However, due to the different nature and role of entrepreneurship across the various stages of a country's

development, a financial and trade contraction due to a global economic crisis could also have a further round of effects that is more subtle, but still important as it will impact on structural change and global disparities.

A key difference between entrepreneurship in developing and advanced economies is that in a developing country entrepreneurs are essentially imitators. They predominantly introduce goods, services or markets that are new to the economy (or firm) but not to the world (Szirmai, et al., 2011). Basically they adopt technologies from leading countries' innovative entrepreneurs (who operate at the world production frontier). Audretsch and Sanders (2011) show how globalization has through global outsourcing contributed to this transfer or know-how through entrepreneurial behaviour. A financial crunch will impact negatively on both the ability of entrepreneurs in advanced countries to innovate, as they substitute internal finance towards working capital purposes. For instance the OECD (2009) reports that international patent filings fell from an average growth of 9.3 percent between 2004 and 2007 to only 2.4 percent in 2008. A financial crunch will also limit their ability, through expansion into foreign markets, to transfer new innovations. It is most often medium-sized (middle class) entrepreneurs that innovate; the rich and the super-rich tend to be less into innovative activities. If a financial crisis / sub-prime crisis affects the wealth (and thus start-up potential) of middle class entrepreneurs more proportionately, this will further acerbated the pool of low-innovation firms in advanced countries (Naudé and McGee, 2009).

In developing countries, entrepreneurs (particularly indigenous entrepreneurs) tend to be found predominantly in small-and-medium sized firms, for whom engaging in international trade is a risky and costly, but also potentially rewarding, endeavour. More and more small and young firms in developing countries have been internationalizing at an early age in recent years (Naudé and Rossouw, 2010). A credit crunch and decline in export demand associated with a global economic crisis will therefore potentially squeeze these international entrepreneurs from both demand and supply side. Because growth and public revenue in developing countries tend to be more export-driven or dependent than in many developed countries with larger internal markets, such a global shock will lead to a disproportionally negative impact on

entrepreneurial start-ups, international entrepreneurship and entrepreneurial innovation in developing countries (a major reason for entrepreneurs to absorb innovations is to be able to compete internationally and with international firms -- a global shock removes this incentive).

If, in addition to these, advanced economies are quicker to provide relief in the form of expansionary monetary and fiscal policies, entrepreneurs in these countries could more quickly recover, with les permanent effects, than in developing countries, where the constraints may bind for a much longer time.

Given that entrepreneurs in developing countries are also different in that they have an important role in fostering structural change, then the implication of the aforementioned is that the GFC could be expected to lead to a reduction in innovative entrepreneurial activity in developing countries, in stagnation in low-productivity activities, and a failure to structurally transform and catch-up. Global disparities may be exacerbated and the vibrancy of emerging entrepreneurial economies negatively impacted on.

6. Concluding Remarks

It has many times been remarked that the origins of the 2008 global financial and economic crisis lies in the 1970s. Most refer to the 1970s because this was the time that financial deregulation and its accompanying free market ideology started to gain the upper hand in the USA and in other advanced economies such as the UK. Over a period of forty years the set of incentives which shaped entrepreneurial behaviour to engage in excessive risk taking in the global financial sector came into being - and coincided with the collapse of Bretton Woods system of multilateral coordination of global finance collapsed. Since then there has really been no 'system' so to speak of – some have referred to it as a 'non-system', and some have even suggested that referring to the global financial system after 1971 as an 'architecture' is an insult to architects[15]. Within this 'non-system', the combination of the globalization of finance, and

[15] See e.g. Jomo Kwame Sundaram in conversation with Jean-Marc Coicaud during the UNU's Conversation series (http://www.ony.unu.edu/economiccrisis/)

the rise of a deregulated financial sector with perverse incentives to entrepreneurship, the preconditions for a private-sector caused financial crisis were put in place. It is perhaps unsurprising then that there has been more than 120 financial crises worldwide since 1971.

The present crisis had been of much greater magnitude than these previous crises, and had also surprised by originating in the private sector and in the world's richest country. It has sparked a number of re-assessments of global development that is likely to continue. However, so far progress in acting on these re-assessments have not been substantial. In essence, the gap at the centre of the global financial architecture (GFA) in terms of co-ordination remain, and the global financial sector and its lobby remains powerful enough to work against fundamental reform. As after the 1997-1998 Asian Crisis, reform of the GFA remain patchy and incremental.

This leaves the world subject to an uncertain recovery and the threat of a repeat. By end-2010 there were signs, following Greece's sovereign debt crisis in February and Ireland's bailout by the IMF and EU in November, that fiscal fatigue was setting in and countries such as Portugal, Spain and the UK were also signaling fiscal strain with the latter's government adopting unprecedented austerity measures. Fears are gaining ground that whereas the first stages of the crisis saw private financial firms failing, the second phase would see governments increasingly running into difficulty. At the same time, food and energy prices have been edging upwards again. Food riots broke out in 2010 in a number of countries. Many governments are steering to the right. Xenophobic attacks on migrants are multiplying – from murderous attacks on foreigners in South Africa to large scale expulsions of Roma populations from France. Bubbles seems to be reappearing in asset and commodity prices, including cotton. Indeed, at the time of writing the gold price reached record heights, and currency wars loomed on the horizon.

There is a justifiable fear that not having addressed the fundamental causes of the crisis that banks will continue their model of highly leveraged trading with all the same risks that implies. Schiller (2009) for instance expressed the concern that speculative investment in housing is again starting in the US. Moore (2009) reports that there is already a 'gold rush underway' by

banks to sell of 'toxic' subprime mortgage assets, known as Re-Remics (re-securitization of real estate mortgage investment conduits) (Apuzzo, 2009).

The world paid a huge price in foregone development in the form of the 2008 GFC. It would be a tragedy if like in 1997-98 the lessons were not taken to hart. The main lesson is perhaps a rather simple one – the world cannot have globalization, financial deregulation and a 'non-system' in its GFA at the same time. If the re-regulation process fail and the reform of the GFA do not succeed it establishing a workable multilateral framework, then the processes of globalization and of countries moving from managed to entrepreneurial economies (including entrepreneurship itself) will fall victim. It is time therefore to urgently fix the gap at the centre of the global financial architecture.

This is easier said than done, given the extent of vested interests described in section 4 of this paper. Global multilateral coordination is vital, but how to go about it? In a recent though provoking paper Brauer and Haywood (2011) argues that, critically for global development, the current system of global governance need to go beyond the narrow confines of the nation-state. As they emphasise 'It is imperative that we recognize that dependence on sovereign states is no longer meeting the needs of diverse societies on Earth. It is not meeting peoples' needs within the state, nor is it maintaining appropriate relations between and among them, nor does it facilitate effective governance of crucial global issues.' (Brauer and Haywood, 2011). Accordingly they call for non-state 'sovereign' entrepreneurs (NSE) that can respond to demands for various (global) goods and services, and have the ability to make and enforce rules globally. Would such NSE be able to make progress in terms of providing more effective governance of global challenges? They provide intriguing examples of ICANN and FIFA and ask how and under what conditions such entrepreneurship can arise, how it can be promoted and by whom, and what the relationship between NSE and sovereign states would involve once the former start to pose threats to the perceived 'internal matters' of latter. Moreover, the call for NSE implies that institutions not only influence entrepreneurship through its reward structure, but is itself influenced by 'institutional' entrepreneurs. A substantial research agenda is implied.

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