SOUTH CENTRE

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Financial Instability as a Threat to Sustainable Development*

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As seen over and again during recurrent financial crises in both developing and advanced economies (DEs and AEs), including the recent global crisis originating in the US and Europe, financial instability and boom-bust cycles undermine all three ingredients of sustainable development – economic development, social development and environmental protection.

Financial bubbles generate excessive investment which remains unutilized for an extended period even after full recovery from the ensuing financial crisis. This includes investment in industry as in Japan in the late 1980s and early 1990s as well as in property, as seen during the current crisis in the US and Europe. This is the main reason why recoveries from financial crises see little investment.

When productive capacity is left unutilized, natural resources used in generating such capacity is wasted. This means that even *weak sustainability* conditions would not be met since natural capital that is depleted would not be compensated by produced capital. There are now 820 thousand newly constructed, unsold, empty houses in Spain, and they are unlikely to be occupied for many years to come even without new investment in housing. These have very high contents in natural resources, notably metals and energy.

The management of both renewable and non-renewable resources is rendered extremely difficult by increased financialization of commodity markets. Rapid entry and exit into commodity derivatives resulting from changed perceptions of risk/return profiles of alternative assets and expectations regarding the evolution of demand conditions tend to accentuate instability in commodity prices. This was seen during 2008 when oil prices peaked at some $150 dollars before the collapse of Lehman Brothers but fell to $30 subsequently and food prices fell by almost one third in a matter of a few months.

Uncertainties caused by financial instability encourage short-termism in corporate and government behaviour, leading to heavy discounting of the future. The pursuit of short-term financial results, a key feature of modern stock markets, stands in sharp contrast with the principle of sustainability that emphasizes cumulative and long-term consequences of decisions and actions.

More jobs are destroyed during financial crises (busts) than jobs created during booms driven by asset and credit bubbles. Even when income levels are fully restored following a financial crisis, it would take several years for lost jobs to be replaced. For instance, in its third year of recovery, the US has not even replaced half of jobs lost during 2008-09. At the current pace, it will take 10 years to replace all jobs lost compared to 4 years in two previous recessions (1981-82 and 1990-91).

Fairness and equity, as basic ingredients of sustainability, are increasingly violated by the predominance of finance and finance-driven globalization which have been a major factor in growing inequality in wealth and income distribution. Almost everywhere income earned on financial assets and property has been rising relative to labour income. There has been a major shift in the global balance between labour and capital. Wages often lag productivity growth because of increased competition among the global labour force and financial incomes are lightly taxed because of the threat of footloose capital.

Income and wealth distribution is further distorted by financial boom-bust cycles. The benefits of credit and asset bubbles are generally reaped by private individuals but the costs of crises impinge on all segments of the society – very much like costs and benefits of exploitation of natural capital. The distributional consequences of crises are aggravated by financial bailout operations. In the US, crisis interventions have increased financial concentration; sys-

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temically dangerous, "too big to fail institutions" are now even bigger, and executive bonuses have been restored while labour incomes remain depressed.

Financial markets, rating agencies and international financial institutions ignore inter- and intra-generational equity and environmental sustainability and focus almost entirely on debt and balance-of-payments sustainability in their ratings and lending decisions. The emphasis on financial sustainability is a source of increased inequality. It also tends to undermine environmental sustainability by leading to acceleration of exploitation of natural resources to fill income and foreign exchange gaps.

These finance-related disruptions imply that any programme of action designed to promote sustainable development should contain, as its integral part, regulation of financial markets and institutions and fundamental changes in the international monetary and financial system to secure greater stability and reduce the likelihood of crises. A broad agreement on this appeared to have been formed in the early days of the global economic and financial crisis, which culminated in the 2009 UN conference on "The World Financial and Economic Crisis and Its Impact on Development."

Indeed, the outcome document adopted by the UN Conference recognized "the human and social impacts of the crisis" (#21) and agreed that the response should focus, *inter alia*, on "designing and implementing environmentally and socially sustainable development paths" (#10). It was agreed that "the global reach of the crisis calls for prompt, decisive and coordinated action to address its causes, mitigate its impact and strengthen or establish the necessary mechanisms to help prevent similar crises in the future" (#5). The document also noted that the "crisis has not only highlighted long-standing systemic fragilities and imbalances, but has also led to an intensification of efforts to reform and strengthen the international financial system and architecture" (#1).

However, a stock taking of the initiatives and actions taken since June 2009 shows that "efforts to reform and strengthen the international financial system and architecture" have fallen short of expectations and "long-standing systemic fragilities and imbalances" underlying the global economic and financial crisis remain unaddressed.

This is a serious matter of concern for DEs. Contrary to widely held view, they are not decoupled from AEs. After spreading from the US to Europe, the crisis is feared to hit the developing world next. Indeed, almost all major DEs are now seeing deceleration of growth. They face significant downside risks from AEs, including dampened export prospects and increased instability of capital flows and commodity prices. As noted by the IMF "even absent another European crisis, most advanced economies still face major breaks on growth. And the risk of another crisis is still very much present and could well affect both advanced and emerging economies."

What is to be done? So far incremental approaches to establishing an international monetary and financial system in support of sustainable development has not yielded tangible results. There is a need for a complete overhaul, based on a broader view consistent with the principles of sustainable development, instead of narrow Treasury and financial perspectives that have so far dominated the debate on the reform in the mainstream international financial institutions with mandates in these matters or *ad hoc* groupings such as G7 or G20.

An intergovernmental task force should be created in the UN to examine the shortcomings in the international monetary and financial systems and propose solutions in such areas as the mandates and governance of international financial institutions; regulation of systemically important financial institutions and markets, including markets for commodity derivatives; regulation of international capital movements; orderly sovereign debt workout mechanisms; financing for sustainable development; the international reserves systems; the exchange rate system; and the multilateral policy surveillance. This undertaking should culminate in a UN conference to bring about fundamental changes in the way the international monetary and financial system is designed and operating. This is no doubt a bigger project than the Bretton Woods Conference because objectives, interests and concerns are now much more diverse and the issues involved are much more complex.

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