

Chapter I

Overcoming economic insecurity: issues at stake

At the end of the cold war, the easing of long-standing political tensions coupled with a rapidly integrating world economy held out high hopes for a new era of peace, prosperity and stability. This became the moment when getting prices right would guarantee big efficiency gains and unleash the dynamic forces of competition and risk-taking. Armed with a ready set of explanations of how unfettered markets lift all boats, trigger converging incomes and put an end to stop-go cycles, conventional economists helped fashion a policy consensus for the new era.

Gains have certainly been made: inflation has been contained, international trade has expanded and capital has flowed across borders on an unprecedented scale. Still, the growth record has been uneven and the macroeconomic environment increasingly unbalanced. The one ubiquitous trend has been sharply rising inequalities.

Yet, perhaps more than any single issue, it is a growing sense of economic insecurity that has come back to haunt the advocates of unfettered markets. In 2008, rising food prices and a growing incidence of hunger have provided a deadly demonstration of the mismatch between market forces and socio-economic well-being. For many of the countries facing severe food insecurity, the problem is often one of multiple threats from poverty, natural disasters and civil violence (see table I.1); but the outbreak of food riots in rapidly urbanizing middle-income countries, some with a solid growth record, suggests more serious structural deficiencies within these markets. The problem has been compounded by energy insecurity as fuel prices hit new highs and future supplies become entangled in a complex web of geopolitical calculations.

Increasingly flexible labour markets have also undermined employment security. In many developing countries, the void left by stagnant or declining public sector jobs and industrial downsizing has been filled by more precarious or poorly paid jobs in the informal economy or the expanding service sector. In advanced countries, middle-class lifestyles have been hollowed out, leaving policymakers scrambling to avoid a populist backlash against cheap imports, the offshoring of jobs and the presence of immigrant workers. Instead of providing shelter against the upsurge of these increasingly turbulent economic waters, money markets have added greatly to the sense of expanding insecurity. Volatile international financial flows, boom-bust cycles, collapsing currencies and speculative panics have put jobs, homes and pensions at risk for many in the advanced countries.

Still, heightened insecurity cannot be put down simply to the destructive impulses of markets. Creative destruction is after all their modus operandi. Rather, it has much to do with the eagerness with which policymakers have ceded economic responsibility to independent central bankers, footloose corporations and managers of unregulated hedge funds, on the promise that they would deliver a healthy investment climate and help secure large economic gains for all. As discussed in chapter II, while the macroeconomic climate has become less volatile, productive investment has not picked up. At the same time, more and more households, communities and countries are being exposed to adverse shocks and downside risks, while their ability to cope with and recover from the consequences is sharply diminished.

Despite greater price stability and increased openness, the growth record has been uneven and the macroeconomic environment unbalanced

Food, fuel and financial markets are not delivering economic security

Volatile international financial flows, boom-bust cycles, collapsing currencies and speculative panics have put jobs, homes and pensions at risk

Table I.1
Countries facing a food crisis that are in need of external assistance

Country	Food insecurity	Vulnerability to natural hazards	Socio-political factors	Economic vulnerability, 1996-2006	
				Number of years in negative growth	Average annual per capita growth
Iraq	Exceptional	Drought, floods	Conflict, insecurity	5	1.0
Zimbabwe	Exceptional	Drought, windstorms	Potential civil strife	9	-3.7
Swaziland	Exceptional	Drought, windstorms, floods		2	0.6
Somalia	Exceptional	Drought, wave surges	Conflict	6	-0.3
Lesotho	Exceptional	Drought, windstorms		3	1.5
Burundi	Severe	Floods, windstorms, drought, earthquakes	Civil strife, internally displaced persons, returnees	7	-1.5
Central African Republic	Severe	Windstorms, floods	Refugees, localized insecurity	6	-1.3
Chad	Severe	Drought, floods	Refugees, conflict spillovers	4	4.4
Côte d'Ivoire	Severe		Civil strife	5	-0.1
Ghana	Severe	Floods		0	2.4
Guinea	Severe	Windstorms, floods	Refugees	2	1.7
Guinea-Bissau	Severe	Drought, floods	Localized insecurity	5	-2.7
Kenya	Severe	Landslides, drought, wave surges, floods	Civil strife	4	0.4
Nepal	Severe	Floods, landslides, drought	Conflict	2	1.4
Timor-Leste	Severe		Internally displaced persons, post-conflict	5	-1.7
Ethiopia	Severe	Drought, floods	Insecurity in parts	3	2.8
Democratic People's Republic of the Congo	Severe	Windstorms, floods, volcanic eruptions	Internally displaced persons	6	-2.1
Sudan	Severe	Drought, windstorms, floods	Civil strife	0	5.3
Uganda	Severe	Drought, windstorms, floods	Civil strife in the north.	0	2.9
Sri Lanka	Severe	Floods, wave surges, windstorms, drought	Civil conflict	1	4.2
Bolivia	Severe	Floods, drought, windstorms, landslides		2	1.2
Haiti	Severe	Floods, windstorms, drought		6	-0.8
Bangladesh	Severe	Floods, windstorms, waves, earthquakes		0	3.6
China	Severe	Floods, windstorms, earthquakes, landslides, drought		0	8.4
Dominican Republic	Severe	Windstorms, earthquakes		1	4.4
Ecuador	Severe	Floods, volcanic eruptions, landslides		1	1.8

Table I.1 (cont'd)

				<i>Economic vulnerability, 1996-2006</i>	
<i>Country</i>	<i>Food insecurity</i>	<i>Vulnerability to natural hazards</i>	<i>Socio-political factors</i>	<i>Number of years in negative growth</i>	<i>Average annual per capita growth</i>
Nicaragua	Severe	Windstorms, drought, floods, landslides		1	2.4
Tajikistan	Severe	Floods, earthquakes, landslides, drought		1	3.6
Viet Nam	Severe	Floods, windstorms, drought		0	5.7
Eritrea	Widespread	Drought, floods	Post-conflict, internally displaced persons	7	-1.1
Liberia	Widespread		Post-conflict	2	7.7
Mauritania	Widespread	Drought, floods		5	1.3
Sierra Leone	Widespread	Floods	Post-conflict	4	-1.6
Afghanistan	Widespread	Landslides, drought, earthquakes, floods	Conflict, insecurity
Democratic People's Republic of Korea	Widespread	Windstorms, floods		4	-0.2

Sources: Food and Agriculture Organization of the United Nations and UN/DESA secretariat.

The politics of economic insecurity

The fact that no social or economic order will be secure if it fails to benefit the majority of those who live under it demands nothing less than what European political philosophers in the seventeenth and eighteenth centuries called a “social contract”: an implicit understanding among members of a community to cooperate for mutual benefit, along with formal rules and institutional mechanisms to help build trust, balance competing interests, manage disputes and provide a fair distribution of the rewards that are generated. A modern State cannot advance to high levels of economic and social development, internal order and peace without such cooperation and rules. Moreover, the higher the level of development, the more complex must be the collaborative effort needed to safeguard past achievements and utilize them as a springboard for further progress.

In the modern era, that contract has been forged out of the challenges and risks generated by expanding markets and a more intricate division of labour. In response to those challenges and risks, there emerged new mechanisms of social protection against work-related accidents, illness and disability, as well as social support for the unemployed, those rearing children and those entering old age. However, the right balance of interests was difficult to secure, all the more so as democratic institutions amplified the demands of those most vulnerable to downside risks. During the interwar years, the fragile consensus had broken down under the impact of waste, despair and violence which had attained unprecedented levels.

The new deal that emerged after 1945 was built around a “craving for security”. New policies and institutions were developed to adapt and control the workings of economic forces and to guarantee social protection. Policies to stimulate domestic investment and growth not only helped prevent a return to the economic chaos of the interwar years, but ushered in an era of full employment, rising wages and freer trade. Strong growth

A modern State cannot advance to high levels of economic and social development, internal order and peace without cooperation forged through a strong social contract

made it easier to fund social protection and to extend the reach of the welfare State. Social stability in turn helped underpin long-term investment planning and facilitate technological progress. A virtuous circle emerged.

Positive leadership was also extended at the international level, backed by resources and willingness to compromise on national self-interest. Newly independent developing countries saw an opportunity to break with the legacy of economic exploitation, backwardness and insecurity which had been the hallmarks of colonial rule. With encouragement and support from their more advanced country partners, the new economic policy wisdom was oriented towards orchestrating an industrial take-off, managing a big push, and moving catch-up countries to higher rungs of the development ladder. Social policy lagged behind, but steady investments in human capital and infrastructure helped many countries break out of a vicious poverty trap.

This period of unprecedented socio-economic progress and security lasted until the early 1970s, when, beginning in the more advanced economies, a combination of internal tensions and external shocks began to threaten the existing consensus. At the end of the decade, an abrupt tightening of macroeconomic policy in these countries signalled a break with past practice, and a willingness to rethink the social contract. Citizenship, cooperation and social protection slipped down the agenda and, in some cases, dropped off altogether; in their place, consumer choice, competition and risk-taking moved to centre stage.

The trend has often been restrained in the advanced countries by practical and social constraints on policymaking. Resistance has proved much weaker in many developing countries, leaving them more vulnerable to downside risks. Indeed, as discussed throughout the present *Survey*, restoring more effective State institutions is an urgent challenge within the context of creating and preserving more secure spaces within which individuals, communities and ultimately countries can pursue their activities with a reasonable degree of predictability and stability, and with due regard for the aims and interests of others.

The economics of insecurity: risk, vulnerability and uncertainty

A rising level of economic insecurity is obviously damaging to the well-being of the affected households and individuals. It can also threaten socio-economic progress by stifling innovation, shortening investment horizons, narrowing choices and generating opportunistic and undesirable behaviour. On the other hand, economic insecurity is an unavoidable fact of economic life and—to the extent that it challenges sclerotic behaviour and opens up new investment opportunities—is to some degree healthy.

Economists have tried to make sense of this duality by identifying insecurity with risk, whose upside is the spurring of entrepreneurial behaviour but whose downside is income and welfare losses. If these alternative outcomes can be calculated with some reasonable level of precision, then individuals can make preparations in advance, by organizing family support, building up savings or hedging through some kind of insurance policy. These are essentially all different types of private strategies for coping with the consequences of risk.

Of course, individuals have little or no influence over many of the events that generate insecurity. In trying to gauge the possible damage from these events, economists

Since the late 1970s, a new social contract has replaced citizenship, cooperation and social protection with consumer choice, competition and risk-taking

Economic insecurity can threaten socio-economic progress by stifling innovation, shortening investment horizons and generating undesirable behaviour

have distinguished between *idiosyncratic risks*, generated by individual and isolated events such as an illness, an accident or a crime, and *covariant risks*, which are associated with events that hit a large number of people simultaneously, such as an economic shock or a climatic hazard, and often involve multiple and compounding costs.

Both types of risk can, in principle, be privately insured or can be covered through various forms of social protection paid for from taxation. Economists and policymakers have long debated the merits of these options, both of which are available in most societies. Assessing the desirable mix is in part a matter of weighing up the potentially negative spillover effects (externalities) that are generated by risky events and often make them difficult to price, against the costs of moral hazard associated with collective response.

In general, private coping mechanisms work best for idiosyncratic risks which carry small potential damages. However, these are often unavailable to the most vulnerable populations. The exclusionary nature of these private strategies and the potentially large size of losses associated with illness, unemployment or destitution in old age provide the rationale for social protection through the welfare State, and make all the more urgent the affirmation by the United Nations that economic security is a basic human right.

To recognize the above is also to accept the implication that risk is not the same as insecurity. Insecurity, which is less clear-cut, has been described as lying at the intersection of perceived and actual downside risk (Jacobs, 2007). Economists have generated a vast and highly specialized literature on the subjective dimension of risk (Osberg, 1998). Perceptions of insecurity are linked, however, to very concrete differences in the degree of exposure to a shared threat and to differences in the ability to control and recover from unforeseen events.

In this regard, vulnerability points to a source of insecurity that is more structural than subjective, which is obviously the case for many poorer countries lacking the resources to cope with threats, particularly those of a more compounded nature. On some counts, this makes poverty the real source of insecurity. Yet, such an argument can be misleading. Vulnerability to significant downside losses may occur at different levels of development with deeply damaging social and economic repercussions. This is obviously true with respect to systemic or catastrophic risks which carry large and widespread damage and are difficult to predict in advance. Indeed, in a world of structural vulnerabilities and endemic uncertainty, insurance is unlikely to create the requisite degree of economic security for individuals, households and countries. Rather, it is investing in preparation, planning and prevention mechanisms before the threat generates real and lasting damage that in fact constitutes the real challenge.

Certainly, then, economic insecurity is a development challenge, but it is also linked to the role of the State in forging a strong social contract.

Dealing with downside risks requires a mixture of public and private strategies

Overcoming structural vulnerabilities and endemic uncertainty requires investing in preparation, planning and prevention mechanisms

The rise and fall of the self-regulating market

The concept of a self-regulating market was not new to the late twentieth century. Economists had been tinkering with it since the late nineteenth century, and it had made a brief (albeit disastrous) appearance on the policy stage in the years immediately after the First World War. What was new was the belief that, thanks to a series of technological, organizational and political developments, this concept could now be given a truly global run.

The political checks and balances that had previously determined how markets could best serve the objectives of growth and stability were rolled back. According to

some, markets could do without a social contract altogether. On other counts, the market would spontaneously forge its own social contract, one centred around strong property rights, the rule of law and low transaction costs. In a world of flexible labour markets, complete and competitive insurance markets, where individuals could purchase protection against any risk at a fair price, and perfect capital markets through which individuals could smooth out their income and consumption decisions, there would be no real insecurity to speak of.

There are growing concerns about the impact of unregulated financial markets

Most recently, unregulated financial markets have received most attention from the adherents of market parthenogenesis, thanks to their attributed informational efficiency (the “efficient market hypothesis”) and their ability to conquer risk (“securitization”), which together promise stable growth and a smooth consumption path into the distant future.

How these developments have played out in the real world, particularly among developing countries, is discussed in greater detail in chapter II. Advanced industrialized economies, for their part, are already wondering whether “financialization” has gone too far. Moreover, the worry is not just that these markets have, in the words of *Financial Times* commentator Martin Wolf (2007), a tendency to “go crazy”, but that by heightening social divisions, underinvesting in social capital and undermining the bonds of community, they might actually threaten the very survival of the market system itself.

Not surprisingly, the theorists of the self-destructive market have begun to make something of a comeback: Karl Polanyi’s *The Great Transformation* (Polanyi, 1944) is required reading again; market analysts have rediscovered Hyman Minsky’s financial instability hypothesis; George Soros has warned about “market fundamentalism”; and Gunnar Myrdal’s notion of vicious circles is liberally quoted. More surprising still, the greatest adversary of the “casino economy”, John Maynard Keynes, until recently persona non grata in policy circles, is once again the “defunct economist” to consult.

Overcoming economic insecurity

The simple truth is that most people in most places want much the same thing; a decent job, a secure home, a safe environment, and a better future for their children. Markets are central to these goals, but they cannot be left alone to achieve them. Various alternative approaches for guaranteeing a more secure economic future have stepped into the breach. For some, the challenge is essentially one of extending the agenda set out in the Universal Declaration of Human Rights.¹ This approach insists that the economic, social and political dimensions of security need to be pursued simultaneously. More recently, “human security” has been closely tied to guaranteeing the “capabilities” that all people need to live a full and free life (United Nations Development Programme, 1994).

For others, insecurity involves more the challenge of providing the world’s poorest communities with effective mechanisms to help them better manage risk by mitigating the impact of shocks through targeted policy measures and strengthening their ability to cope with the consequences through insurance measures and safety nets and by strengthening civil society groups (World Bank, 2001).

For still others, the challenge is principally one of building social solidarity, centred around secure jobs and decent employment conditions, by strengthening the collective representation and voice of working people (International Labour Organization, 2004a).

¹ General Assembly resolution 217 A (III).

These perspectives shed light on the insecurity challenge. They confirm its multidimensional nature and indicate that security and growth need not necessarily be opposing objectives. They do not, however, unite so as to yield a more integrated perspective. This is, in part, because they tend to depict the origins of insecurity as lying in its omission from an otherwise sound economic policy agenda and, in part, because they tend to be infused with the belief in a ubiquitous process of rising insecurity, when the reality is that some—including intellectual property owners, international bankers and transnational corporations—have enjoyed rising levels of protection in recent years, while others—the landless and working poor, small farmers, industrial workers, and those in the informal sector—have seen their levels of protection fall; but in largest part, the lack of integration is due to the fact that these perspectives all tend to reflect a somewhat hostile view of the State and understate the pivotal role of policy measures in creating and addressing economic insecurity.

Arguably, the security of its citizens, in all its dimensions, is the defining responsibility of the State, even when this involves some delegation of responsibility to non-State actors. Guaranteeing that security also requires an integrated policy approach which mixes regulation, redistribution and risk management.

This year's *Survey* builds on a number of interlocking themes which point towards a new deal on economic security:

- Systemic risk, in particular as linked to unregulated financial markets, has become the most serious threat to economic security (chap. II): volatile capital flows, asset bubbles and rising levels of debt have failed to establish a strong investment climate or to create an inclusive and stable pattern of growth. Moreover, this has often come at the cost of diminished policy space which makes it all the more difficult for countries to manage their integration into the world economy in a balanced manner.
- In many developing countries, economic insecurity is compounded by their vulnerability to repeated and catastrophic shocks associated with natural disasters (chap. III) and civil conflict (chap. IV), which can lead to vicious circles of chronic poverty and perpetuate exposure to future shocks. Safety nets, insurance schemes, and risk management techniques can help countries respond to idiosyncratic shocks and to smooth income and consumption, but these are not in themselves enough to address the insecurity challenge or to build sustainable and inclusive recoveries.
- A basic challenge facing policymakers is one of investing *ex ante* in various mechanisms needed to plan for shocks and prevent them from turning into disasters. This requires effective State capacity to implement public policy responses and deliver public goods. In the case of post-conflict countries, this challenge is inseparable from that of rebuilding an effective State which can prevent the return of violence (chap. IV).
- The fact that, for most developing countries, economic insecurity is first and foremost a development challenge calls for economic diversification and policies that foster productive investment (chap. II and III). However, bringing the State back into focus in the security agenda also requires a better marriage of economic and social agendas (chap. V), which can strengthen efficiency gains and create a stronger growth environment. Doing this will probably necessitate a shift from an approach comprising targeted social policies and universal economic rules to one characterized by a more universal social agenda and targeted economic policies.

Guaranteeing economic security requires an integrated policy approach which mixes regulation, redistribution and risk management

A global new deal

Developing an alternative economic security agenda will, of course, require plenty of ingenuity if the new forms of solidarity and political mobilization appropriate to today's more integrated world economy are to be established. The chapters in this *Survey* offer policy options at both the national and the international level for dealing with the different dimensions of economic insecurity that are discussed.

In an interdependent world, economic security cannot be guaranteed by countries acting alone

Each country will need to experiment and find the configuration of institutions and conventions that will work best within its national conditions and that will meet the expectations of its population. However, in an interdependent world, economic security cannot be guaranteed by countries acting alone. In the world of the first three decades of the post-war period, this was achieved by establishing a multilateral trade and payments system that would facilitate rapid growth and development. In addition to a formal mechanism of multilateral negotiation needed to establish a more open trading system, this system also required additional safeguards to ensure its efficient operation and preservation; and it was backed up by a an orderly system of multilateral payments at stable, but multilaterally negotiated adjustable exchange rates, in conditions of strictly limited private international capital flows. While it is recognized that the growth in global interdependence poses greater problems today, the mechanisms and institutions put in place over the past three decades have not been up to the challenge regarding the coherence, complementarity and coordination of global economic policymaking. Strengthening multilateral arrangements based on full participation and open dialogue across the international community is the best hope for providing a secure economic future for all.