

Bickenbach, Frank; Gern, Klaus-Juergen; Heller, Peter S.; Schwenker, Burkhard

## Conference Paper

# Dealing with the new social divides 2009

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## The Global Society

# Dealing with the New Social Divides 2009

### The Challenges

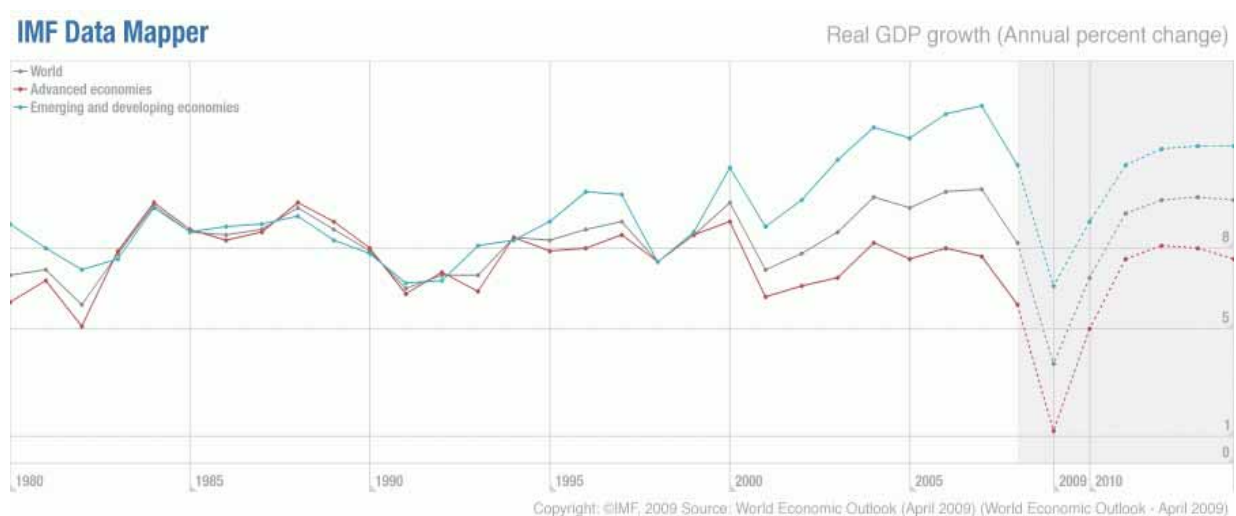
Around the world – from the US to Europe, from Latin America to the Far East – people are losing their jobs in the aftermath of the financial crisis and the consequent economic downturn. In Europe and the US, many of them are joining the ranks of the unemployed; in China, many are returning to the rural areas from which they came. In developing countries millions and millions of workers are being pushed into extreme poverty.



At the same time, as a result of decreasing asset prices, millions of families over the world have lost significant parts of their wealth and life-time savings, and many lost their homes through repossession. The resulting negative consequences could last a lot longer than the crisis itself.

The immediate reduction of income and wealth could generate additional adverse long-term effects, notably through reduced investments in the education of children compounding their vulnerability in the future. Also, there are fears around the world that the crisis may lead to rising protectionism and even social unrest.

While the current financial and economic crisis is global in nature, it is likely to have heterogeneous welfare impacts, with some countries, and some people, more vulnerable than others. The downturn may lead to profound changes in countries' growth strategies and international trade patterns with potentially far-reaching consequences for certain population groups. Against this background the challenge for national governments and international organizations is to find responses in order to mitigate the longer term social divides created.







## **Proposed Solutions**

### **Frank Bickenbach**

*Kiel Institute for the World Economy*

### **Klaus-Juergen Gern**

*Kiel Institute for the World Economy*

#### **1. Provide short-run assistance against income shocks, in particular for the poorest and most vulnerable segments of society, while protecting human capital investments and facilitating economic adjustment.**

Due to the crisis many people are experiencing unemployment and are facing substantially reduced earnings as well as other income, e.g., from remittances. As a consequence malnutrition is spreading, particularly in poor countries, and people are less likely to seek medical treatment in case they are sick. In addition, people tend to reduce investments in human capital as children are forced to drop out from school either to supplement household income or because their parents can no longer afford school fees or travel. In this situation, poverty alleviating policies should be key priority. However, scope to undertake such kind of policies will often be severely limited due to a deterioration of macroeconomic positions (fiscal and current account balances) and many countries' vulnerability to shocks such as sudden stops in private capital inflows, domestic financial system stress or adverse developments in primary commodity prices. Tight financial constraints require refocusing of government expenditures to safeguard education, health and nutrition outcomes. In addition, for countries with particularly bad situation additional external financing from official sources and non-governmental organizations will be needed. When designing programs for immediate relief, policy makers should be aware of potentially adverse effects on recipient behavior that may be detrimental to long-term poverty reduction and human development.

#### **2. Use the crisis as an opportunity to introduce and improve on social safety nets.**

Policy response should be generally pro-poor, not only because of obvious ethical reasons but also because stimulus that favors the poor is likely to have a stronger impact on aggregate demand. In the developed world, although to a different extent across countries, there is generally a social safety net in operation which works as an automatic stabilizer in the economy. In the current crisis, welfare programs designed to protect the poor and the vulnerable should be reappraised; often it may be necessary to expand them, but there may also be scope for significant efficiency gains within the existing social safety nets. The principle of co-responsibility with a strong activation focus to minimize work disincentives should be strengthened when adjusting the welfare system and raising current levels of spending on social safety nets to meet needs in times of crisis. In the medium term more far-reaching reforms could be considered to provide more flexible forms of social insurance, such as individual "welfare accounts" (e.g., unemployment accounts, skill accounts and retirement accounts) or "benefit transfers", which transform parts of people's welfare benefits into vouchers. Reforms along these lines would improve people's opportunities and incentives and help them adjust to changing market conditions.

In the developing world, social safety nets are less prevalent. Here the current crisis should be taken as an opportunity to create pro-poor stabilizers of sufficient dimensions. These should also be designed along the lines of co-responsibility – i.e., helping people to escape poverty now while also pushing them to take actions that reduce dependency on welfare in the long run. An important element in these welfare programs could be Conditional Cash Transfers, which give cash directly to poor people in case they agree to an action such as enrolling children in school or taking them to health clinics regularly. Another promising policy is setting up workfare schemes, which aim to support poor people in rural areas by providing them with unskilled manual labor at low wages on demand; they can be a timely and flexible way to



provide assistance. If well designed, with such kind of programs it is possible to protect a significant number of poor people in a crisis, without damaging their longer-term prospects of escaping poverty. They will have to be complemented by a set of transfers in cash or food targeted to specific groups who either cannot work (due to physical incapacity, including poor nutritional status) or should not be taken out of other activities (notably school) to join relief work. The budgetary cost of such a permanent safety net need not be very high, although it may be highly variable over time, and it may well bring longer-term efficiency gains to the economy.

### **3. Assure that the population, and especially the part that is poor and vulnerable, has access to essential social services such as health and education.**

The potential impacts of the crisis on health and education outcomes will work through both the demand and supply sides of education and health service systems because household incomes and fiscal resources will be negatively affected at the same time. While the demand side effect can be cushioned by providing a sufficient social safety net as described above, it is paramount that social spending on health and education does not fall victim to increased fiscal pressures, as has often been the case in previous crises. If cuts in total public expenditures cannot be avoided, governments should be selective and protect those services that are essential to the welfare and long term prosperity of the poor. On the health system side, health expenditures should be protected in real terms, particularly for those services and programs utilized by poor and most vulnerable populations. Securing the supply of essential drugs and supplies is key; a special focus should be on maintaining (or even expanding) access to HIV treatment and prevention, as HIV treatment interruptions come at a high social cost. With respect to the education system it is more important to pay teachers in time and assure that they are in classrooms than invest in physical assets and school buildings. Cost savings should sought to be realized by improving the efficiency of education and public health systems and improved targeting of health expenditures to those most in need. This would be in contrast to past crises, when governments often failed to maintain poor people's access to essential social services and ended up helping better-off groups in society instead. International organizations and donor organizations may attempt to help implementing a set of pro-poor expenditures policies through loan and credit agreements.

### **4. Use active labor market programs such as public works or job and skills to spur employment during the crisis and in the aftermath.**

One major achievement in labor policy reforms over the past decade has been the increased implementation of mutual obligation strategies. In developed economies, active labor market policies combine effective re-employment services and public work and training schemes with strong job-search incentives enforced by partially conditioning unemployment income support on recipients' active participation in the re-employment process. Given the steep fall in labor demand in the private sector associated with the current crisis, expanding effective employment programs will be important to maintain high activation levels. These programs should include well-designed education and training programs to give workers skills that will be needed as labor markets recover, but may also involve direct job creation in the public sector as a temporary backstop option for the most hard-to-place benefit recipients. In addition measures should be considered to promote labor demand and reduce socially costly layoffs by firms facing significant, but temporary decline of demand and credit constraints. In this context well-designed short-time working subsidies or temporary reductions in payroll taxes could be justified. In developing countries, "workfare" (or "relief work") programs have proved to be an appropriate form of a mutual obligation program. To deal with the current employment crisis developing countries should consider implementing workfare programs that ideally would guarantee low wage work in labor intensive public works projects. They may also consider projects that include training in useful labor market skills, such as basic literacy and numeracy.



## **5. Design labor market policies to pay particular attention to groups that are the most vulnerable to worsening labor market conditions.**

Past recessions have shown that young people, older workers, the low skilled, and migrant workers tend to be particularly vulnerable to worsening labor market conditions and run the greatest risk of becoming long-term unemployed and disconnected from the labor market. Activating labor market policies should therefore pay particular attention to these groups. Long-lasting negative effects have in particular been found for young unemployed, which may also be more prone to crime or causing social unrest. Therefore key priority should be to help the youth in their transition from school to work and to minimize the number of youth trapped in unemployment by targeting a range of effective education, training and work options to the young unemployed. Adequate re-employment services and skills training should also be provided to migrant workers as well as older workers. Stigmatization and discrimination of migrant workers should be countered; pressures to ease older worker unemployment by promoting early retirement or disability benefits should be resisted. Reducing the labor supply is not the right way to ease unemployment pressures.

## **6. Increase resilience of pension systems to macroeconomic shocks and reduce the exposure of individuals to short term financial risks in funded systems.**

The global financial and economic crisis has had a major impact on pension fund assets around the world, although losses vary significantly between countries. At the same time the global recession will also impose additional pressures on public pension schemes financed on a pay-as-you-go basis, which add to the sustainability problems they face due to ageing populations. Consequently, private pensions still have a major role to play in maintaining balanced sources of retirement income, and governments should avoid imprudent reversals of past pension reforms, which had been designed to strengthen the funded pillar of the pension systems. In the light of the current crisis, however, increasing attention should be paid to reducing the exposure of individuals to the financial risks associated with funded arrangements. Pension fund risk management and supervision needs to be improved to reduce exposure to unduly risky investments (or assets not fully understood). Rules that reinforce selling in depressed markets should be reviewed. Among the individuals with a large reliance on funded pension schemes those most affected by short-term declines in asset price are those who have to retire in the midst of the crisis, particularly if they are mandated to transform their accumulated savings into an annuity. Measures that should be explored to limit the impact of financial volatility should, thus, include the introduction of life-cycle portfolios, which require workers to shift part of their balances to less risky assets as they get closer to retirement, as well as increasing flexibility in the timing of buying an annuity (phased or deferred annuitization). This would permit people near retirement to avoid locking in losses (liquidating their assets when markets are down and buying an annuity when interest rates are low). Overregulation, however, should be avoided. Regulations relating to private pensions need to be considered in light of the pensions system as a whole. When public pensions already provide a minimum adequate level of retirement income, regulators may allow individuals more flexibility in their choice of investments than when private pensions are the dominant source of retirement income.

### ***Background***

The current economic crisis threatens to escalate to a full-blown economic and social crisis. Global output is set to decline this year for the first time since the Second World War, and any subsequent recovery is projected to be sluggish given the nature of the downturn. As a result, employment will decline massively in the developed countries with unemployment in the OECD countries estimated to rise from less than 6 percent to more than 10 percent. In developing countries, labor market adjustment in times of economic crisis historically has occurred predominantly through pronounced real wage declines and shifts from the formal sector into the informal sector and subsistence agriculture, rather than sharp reductions of total employment. Which type of adjustment predominates is important for defining the adequate policy



response and depends on the specific structure of the economy in general and the labor market in particular.

Evidence from past financial and economic crises in low- and middle income countries shows that reduced income as a result of downward pressure on wages and employment as well as falling migrant remittances from abroad may lead households to take actions to cope with the immediate crisis that prove to be harmful in the longer term. Absent assistance, households may be forced into the sale of the assets their livelihoods depend on, withdrawal of their children from school, inadequate use of health care, inadequate diets and resulting malnutrition. At the same time, public expenditure in social sectors tends to be pro-cyclical in many developing countries rather than working as an automatic stabilizer, and, even worse, historical experience suggests that it is the poor that are disproportionately affected by aggregate cuts in social programs.

In the developed countries, past – generally comparatively mild recessions – have shown that worsening labor market conditions can have longer term adverse effects particularly for the most disadvantaged labor market groups, which include young people, older workers, the low skilled and migrant workers. They are often the first to lose their job and face serious difficulty in finding a new job, running the risk of becoming long term unemployed or discouraged. Several studies have found that youth unemployment in particular leads to a persistent disadvantage in the labor market that can take years to overcome. This may be socially harmful also because unemployed youth tends to be more prone to crime or causing social unrest.

The international financial crisis has severely affected the value of pension fund assets worldwide. While losses have generally been considerable, there has been a wide variation across countries (ranging from 8 to 50 percent at some point in autumn 2008 in a selection of countries, according to World Bank figures). The impact of the crisis on individuals in funded, defined contribution schemes depends on four main factors: (i) changes in asset prices and the potential recovery over the medium term; (ii) the proportion of pension wealth that is supported by funded individual account assets; (iii) the requirement and framework for mandatory annuitization of the accumulated balance at retirement; and (iv) the presence of minimum social pensions or guarantees that are integrated into the pension system; and. Workers most severely affected in the short term are those with a high reliance on funded accounts who have to retire in the midst of the crisis, particularly if they are mandated to transform their accumulated retirement savings into an annuity. The number of these workers is fortunately currently relatively small since most countries with mandatory funded systems have established these in relatively recent years and the participation rate of older workers is generally not very high.

## **Peter S. Heller**

*Professor of Economics, Johns Hopkins University*

### ***Reconsider generosity of state pension programs and actively regulate investment options in funded schemes***

**Countries reliant on minimal first tier social security benefits (e.g., UK, Australia, US) and substantial reliance on voluntary or mandatory funded tier two schemes (normally defined contribution plans) may need to reconsider the level of generosity of these first tier programs and/or more actively regulate and supervise how second tier assets are invested.**

The current financial crisis has revealed some of the vulnerabilities of current approaches to retirement saving and social insurance schemes. Households in countries with more generous social insurance systems (high replacement rates, with public defined benefit plans) were



largely insulated from the effects of the crisis. Households in countries heavily reliant on funded defined contribution schemes have seen the assets in their portfolio drop sharply in value, exposing the degree to which retirement risks in such countries have been largely shifted to the household.

In the latter group of countries, governments can continue to limit their fiscal exposure by maintaining current benefit levels, but they then create the potential of a significant social divide between those dependent on minimal state benefits and little private assets and those who have accumulated adequate private financial assets. Those households in the former group would then require even more active government efforts to facilitate job creation for the elderly. Governments may also find that they will be drawn heavily into social safety net outlays – one of the reasons that motivated the UK to reexamine its state pension system (indexed only to prices) several years ago. Also in this case, governments will need to do more to introduce regulations that limit the extent of risks that households can take in the investment of their defined contribution portfolios. This may entail proscribing too risky an investment position or one that is too heavily imbalanced as between equities and fixed income securities.

In these countries, governments may seek to augment the generosity of their first tier benefits (and the associated payroll tax contributions) in order to achieve a better balance in the distribution of risks as between the individual and the taxpayer.

In those emerging market and developing countries that have not yet begun to implement a social security system for the bulk of their population, the issue of the appropriate balance between the first and second tiers of retirement income saving will be a critical policy issue. Such countries must be aware of the fiscal sustainability burdens that have characterized the former set of countries and the elderly poverty issues that may be associated with too lean a social security system in the latter set.

### ***Strengthen policy initiatives to foster the employment of the elderly***

**Strengthened policy initiatives are needed to foster the employment of the elderly. These include efforts at job training and skill enhancement; promoting labor market search initiatives; revised social security benefit rules incentivizing work to work beyond retirement; promotion of flexible wage structures that are less seniority-focused as well as potential for part-time employment of elderly; elimination of mandatory retirement ages; banning age discrimination in employment.**

In a number of countries, the recent financial crisis has highlighted the extent to which many workers are recognizing that their financial assets, coupled with any social security benefits, will be insufficient to allow full retirement at the early ages that have become the norm in many industrial countries. In particular, the impact of volatile equity and real estate markets has sharply cut – often by at least 25%, financial and home asset values. Increasing longevity and better health have both increased the required pool of assets required for an adequate replacement rate and enhanced the capacity of the elderly to continue working beyond the point of eligibility for retirement benefits. Governments themselves will be adding to these pressures as the mounting cost of social security benefits encourage policies to push back the age of eligibility for retirement benefits, even beyond the age of 67 (which is itself above the age of eligibility in many countries).

But the ability of the elderly to find or retain jobs is stifled by a number of constraints in the labor market and from government policies. Some relate to current social insurance rules that tax wage incomes received at the same time as social security benefits are received. Others relate to business doubts as to the profitability of employing elderly workers. Others derive from forced retirement rules in many spheres. Elderly workers also may need to accumulate new skills in order to be able to function competitively in today's labor market.





### ***Develop resettlement plans for countries at risk of substantial climate change***

**For countries at risk to significant adverse climate change impacts, particularly with regard to flooding and sea level rise, governments should proactively develop plans for resettlement of major population groups.**

There is little doubt that there will be, figuratively speaking, “more Hurricane Katrinas” in the future that will require resettlement of significant population groups. In some cases, this may be considered as temporary, as with Katrina, arising from the impact of extreme weather events that cause massive flooding of river valleys or coastal regions. But with rising sea level emerging as a major threat in coming decades, one can see a number of coastal areas that may become simply nonviable for settlement. This will be certainly true for a number of developing countries (Bangladesh, Egypt’s Nile Delta). Other areas may continue to be viable for habitation, but will require major restructuring of the focus of economic activity as climate change undercuts the viability of the previous economy.

A “new” form of social divide may thus arise, deriving from the forced resettlement of large groups of the population and their relative impoverishment due to the loss in the value of their assets (particularly real property). Since much of the impacts of climate change in coming decades are now readily recognized, governments should begin to anticipate what policies of adaptation and of resettlement may be necessary to address the social consequences of climate change and the new social divides that may arise. Complementary to such policies, there will be a need to strengthen infrastructure in exposed coastal regions in order to limit the potential economic losses associated with extreme weather events (a la Katrina) even if they are not likely to require the permanent evacuation of an area.

### ***Emerging market and low income countries should elaborate systems of unemployment insurance and pensions***

**Emerging market and low-income countries should attach a high priority to developing or elaborating systems of social insurance – particularly in the spheres of unemployment insurance and pensions.**

One lesson that can be drawn from the current financial crisis has been the efficacy of social security institutions as a means for implementing not only social safety nets but countercyclical fiscal policy. Countries that had well-functioning social security systems found them a convenient institutional vehicle for policy implementation. Unlike public investments for infrastructure, which can take time to plan and implement, social security and unemployment insurance payments can be made with little delay to targeted groups that are likely to have a high propensity to consume rather than invest. For many countries, the crisis has allowed policy makers to innovate in using social security systems to achieve policy goals, extending benefits and implementing labor market programs that have gone considerably beyond what had been the traditional scope of these systems before the crisis.

Reviewing what many countries have done, policy interventions have included the provision of additional social benefits to vulnerable groups (e.g., dependent children, female-headed households, the long-term unemployed); increases in the level of unemployment benefits; exceptional unemployment allocations to previously excluded groups; extension of the permissible duration of unemployment insurance benefits as well as an easing of qualifying conditions for unemployment insurance; extending existing work-sharing agreements; provision of training programs for the unemployed; financial incentives for employers to hire the unemployed (particularly among the older segments of the work force); programs dedicated to the creation of jobs for the young; a strengthening of employment search mechanisms for the unemployed; and extension of health insurance benefits to the unemployed.

The crisis has also illustrated that social security systems are a valuable institutional mechanism for the formulation and implementation of social safety net policies. Where such systems exist, they occupy a special niche within governments. They provide cash and



services to much of the population – retirees, survivors, disabled, unemployed, and families or children who are poor and vulnerable. Their proximity to their client base enables them to be an ideal vehicle for providing information and other kinds of services. They employ considerable human resources. Their databases can help policy makers in the formulation of policy, letting them know what is possible. And, as noted, social security institutions are often charged with implementing enhanced government transfer policies. In effect, such institutions end up determining whether the policy that is actually implemented is as intended or different. This also suggests the importance of governments relying more on social security institutions in the formulation of policies during a crisis.

### ***Develop prioritized list of public investment projects***

**Governments should move to develop a prioritized program of public infrastructure projects as well as a detailed agenda and timetable for maintenance and rehabilitation spending on existing public infrastructure.**

The potential importance of public investment as a tool for countercyclical fiscal policy and social safety nets in the event of an economic downturn has once again been recognized in the current financial crisis. But that recognition has come too late for most countries in terms of using the tool very effectively or substantially in the near term. What approaches are available to governments in addressing the obstacles of an absence of “shovel-ready” projects? An obvious starting point is the development of an asset registry of government infrastructure that specifies an appropriate schedule for maintenance and rehabilitation. Such a registry would not only facilitate guiding ongoing government spending on maintenance of public infrastructural assets but also be available for an accelerated program of rehabilitation and maintenance when there is a need for an active countercyclical policy. Next in priority would be for governments to adopt the approach recently pursued by Australia and China and move proactively to develop a portfolio of appraised, acceptable, and prioritized infrastructure projects, with a categorization of those projects that can be implemented relatively quickly. The Australian initiative also is a model of how governments can develop a public investment program that is responsive to the challenge of enhancing growth. Though not necessarily as productive, some consideration could be given to labor-intensive public works schemes, similar to those adopted by India in recent years, which might provide a form of social safety net for underemployed low-income workers.

### ***Strengthen government fiscal positions after the crisis***

**Once the current crisis has passed, governments will need to move expeditiously to reduce government debt ratios and address anticipated threats to fiscal sustainability.**

The current financial crisis has highlighted that the capacity of governments to find the “fiscal space” necessary to pursue appropriate countercyclical fiscal policies – including active social safety net policies--in response to an economic downturn is enhanced when the government’s initial fiscal position is strong. China’s capacity to move swiftly in implementing a countercyclical fiscal policy package contrasts with the concerns and constraints faced by many industrial country governments with higher levels of outstanding debt. A number of industrial countries now face the prospect that they have built up substantial levels of public debt in responding to the current crisis at a time but are also now exposed to the challenge of funding the looming costs from the retirement of the baby boom population. The obvious concern is that when and if the next economic crisis arises, governments will have dramatically reduced their degrees of freedom for an appropriate countercyclical fiscal policy response, including the use of social safety net policies.



## **Burkhard Schwenker**

*CEO, Roland Berger Strategy Consultants*

### ***The management approach makes the difference***

A growing uncertainty is one of the main results of the global crisis and of the modern economy for almost everyone. To restore a feeling of security for employees throughout the world we need in our companies managers who care. When we cannot trust in trends and numbers anymore, the only source of trust and security in a company can be the management. And only companies (esp. transnational companies) that are led by managers with a conscience for social needs can help cushioning the severity of the crisis – and help avoiding a widening of divides between the developed and developing world. The economist Martin Hilb put the characteristics of a good manager into short words that are nevertheless spot on: Managers need “a cool head, a warm heart and working hands.” A cool head to deal successfully with the uncertainty of today’s business environment. A warm heart to reach out to the people they work with and whose support they have to win for the ongoing change process; only those, who like people, can lead them. And working hands because managers have to show commitment of their own, if they ask their employees to do their best.

The European management model fits better to the post-crisis requirements than the Anglo-Saxon model that failed because of its short-term perspective, its wrong definition of shareholder value, and its strong “hire and fire” mentality, to name only a few characteristics. We know that many developing countries, especially China, consider alternative models for their economy. They should turn to the European one with long-term orientation, a broader understanding of success, a higher valuation of their employees and strong roots in the community.

The management approach is a key requisite in a globalized economy that helps the developing world as much as the developed world, thus minimizing the tensions between the both.

### ***Strengthen the real economy***

The current global crisis shows how important the real economy is. The virtual advantages of the financial economy were an illusion. The result of this learning process are high costs in money and in social terms and, currently, it puts a strain on the development of the whole world economy. It is also a chance though. If we learn to concentrate our resources on the real economy, there will be opportunities for the greater part of the working population not only in the industrialized countries but as well in the developing countries. So we have to define new mechanisms to make it more favorable to put the vast global monetary resources, that still exist, into better use. The proposals of G20 for a better (and stricter) regulation of capital markets point into the right direction.

### ***Counter new social divides through growth***

We have to secure wealth in the developed world to secure the creation of new wealth in the developing world, thus to counter the emergence of deeper New Social Divides. Because stabilizing the situation of the middle class in advanced economies – through instruments like flexible job schemes, guarantees for bank deposits, and an intelligent tax regime – is vital to keep the most important economic pillar of any modern economy in a sound condition. Without the mass demand of middle class consumers in the developed world the developing world will lose one of the main drivers of growth – the main generator of wealth for larger parts of the society and for the emergence of an own middle class in the developing countries. We have to remember that hundreds of million people in China alone have left poverty thanks to growth, and that was helped by the demand for Chinese products throughout the world. There is no better instrument to fight poverty than economic growth. Everything that is done to get the



advanced economies growing again, with the effect of consumers with renewed confidence, will help to mitigate the negative effect of the current economic crisis in developing economies.

That is why one major instrument to counter the New Divides could be and should be fighting protectionism. Every protectionist measure will only prolong the crisis – and weigh heavily on the potential of future growth and wealth. Free Markets are not a the heart of the current crisis, but poor regulation of the markets, people, who took advantage of some intransparent markets, and limited access to the global market for many people, especially in the developing world.