

From rising Inequality to shared societies –
Creating a sustainable International Monetary and Financial System

Club de Madrid

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Can the IMF really be reformed?

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Pablo A. Pereira - Economist

Former IMF Executive Director - Southern Cone Countries

pereira@infoarg.org

pablo.andres.pereira@gmail.com

Preamble

- In the onset of this crisis, voices were raised to reinvent BWIs – these institutions were recognized as part of the problem - wholesale reforms were called for to tackle the challenges ahead.
- There was an opportunity for real reforms, but it was blown. Although progress has been made in different areas, BWIs are still ill-equipped to facilitate multilateral cooperation and promote sustainable global growth
- BWIs have been designed for another era - for the post-war years and the Cold War – they need to be rebuilt for a new era (global and multipolar era) - where solutions will come from collective and cooperative actions.
- Above all, the BWIs need a new Economic Paradigms under a new Global Ethic

Part I

Where did the IMF fail?

The crisis is entering a perilous new phase

The world economy is at a cross-road.....we are on the verge of a disastrous recession – this will lead to further poverty and inequality with unprecedented social – economic consequences

Is this a merely a global financial crisis? Have we all been worried about the right things? Is fiscal austerity the solution to the debt problem? Can ‘internal devaluation’ policies really tackle the challenges ahead? Why the recovery in advanced countries is further away? Will more of the same be the solution?

We are going fast in the wrong direction...toward a world of economic fragmentation and protectionism.

Where did the IMF fail?

- In timely recognizing the true nature of this global crisis
- In fundamentally revamping its lending toolkit and enhancing its lending capacity to curb global systemic contagion
- In adapting its governance structure and decision-making process to a multipolar world economy

Problem I – failing to recognize the root causes of the crisis.....

This is not a financial crisis. This is a crisis of global capitalism. In a nutshell, the era of credit expansion based on the dollar as the main international reserve currency is coming to an end. This crisis marks the culmination of a super boom that has lasted for more than three decades. It will constitute an inflection or cross-over point for the world economy. The era of cheap capital will also be close to an end.

I believe that the IMF has failed to unveil the root causes of this systemic crisis in at least two fundamental areas:

- 1) This financial crisis, originated in advanced economies, is rooted in the configuration of the international monetary system (IMS) based on the national currency as the main reserve currency → insufficient recognition that the system is broken and need to be fixed → as problems in the IMS are not addressed, the world economy will become more and more vulnerable – global imbalances are unsustainable –
- 2) The flip side of the insufficient global aggregate demand has been a flood of liquidity – globalization has brought significant economic progress but also an outrageous concentration of income – rising inequality has been important in effecting the increase of both demand and supply of credit

The IMS at the root of this systemic crisis.....

Large and widening global imbalances have critical implications for global growth and global financial stability.

The current account deficit of the United States has been the norm since the collapse of the Bretton Woods system (BWS) in early 1970s and has risen to unprecedented levels since 2000 – the US is the world's largest debtor.

The absence of external constraints has allowed the United States to adopt policies that are more stimulatory than those of other countries. The vast majority of countries must accumulate reserves (money put into reserves is income not spent)

The US has played an important role in keeping the global economy growing. Without the American profligacy, there would have been insufficient global aggregate demand. Yet, this crisis has also brought to the fore a fundamental flaw: the surpluses of savings of the rest of the world have been misspent. In the absence of an investment boom (1990s), the US must have run an aggressive consumption and fiscal deficit to keep “full” employment. So the deficit financed domestic consumption and military expenditures (rather than investment) and it was increasingly funded by short-term flows rather than direct investment. In particular, an increasing share of the financing needed was provided by the world's Central Banks (reserve accumulation), not by private investors → then the story is well known: financial exuberance, financial and labor deregulation and pro-corporate policies engineered the worst asset price bubble ever witnessed in recent history

Rising inequality as also a root cause of this crisis ...

As economic inequality has been in the rise in the US and elsewhere for almost 40 years, households have to go deep into debt to keep its consumption levels afloat. More and more people relied on credit to meet their needs.

The political response to rising income inequality was to expand lending to household, particularly low income households after the pop of the dot.com bubble (2000). The result of debt-fueled consumption was a long-term super bubble that collapsed in 2008.

Supposedly, making the rich richer and unleashing the forces of market capitalism would have resulted in higher savings and more capital investment, raising productivity and growth. However, big money has not gone to productive investment, but it was pumped into financial markets to make big profits. The 'trickle down' did not work either. The flip side of this super-bubble built during the last three decades has been the increasing un-competitiveness of U.S goods. Printing T-bills did not create jobs!

It is critical to look at the fault lines behind this financial crisis in order to understand its consequences and remedies. Priority has been given so far to financial regulation and the enhancement of the global financial safety net. But much of the work lies outside the financial sector. It is about curbing income inequality- educational underachievement, tackling the trade imbalances or export-led growth characteristic of surplus countries (the so-called global supply glut) or developing different types of financial systems capable of intermediating domestic savings and investments stemming from different patterns of growth. → the IMF failed in passing this critical message - it will take many years to fill these fault lines and the danger is that the authorities will continue to ignore them when rushing to lure markets with austerity measures

Problem II: ill-equipped lending instruments...

Progress has been made in different fronts: the IMF resources have been tripled; the NAB has been expanded; precautionary credit lines have been added to the menu.

However, the IMF lending has failed in containing the debt explosion of countries at the periphery and therefore systemic contagion.

Fiscal austerity is delivering social unrest and political backlash, no debt sustainability. The belief that slashing spending will create jobs because fiscal austerity will improve private-sector confidence is 'voodoo economics'. The confidence fairy does not exist. As the excess leverage has shifted from the private sector to the governments, the economic recession would end up being the key driver of the debt explosions. The upward redistribution of income (due to the bailouts) has also exacerbated the inequality problem and therefore the lack of aggregate demand.

The IMF failed in recognizing the global and systemic nature of the crisis – policy conditionality is wrong when there is a risk of systemic contagion. Attempts to further shift the burden of the adjustment onto workers will never be the solution to this crisis – the IMF policies still put the repayment of creditors above everything else

Problem III -.....the unresolved democratic deficit

The IMF effectiveness is still hampered by concerns about governance and stigma.

Changes in voting power among groups of countries has been so far ‘too little – too late’. There was an opportunity for fundamental reforms, but it was blown.

The IMF decision-making process is still dominated by key advanced economies. Parity in the distribution of voting power has not been achieved yet. Special majorities have not been changed.

Promises of fundamental reforms have not been delivered. The IMF is ill-equipped to tackle the challenges ahead (global problems require global solutions) – the cooperative nature of the IMF is still hampered by its governance structure

The democratic deficit is a key impediment to turn the IMF into more legitimate and effective global multilateral institution

Part II

What can be done?

Can the IMF be reformed?

Can the IMF contribute to a
sustainable economic recovery?

Can the IMF help reduce rising inequality?

A new Mandate is needed

First, we need to ask ourselves what should be the IMF mandate in this new global and multipolar era – what is IMF for? Look at the key challenges ahead:

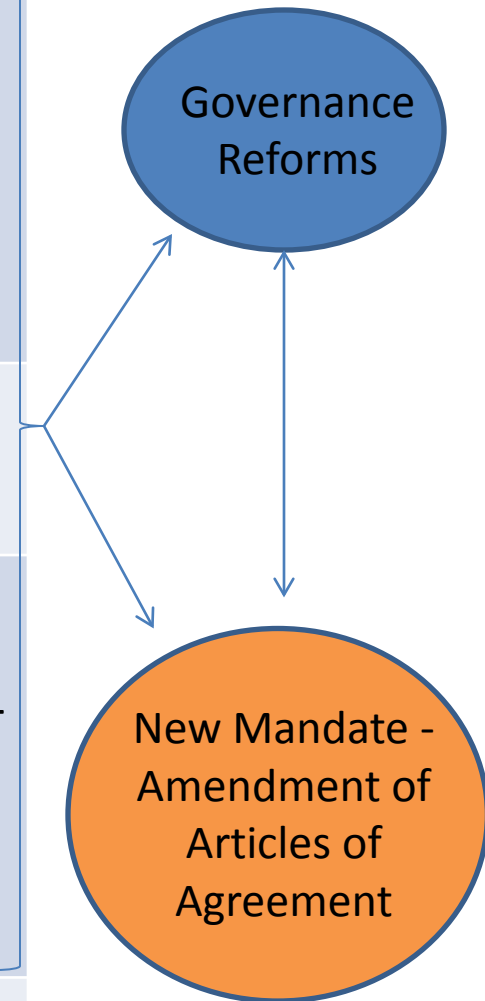
- Contain the impact of this systemic crisis without resorting to measures destructive of national or international prosperity – give confidence to members that resources will be available to correct maladjustments
- Ensure an adequate functioning of International Monetary System (IMS) – we face the unprecedented task of managing the declining role of the dollar and integrating highly dissimilar economies into the core of the IMS
- Take a more prominent role as a crisis prevention institution – 1) functioning as an Early Warning System to prevent to occurrence of new crises through its surveillance function; 2) agenda for regulation on cross-border capital flows
- Facilitate orderly sovereign debt restructuring process

Both the surveillance and lending functions of the IMF are still incomplete. A new mandate is needed but it will require the amendment of the Articles of Agreement

Rethinking modalities will NOT suffice

An Agenda for reforms

Challenge	Areas of Reform
Containing the impact of the crisis (more money / less conditionality)	<ul style="list-style-type: none"> -Large and regular SDR allocations to strengthening the global financial safety net -Overhaul of the IMF lending facilities (add pure liquidity line) -Increase the IMF lending capacity
Ensure adequate functioning of the IMS	<ul style="list-style-type: none"> -Revamping the role of SDRs -Facilitate the internationalization of key EME's currencies
Crisis Prevention role	<ul style="list-style-type: none"> -Stronger surveillance over issuer countries -Refocused surveillance toward systemic – multilateral risks (early warning system) -Financial surveillance -Regulations on cross-border flows / reducing capital mobility to avoid crisis
Orderly Debt restructuring process	<ul style="list-style-type: none"> - Revisit the SDRM initiative



New Mandate - recovering the IMF's original cooperative nature

The main purposes of the Fund need to be revisited. International monetary cooperation and collaboration must be intended to facilitate balanced growth and promote high level of employment and real income for all members. Reducing inequality and ensuring a fair burden sharing of the adjustment must be a new overarching goal in the IMF's mandate.

Under the BWS, three elements have been agreed upon: 1) an orderly exchange rate arrangements; 2) an adequate multilateral system of payment; and 3) a temporary financing assistance from the Fund without resorting to measures destructive of national or international prosperity.

A new delegation of responsibilities over sovereign policy options must be agreed upon to ensure that the IMF will be able to tackle the challenges ahead.

Proposal: a Commission of Experts must be created to study the amendments of the Articles of Agreement needed to prepare the IMF for this new global and multipolar era. A new 'Bretton Woods Agreement' is needed - a new foundation.

The criticality of governance reforms

The IMF effectiveness is hampered by its governance structure. The ability of developing countries to tailor the IMF' policies to their need is impaired. The IMF decision-making process needs to be de-centralized.

- 1) Activation of a Global Economic Coordination Council set in the framework of the UN to assess developments and provide leadership in economic and social issues (related to the functioning of IMS, global financial safety net, economic inequality, etc.) → a Ministerial Council at the IMF level will not suffice.
- 2) Rebalancing of the voting power at the Executive Board, giving developing countries as a whole more voice and representation in the decision-making process + Formal voting process need to take place (transparency and accountability) under a double-majority system for key – selected decisions
- 3) Effective oversight of the Executive Board over management – The MD cannot longer chair the Executive Board. The Board must define its own agenda - priorities and oversees the work of the Institution – Governors should also oversee the work of the Board – Stronger Independent Evaluation Office is key
- 4) Revisit supermajority and voting thresholds - double majority – MD selection - diversity

What other reforms are needed to put the IMF at the center of global cooperative actions?

1) Overhaul of the IMF lending facilities to avoid systemic contagion

- Large and regular SDR allocations during the time of crisis -access on demand to 'freely usable currencies' on an unconditional basis and with not fixed maturity.
- Add a pure liquidity line without artificially differentiating among countries – broad access against eligible collateral – just capacity to repay to ensure the revolving nature of IMF resources
- Backstopping regional reserve pooling arrangements

2) Increase the IMF lending capacity

- IMF issuance of SDR-denominated notes – SDR can be used to finance IMF programs allowing countries to implement pro-growth policies

3) Revamping the SDR system to strengthen the international reserve system

What other reforms are needed to put the IMF at the center of global cooperation?

- 4) Refocusing surveillance toward systemic – multilateral risks – Early warning system + stronger surveillance over issuer countries
- 5) Regulation on cross-border capital flows – agenda for reducing capital mobility to minimize future financial crises – idea: discourage short-term speculative cross-border flows that cause socially disruptive adjustment
- 6) Revisit the sovereign debt restructuring mechanism – this crisis proves that orderly multilateral mechanism for facilitating debt restructuring is critically needed – Clear set of international rules and procedures to force holdouts creditors to accept the terms of a debt restructuring

Final Remarks

We are rapidly heading in the wrong direction. The crisis is entering a perilous new phase. The recovery is now further away. Developing countries will be dragged once again by this crisis not of their own making. Increase poverty and inequality will be disastrous.

At the light of the nature and scale of the crisis, stronger counter-cyclical measures would have been needed. We have thrown free money to those who created the crisis in first place...we wanted to reignite the illusion that wealth can be generated by financial markets...we cannot create wealth of thin air. We are in the midst of a huge ideological crisis that is precluding the needed actions.

Ironically, the great depression in the 1930s was resolved by shifting the burden of adjustment to capital - not to labor and working classes as of today. Higher wages and mass consumption driven by a downward redistribution of income was at the core of the crisis resolution strategy. It was possible after the WWI and with socialism as a global alternative. Today, economic fragmentation and protectionism are the alternative – a lost decade with unprecedented social and political consequences.

The IMF is ill-equipped for a global – multipolar economy. Fundamental reforms are needed. The IMF still needs to change its narrow economic policy thinking. Its original cooperative nature needs to be brought to the fore.