FRIEDRICH EBERT STIFTUNG

New Directions for International Financial & Monetary Policy

Reducing Inequality for Shared Societies

WERNER PUSCHRA & SARA BURKE (EDS.)

SEPTEMBER 2011

- »It is no secret that the international monetary system has basically been a 'non-system' for the last four decades. We should revisit the spirit of Bretton Woods: President Roosevelt was not just concerned about monetary and financial stability, but had a much greater vision of a truly inclusive shared (international) society after the 'war to end all wars'—to which I hope we are able to rise, in our times, from the wreckage of our recent and ongoing global crises.«
  —Jomo Kwame Sundaram, Assistant Secretary General, Department of Economic and Social Affairs, United Nations

- »A 'shared society' is a socially cohesive society. It is stable, safe. It is where all those living there feel at home. It respects everyone's dignity and human rights while providing every individual with equal opportunity. It is tolerant. It respects diversity. A shared society is constructed and nurtured through strong political leadership.«
  —Kim Campbell, Prime Minister of Canada (1993); Member, Club de Madrid

- »Among the 7 characteristics of a good international monetary system are that it should promote development and provide correct incentives for those who work hard, so their efforts can pay-off, whether the country is big or small, and regardless of its region or religious makeup.«
  —Yi Gang, Deputy Governor, People's Bank of China

- The collected essays—from heads of governments, central banks, governmental advisors and ambassadors, as well as experts from the United Nations System and civil society—pose timely and important questions about the social and political challenges presented by inequality and the global economic policy framework needed to support and nurture equitable development and shared societies.

Dialogue on Globalization

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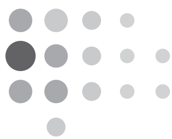

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Preface

Recent events—from the global financial crisis of 2008-9 to the ongoing democratic uprisings in the Arab World—show that the current international monetary and financial system is dysfunctional. Neither national nor international policies adopted in response to recent crises have translated into strong recoveries, and the rebound has been especially weak in the labor markets. In addition, the limited role that public policy has played in addressing chronic and increasing inequality—especially the particular challenges presented by group inequalities, which are fuelled by perceived and real injustice, and often have international dimensions—underscores the urgency of finding ways to correct these ineffective policies.

Global income inequality has grown in the crisis, especially the inequality between the top 5% of income earners and the rest. The ratio between the average income of the richest 5% and the poorest 5% of people in the world amounts to a staggering 165:1. Considering the top 20% in comparison to the bottom 20% the difference of their average income is still 50:1.

There are several reasons for this, economic as well as political. Economically, globalization has created opportunities for those who were educated and mobile enough to profit from them. But at the same time, wages as a share of national income have fallen, and the inequality in labor earnings has increased. The sustained political push for financial deregulation and tax cuts for high-income earners has also contributed to growing inequality.

The picture of wealth inequality is even worse. In 2010 the global wealth held by households increased to $120 trillion. That level is 20% higher than it was just prior to the financial crisis. Millionaire households around the world own almost 40% of global wealth, although they constitute only 0.9% of all households. The total number of millionaire households worldwide stands at 12.5 million.

These figures show that the way globalization is organized has contributed to concentrating wealth and incomes among very few people. It is no wonder more and more people around the globe feel left out of any economic and social progress and think that globalization is only bearing fruit for a few, and not for the many.

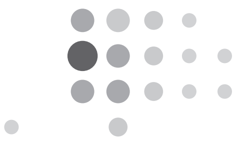
We can also see from the democratic uprisings in the Arab world and the protests against further social burdens in southern Europe that inequality matters to people. These protests are a sign of the vast disillusionment with the legitimacy and effectiveness of the current international arrangements for dealing with economic crisis. The social strains arising from countries with high unemployment and widening income gaps have the potential to threaten the future of globalization, given the present organization of the global economy and its institutions.

Inequality poses not only social and political challenges to the present system, but also economic ones and has become the world's most serious challenge. Addressing inequality holds the potential to bring significant long-run benefits for growth, as reduced inequality and sustainable growth can be seen as two sides of the same coin.

A better system of Global Economic Governance could create an enabling environment for the development of global welfare, which requires a shared awareness among all countries of common challenges and a shared diagnosis. A better system must also forge a new balance between decision-making at the national level and decisions taken at the global level in order achieve consistency. Often, domestic political constraints hamper and limit multilateral processes of negotiation.

Part of a new global agenda must include policies to revitalize economies, bringing more people into the formal economy and creating jobs that allow a greater number of people to participate in the creation of wealth. Other policy challenges include progressive tax systems aimed at reducing income inequalities and the reduction of fossil and agricultural subsidies in advanced countries. Governments should also not shy away from introducing the following issues into the global agenda: prioritizing social spending, the expansion of universal education, setting livable minimum wages and supporting collective bargaining, cash transfers for the poor and the extension and improvement of social delivery services.

This publication presents the results of a high-level conference linking two goals that conference organizers in the Friedrich-Ebert-Stiftung, Club de Madrid and Center of Concern believe should be pursued together: reform of the international financial and monetary system and achieving equitable and shared societies. The objective



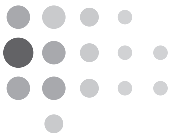
of that conference, this publication and upcoming conferences is to contribute to the current debate about the need for a new paradigm for the international financial and monetary system toward producing an agenda for equitable development and social cohesion.

The focus is specifically on the need to forge a new consensus to directly incorporate social as well as hard economic considerations into the framework of the international monetary and financial system and to bring social-policy indicators into the policy-performance goals that Member States are required to meet by the international financial institutions.

Looking ahead, we see a unique confluence of forces that provide a favorable political environment to reexamine and set the basis for a renewed world economic system. We would like to thank our co-organizers—Rubén Campos, Clem McCartney and Carla Fernandez-Duran of the Club de Madrid, and Aldo Caliari, of the Center of Concern's Rethinking Bretton Woods Project—for their insights and their partnership to bring the issue of inequality to global debates on the reform of the international monetary and financial system. Through our work with them, we have come to believe that this year and those to follow present an important opportunity to examine alternative global economic policy frameworks from the perspective of what is needed to support and nurture equitable development and shared societies.

—Werner Puschra & Sara Burke

Werner Puschra is Executive Director of the Friedrich-Ebert-Stiftung's (FES) New York office. Sara Burke is a Senior Policy Analyst at the FES New York office and editor of this publication.



Introduction

José Antonio Ocampo, Professor at the School of International and Public Affairs and Fellow of the Committee on Global Thought, Columbia University

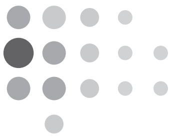
The recent global financial crisis demonstrated how dysfunctional the current international macroeconomic and financial architecture is for managing today's highly integrated global economy. The fact that the center of the storm was the industrialized countries implied that, under the leadership of the G20, strong steps were initially taken to both mitigate the crisis and to strengthen the international architecture to prevent future crises. Similar calls for reform had been made after the 1997 Asian crisis that soon engulfed most of the developing world, but reform was then marginal at best. This time, the initial »Keynesian consensus« has been succeeded by a growing divergence of views and the scope of cooperation has been, in any case, limited.

As a result, the evolution of the global economy is only partly encouraging. A new Great Depression was avoided and the financial meltdown was contained, but four years after the US subprime crisis the recovery in the industrial world continues to be weak, particularly in terms of employment generation. In turn, the European Union (EU) has been facing severe difficulties in reaching consensus to support its economically weaker members, and the US is mired in a political stalemate regarding its fiscal policy. Thanks to the stronger margin that they had this time to undertake counter-cyclical macroeconomic policies, the emerging economies—and, particularly, the largest among them—have been doing well, but they are also facing a slowdown and destabilizing pressures associated with booming capital inflows, risks of asset price bubbles, and strong appreciation pressures in those using more flexible exchange rates. More generally, uncertainties associated with global imbalances and the credibility of the (essentially) dollar-based global monetary system are back on the agenda. There are three fundamental problems with reforms underway. The first is that they constitute an incomplete agenda. Most of the action has concentrated on macroeconomic policies to counter the world recession (now weakened by diverging policy views), prudential regulation of financial activities and building a better, though still incomplete international financial safety net. Other issues have been absent or only weakly present, including global monetary reform, the regulation of cross-border capital flows and the design of adequate debt workout mechanisms at the international level. Second, the reform process has been led by an ad-hoc arrangement, the G20. Although this represents an improvement over the G7, and the representation of developing countries in international financial institutions has increased, no fundamental reform can take place if the process does not lead to the design of *inclusive,* representative institutions. Thirdly, equity dimensions have not figured prominently in either the diagnosis or the policy agenda, and some actions may actually be leading to the weakening of the social protection system in countries undergoing harsh adjustment programs.

Equity dimensions have been important in many ways. A now voluminous literature indicates that worsening inequality at the national level has been a central feature of the world economy in recent decades. Some analysts, and more prominently the United Nations Commission of Experts on Reforms of the International Monetary and Financial System (Stiglitz Commission)[1] have indicated that rising inequalities contributed to the crisis. In the US, falling median wages were a major factor behind rising household indebtedness, particularly in the face of rising real estate prices. In Europe, rising income inequality may have contributed to weakening aggregate domestic demand. And in China, the historically unprecedented low share of wages in national income contributed to large domestic savings and associated current account surpluses, one of the major sources of global imbalances.

This volume collects the views of a remarkable group of analysts, coming from politics, academia, social movements and international organizations, on the common theme of how to rethink international financial and monetary policy from the point of view of the objective of building shared societies. The scope of the issues covered is broad and the contributions tend to further widen it to include other important topics, such as food security, international tax cooperation, climate finance, and international migration. One way to summarize the issues covered in this book is by dividing them in two broad categories: those associated with global monetary reform, and those related to domestic policies that contribute to building shared societies.

1. *Report of the Commission of Experts Convened of the President of the UN General Assembly on Reforms of the International Monetary and Financial System*. United Nations, New York, September 2009. www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf



Global monetary and financial reform covers a broad set of issues. The former includes at least five major objectives: (i) designing an international reserve system that contributes to the stability of the international economy, in particular through the provision of adequate international liquidity; (ii) creating mechanisms that facilitate the consistency of the national economic policies of major countries with the stability of the world economy; (iii) in close relation to this, designing an exchange rate system that promotes stability and avoids negative spillovers on other countries; (iv) regulating cross-border finance, in order that it facilitates trade but also mitigates the risks associated with the pro-cyclical behavior of international capital flows; and (v) offering appropriate emergency balance of payments financing during crises.[2]

Financial reform includes stronger prudential regulation and supervision of financial activities, with a comprehensive view of what financial activities should be regulated and a strong focus on the links between prudential regulation and macroeconomic stability, particularly through a focus on the countercyclical role that prudential regulation should play. This »macroprudential« perspective, as it has come to be called, can also be understood (as indeed the IMF itself has underscored) as also including the management of cross-border capital flows. Since emergency balance of payments financing is only a good alternative when payment difficulties are associated with liquidity problems, it has to be complemented with adequate debt workout mechanisms at an international level to manage problems of over-indebtedness. The two, together with cooperation among central banks through swap arrangements, and foreign exchange reserves, constitute the core of what is usually referred to as the financial safety net.

Most of the contributions to this volume analyze different dimensions of this reform agenda, with variable emphases and some divergence of views. A common theme is the need to increase the role of the IMF's Special Drawing Rights (SDRs), as part of a broader reform of the dollar-based international monetary system. This includes a broader composition of SDR basket, particularly to comprise currencies from major emerging economies. In relation to the latter issue, one of the authors underscores the fact that new currencies in the basket must be »fully usable« and not necessarily »fully convertible«.

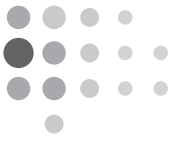
2. José Antonio Ocampo, *Reforming the International Monetary System*, 14th WIDER Lecture, Helsinki: UNU/WIDER, 2011. www.wider.unu.edu/publications/annual-lectures/en_GB/AL14/

The need for stronger forms of macroeconomic policy cooperation—including associated exchange rate issues—is also underscored by several authors. I find particularly interesting the reflections on the need to increase the effectiveness (»traction«) of IMF macroeconomic surveillance, particularly to guarantee that it contributes to correcting global imbalances. This implies, in particular, that such surveillance should be particularly effective vis-à-vis the major economies, for which surveillance has been essentially irrelevant in the past. Some authors also mention the need to improve balance of payments financing while avoiding undue conditionality and leaving room for countercyclical macroeconomic policies.

Several of the contributions also call for regulating cross-border capital flows (i.e., to impose capital controls), and some suggest the need to adopt a multilateral framework for capital flows, giving the IMF a mandate in this area. However, as another author argues, the extension of the IMF mandate in relation to capital flows has been very controversial in past and recent debates. In 1997, the then IMF Managing Director tried to move in this direction but failed due to the opposition of developing countries. In recent IMF debates on this issue, some emerging countries have also argued that under the current order they should continue to have total freedom to regulate capital flows, given the limited amount of alternatives instruments they have. So, any move in the direction of a multilateral framework for capital flows would have to start by industrial countries recognizing that capital account regulations are part of the broader family of financial regulations and be willing to cooperate with countries using them to make them effective, and be even willing to adopt such regulations themselves to avoid destabilizing capital movements, some of which may weaken the effectiveness of their monetary policies.

Aside from the regulation of cross-border capital, other aspects of financial regulation are not analyzed by authors in this volume. This reflects the fact that this is the area where most progress has been made in recent year. This is not true, however, of debt workouts, a major missing item in the global agenda, which has played an important role in European debates.

Some of the contributions also refer to the governance of the global financial and monetary system. This involves, first of all, the need for a more representative and accountable IMF. Some, though incomplete reforms have been



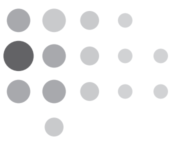
adopted in this direction in recent years, including the quota reform, the increased participation of developing countries in the board, and the move to an all-elected IMF board. Also, as one of the contributors argues, despite the advance that the G20 has represented, it still faces significant institutional problems, in at least two different ways. The first is the collision of functions between the G20 and the IMF in the areas of macroeconomic policy surveillance and coordination. The second is the legitimacy issues that the G20 faces, which can only be solved by moving into an organization with universal membership.

In the latter case, the need for an effective and legitimate system can only be solved by an arrangement in which a small global policy board is nominated according to a constituency system. Although the author suggests a system centered in the IMF, a better alternative is the Global Economic Coordination Council proposed by the Stiglitz Commission. The latter would be constituted in the framework of the UN *system,* to which the IMF and the World Bank belong. Its basic advantage is that it would have a broader mandate, not limited to macroeconomic policy, and would benefit from cooperation from a broader set of international organization, not only the IMF, using of course the latter as the essential framework for cooperation in relation to macroeconomic policies.

The second set of policy issues, those related to building equitable and shared societies, are essentially covered in the third part of this collection. However, several authors in the first two parts make the case for countercyclical policies and strengthened social protection systems as an essential part of a policy framework with that objective in mind. Countercyclical policies are particularly important for combating the major adverse outcomes of the recent crisis: weak employment generation and rising unemployment and underemployment. Indeed, according to some of the contributions, one of the major issues facing the global economy is the fact that macroeconomic policies may be turning unduly restrictive at a time when the recovery from the crisis is still fragile. One of the authors goes so far as to claim that the gravest threat to the world economy is the wave of austerity policies that has been adopted by industrial countries.

One of the contributions claims, correctly, that a shared or inclusive society is a precondition for prosperity and security. In this regard, another argues that globalization has generated material growth but also unprecedented inequality, which—as argued above—has contributed to rising global imbalances. There is, therefore, according to several authors in this collection, a need to adopt a policy framework that mainstreams equity concerns. This means, above all, the need to mainstream equity concern in the design of macroeconomic policies. This is an area that we must continue to discuss, as there is no clear consensus in this regard. A first step could be the explicit inclusion of employment as an objective of central bank policies, as in fact it is in the charter of the US Federal Reserve Bank. This is underscored by the fact that the recent crisis has made patently clear that a low inflation rate may be consistent with dismal employment. This would make it necessary to revise the mantra in favor of inflation targeting that has characterized macroeconomic orthodoxy prior to the global financial crisis, and that seems to be surviving it.

This collection represents an important contribution to one of the central debates of our times. Let me congratulate the Friedrich-Ebert-Stiftung, Club de Madrid and the Center of Concern for bringing this excellent group of practitioners and analysts together to broaden our understanding of this complex set of issues.



1. The Need to Reform the International Monetary and Financial System so that it Contributes to Stability and Social Equity

1.1 How to Promote Equitable Development and Shared Societies

P.J. Patterson, Prime Minister of Jamaica, 1992-2006, Member, Club de Madrid

I welcome the opportunity of contributing to the debate on the need to reform the present international monetary system. There is a general feeling in many quarters that the crisis has abated and that the world economy is recovering. Old policies still need to be addressed, as new issues are presenting themselves for consideration.

The international community is facing multiple and diverse challenges. These include slow growth, high levels of unemployment, fiscal and financial vulnerabilities, escalating food crisis and, more recently, rising oil prices. When one combines all of these with the unpredictable climatic consequences and further add the political and social unrest currently underway in the Middle East and North Africa, we must conclude that the international community is faced with some grave problems that need our immediate attention.

The crisis demonstrated the interconnectedness of the world economy and highlighted the need for cooperation and effective global governance as prerequisites for maintaining global stability. While some reforms have been adopted, there is still need for more to be done, as the consequences of the crisis are still apparent.

There is the need for example for further policy collaboration among key players to ensure that their domestic policies are not disruptive of global stability. Monitoring and management of capital flows to ensure orderly and stable exchange rate arrangements particularly between surplus and deficit countries is critical in order to minimize volatility. Suggestions have also been put forward for an advanced role for SDRs as a reserve asset with the ability to reduce the impact of exchange rate swings in global trade.

We, who belong to the developing world, however, are very concerned that the restructuring of the international financial and monetary system must have an inclusive rather than exclusive approach and must allow the participation of developing countries in the global institutions, which was not the case in the Bretton Woods agreement.

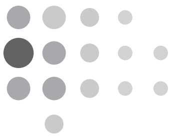
History suggests that financial crises occur at times when other crises are also competing for our attention, whether political, social, or recently nuclear. This is certainly the case today, but as we focus on fixing the financial architecture, we must not ignore all the other formidable challenges that we face.

My basic thesis is that we need to reform the present international monetary system but we cannot do that in isolation of all the other areas of economic activity in the global framework.

For this article, I focus on the special problems of small middle-income developing economies which are characterized by their high degree of openness, narrow range of economic activities, the concentration of exports and limitations imposed by the economies of scale. All these countries are acutely vulnerable to exogenous external events. Their vulnerability is further compounded by the proneness of island states to natural disasters, including volcanic eruptions, hurricanes, earthquakes, droughts and floods.

It is the case that the situation of small, middle-income developing countries has largely been overlooked by the international community because they are not regarded as posing a serious threat to the international financial system. They are unable to pursue countercyclical stimulus programs in the manner in which the developed countries have been able to do. The resources available from the multilateral financial institutions have been conditional on deflationary fiscal and monetary policies. These policies have not only deprived the economy of endogenous growth impetus but have constrained the capacity to provide social safety nets to shield the poor and the most vulnerable.

The economic slowdown in the global economy has had a serious effect on these countries because of their pronounced economic vulnerability and their limited capacity for adjustment. The social impact on these



countries has been grave, leaving them at the mercy of destabilizing forces such as international crimes, which undermine law and order. To address crime must involve the reassertion of states focusing on poverty alleviation to replace the largesse with which criminals purchase the allegiance and support of the needy. In the absence of social safety nets, education for re-skilling the unemployed and encouragement towards private enterprise, criminal gangs will induce and coerce poor communities into a web of crime.

The fiscal constraints faced by the small, middle-income developing countries severely impinge on their capacity to maintain social safety nets and in a sense undermine the concepts that would influence the creation of shared societies. Curtailment in social expenditures will result in slowdown in economic activity, rising unemployment, underutilized export capacity and declines in social cushions. Social safety net expenditures are essential for poverty alleviation and critical for the preservation and development of the human resource component of productive capacity.

It is further the case that the erosion of preferential trade agreements and the fall in global demand has negatively impacted traditional exports such as sugar, bananas and bauxite. Add to that, the situation in relation to the Doha Development Round in which many of us had some hope. The simple fact is that the Development Round is comatose and moribund and is now ready to be condemned for final burial.

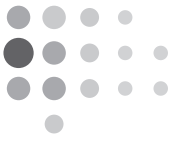
In the Caribbean, vital economic activities such as tourism, fishing and shipping are dependent on the quality of coastal and sea resources. Natural disasters such as hurricanes are almost an annual event, and of course we have the reminder of the earthquake in Haiti last year. For all these countries, climate change poses a clear and present danger. The identification and mobilization of resources to enable governments to address these issues is therefore a clear priority. If small, middle-income developing countries are to resume and sustain economic growth, there must be an open multilateral trading system in the growing global economy.

The interconnectedness and the interdependence of all countries must always be at the forefront of efforts for global expansion. Links have become more complex between economies both in trade and in finance where there are several networks of connectedness. Output shocks in the large economies have long and lasting repercussions throughout the system. While there has been progress since the financial crisis, more ambitious reforms must be implemented for sustainability, and these reforms should not only focus on financial issues. They must include underlying issues such as energy, trade, agriculture, climate change and migration, which impact the sustainability of the global economy.

We who belong to vulnerable small states recognize that the international community is beginning at long last to acknowledge the inextricable link between security and economic development. Developed, rich countries must be made to understand that palliatives and border patrols cannot insulate them against the poor and desperate, hence they become a threat to security everywhere.

The shared society's concept is ever so relevant today as we ponder the challenges that we face and seek to find solutions. Now more than ever, we need the cohesiveness and stability that is envisioned, where all individuals, communities and states are committed to working towards the common good.

As part of the group of 77, Jamaica will be working with other developing countries to make our response clear, and we hope it will trigger appropriate action.



1.2 Key Issues in International Monetary Reform

John Williamson, Senior Fellow, Peterson Institute for International Economics

There are two and a half issues that have dominated the debate about international monetary reform up to now: adjustment, liquidity and capital controls. It is important to recognize that the issues here are international. We are discussing the reform of the international monetary system, and therefore it's essentially a question of one country against another country. At stake is the distribution of the gains between countries, not individuals.

The aim of achieving adjustment (the basic *raison d'etre* of the IMF) is not likely to be feasible with the ambitious objective of eliminating unemployment entirely. A certain amount of unemployment will inevitably occur in the course of adjustment. Minimizing unemployment however is a realistic and worthwhile aim. Eliminating it would not be realistic.

But having said that, let me return to the main issues that have surfaced in the debate on reform up to now. To begin with, the issue of adjustment: this has been at the center of the discussion right from the 1960s on. It was, in fact, the realization that the C20 (not the G20!) was not going to face up to this issue that led me to formulate the title of my first book (*The Failure of World Monetary Reform*) during the second meeting of the Committee of 20, when it became quite clear that there was no willingness to discuss the role of the exchange rate in adjustment. Instead there was the hope that adjustment would just happen if one sat back. That is also not realistic.

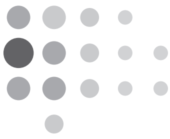
Certainly, if one wants to minimize unemployment, then the objective has to be to introduce the exchange rate as a central element in the adjustment between countries. Where that's not possible because a country has entered into a monetary union, then one has to face the uncomfortable fact that there's going to be additional unemployment created as a result of the need to adjust. We are still waiting to see whether Greece manages to make the adjustment despite that. But I don't think most of us would have thought that Greece was in a fit condition to enter the European monetary union in the first place. Had they not misled their partners as to the health of the economy, they would have been excluded, and I think that would have been for their own ultimate long run good. But now they're in and it would be an extremely costly exercise to leave the Euro. The idea of restructuring debt while remaining in the Euro really doesn't answer the need. The really fundamental point is that it wouldn't solve Greece's problems because it would do nothing to restore Greek competitiveness.

The latest initiative in regard to adjustment is the resolve of the Group of 20 to create a Mutual Assessment Program (MAP). The aim is to get the member countries to diagnose which policies are responsible for the non-adjustment and then modify policies accordingly. This is unlikely to be any more fruitful than previous initiatives along these lines. Ultimately China will make the necessary moves, but it will do so because of a perception of self-interest, and not because it is being goaded by the international monetary system or feels it has responsibilities to the international monetary system.

The other big issue, apart from the adjustment process, is the reserve system. At the present time, that's based on dollars. The big initiative (outside of certain enlightened circles) appears to be to go to the multiple reserve currency system, which means adding additional reserve currencies. The currencies that are always mentioned here are ones like the euro, the renminbi, and the yen, in other words, strong currencies of countries that don't need additional reserves. They don't need to issue reserves to get all the resources that they in fact need.

This is a big problem with the international monetary system as it is constituted at the moment. The fact is that it encourages a net flow of resources in a perverse direction. At the moment, it's predominantly towards the dollar, and the US is not a country that is notably short of capital. The multiple reserve currency proposal would expand this somewhat, so that instead of the flow being just toward the United States it would also go towards Europe and China and Japan, towards other countries that don't need capital.

There is only one reserve asset that has been created so far which distributes the benefit of reserve creation more broadly, and that is the IMF's Single Drawing Right (SDR). That is, to my mind, the basis for advocating a bigger role for the SDR. It's the basis for supporting the proposal of the Chinese People's Bank Governor to give the SDR a bigger role in the international monetary system. If the SDR were given a bigger role, there would be a big gain in terms of the distribution of resources internationally.



It's true that the initial distribution of SDRs is not optimal. They go primarily to the industrial countries that have little need for an increased flow of resources. Ideally one would like to see a reform so that they go in much larger measure towards countries that in fact are building up their reserves at the present time. This would save the countries from running such large payments surpluses in order to build up the precautionary reserves that these countries feel they need. (Indeed the results of the last crisis suggest there were benefits from holding larger reserves.) It's not clear that a reform of the distribution of SDRs could be accomplished without amending the IMF Articles, but we shouldn't therefore dismiss the possibility.

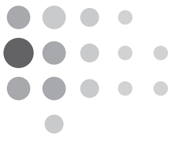
Other reforms of the SDR are undoubtedly desirable. For example, the SDR is poorly named (the result of a historic accident), but think of a better name. Or take the proposal for the SDR to be used as a private asset: that's a very desirable long-run evolution, but I really think it is for the long run. It's something that could be left until later. For SDRs to play a more important role in the provision of liquidity in the short term, it is really not essential that they be traded in private markets. I think the suggestion in the literature that this would be essential is quite wrong and that they could play a much needed enhanced precautionary role long before that reform is feasible.

The big change that is needed is that countries must want to hold SDRs. Why do countries at present not want to hold them? Why do many countries that get allocated SDRs seek to get rid of them and hold dollars instead? Well, quite simply it's a matter of yield. The logic of the present basket is that by having the yield equal to the average of the short-term interest rates of the currencies in the basket—and since the private sector is free to arbitrage between the component currencies—one also eliminates the incentive of the private sector to arbitrage between the SDR and any of the component currencies. If there is no incentive of the private sector to arbitrage, then presumably there is no incentive for the public sector to arbitrage either.

However, it is not clear that short-term rates are what drives the public sector, while it is clear that the yield of the present SDR is too low to encourage monetary authorities to want to hold it. If one retains the present form of the SDR, one could accomplish an increased yield quite simply by adding a certain premium to the yield calculated as it is at the present time, or one could take some other point on the yield curve if one felt unhappy with the average of the short term interest rates. That seems to me to be the key reform that is needed in order to make the SDR attractive to hold and thereby enable large allocations to go forward each year.

I said that there are two and a half major reforms that are being discussed, and I've discussed two of them, adjustment and liquidity. The half reform is about capital controls. The IMF used to take a terribly anti-capital control line. (Incidentally, the author of the »Washington consensus« actually disagreed with this very strongly.) The IMF has now decided that it's going to be much more flexible on this issue, but nevertheless international agreement hasn't been reached to give the IMF a role in supervising capital controls.

I think this is somewhere the G20 might well be able to make a mark. There may be sufficient gelling of opinion in the course of this year that in fact there would be potential agreement on that issue by the time of the Cannes summit. I certainly think it's more likely that they will make a breakthrough here than on the MAP, on adjustment. I also don't sense a great willingness on the part of the central banks (in particular) to give a significant role to the SDR, and therefore I think we'll be lucky if to see much agreement on SDRs, but I do see a possibility of agreement on capital controls.



1.3 France, the G20 and Reforming of the International Monetary System

Emmanuel Moulin, Economic Advisor
to the President, Office of the President
of the Republic of France

President Sarkozy first talked about the idea of putting the reform of the international monetary system on the agenda of the G20 in August 2010. His proposal was greeted with a lot of skepticism and even some suspicion. This is certainly the case because the French have always been critical of the functioning of the international monetary system. Actually, the expression of »exorbitant privilege of the dollar« was first used by a French President when he was Finance Minister.

Three months after this first declaration, the so-called »currency war« was making the headlines. Now this issue is in the minds of all policymakers but also academics, think tanks and others. The positive consequence of this concern is that a lot of work has been done in various organizations such as the United Nations, the International Monetary Fund, and in academic institutions. I want in particular to acknowledge the Palais Royal Initiative,[3] which produced a very important piece of work on this issue.

The view of the French presidency is that, certainly, we do need to continue all efforts on financial regulation, macroeconomic coordination and development, which were dealt by the G20 under the Korean presidency and the previous presidencies. Nevertheless, while the G20 has been very efficient during the crisis, to remain legitimate, it needs to tackle the macro issues that the global economy is facing. One of them is the reform of the international monetary system; the other one we have put on the agenda is the question of commodity price volatility.

The international monetary system we have inherited has actually proven quite resilient to the shocks. It has been able to deal not only with the financial crisis but also with the debt crisis. But it has also proven its limits.

The first limit is well-known: it is the inability of the current international monetary system to deal with the increasing global imbalances. The global imbalances have nearly doubled over the last decade. If we do not tackle the issue, it is very likely that, with the recovery, the global imbalances will resume their increase.

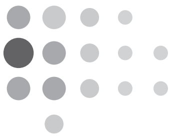
The second limit is the increased volatility of exchange rates and the increasing number of episodes of currencies misalignments. As an example, in March and April 2011, the yen reached its highest level against the dollar since World War II. It was also the case for the euro-dollar parity, with the euro going from 1.30 to 1.45 dollar in a couple of weeks, which does not reflect any change in the euro area economic fundamentals.

The third limit is the increased volatility of capital flows, especially flows to emerging countries.

The number of »sudden stops« (outflows of capital) has increased dramatically over recent years. We can count 42 episodes of sudden stops since 1990. The issue is that sudden stops have a detrimental impact on the economic situation of emerging markets but also on their social situation and their political stability. To fight against that, a number of countries have felt the need to accumulate foreign exchange reserve to a point that the amount of official reserves as a percentage of the global GDP has significantly increased.

The last limit of the current international monetary system is that it does not take into account the evolution of the global economy and the rise of emerging markets, in particular the »BRICS« (Brazil, Russia, India, China and South Africa). When we built the Bretton Woods system, there was only one economy and one currency: the United States with the dollar. When we moved to flexible exchange rates in 1976 with the Jamaica Agreements, there were only three main economic zones and three main currencies: Europe, Japan and the United States. But for now, the international monetary system needs to reflect the fact that the BRICS share of the world GDP will be larger and larger. The governance of the international monetary system should reflect that too. We have started to reflect this evolution in the governance of the IMF and of the World Bank. It is now time for large emerging markets to be better represented in the international monetary system.

3. The Palais Royal Initiative is a group convened by Michel Camdessus, Alexandre Lamfalussy and Tommaso Padoa-Schioppa, and also comprising Sergey Aleksashenko, Hamad Al Sayari, Jack T. Boorman, Andrew Crockett, Guillermo de la Dehesa, Arminio Fraga, Toyoo Gyohten, Xiaolian Hu, André Icard, Horst Koehler, Guillermo Ortiz, Maria Ramos, Y.Venugopal Reddy, Edwin M. Truman, and Paul A. Volcker, whose objective is recommendations for a cooperative approach to reform the international monetary system for the 21st Century. www.elysee.fr/president/root/bank_objects/2011-007. Palais-Royal_Initiative-Final_version_of_the_Report-Jan_18.pdf [see also »The Role of Surveillance in the Reform of the International Monetary System« by Jack Boorman, page 19]



To reform the international monetary system, we set an agenda that relies on several pillars. But before anything, it is important to clearly say what we do not intend to do.

We do not intend to go back to fixed exchange rates. On the contrary, we feel that the evolution towards flexible exchange rates is the right way to go because it is the best way to absorb shocks. At the same time, we feel that there is a need to accompany this evolution toward flexibility of exchange rates with rules and with enhanced surveillance.

We are not questioning the role of the dollar. We know that the role of the dollar will remain very important. It represents around 62 percent of international reserves and about 80 percent of international trade flows. So it is not a question about the role of the dollar. It is a question of looking at the reality of the world and the changing pattern of economic powers in the global economy.

We neither want to push for a systematic liberalization of capital flows everywhere and at all times, neither to impede these flows because we believe that international movements of capital is a good way to better allocate savings and foster growth. It is interesting to note that the doctrine of the IMF has evolved very recently on this matter.

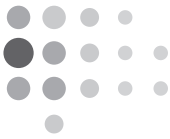
More precisely, the pillars of what we suggest as a reform of the international monetary system are of the number of four.

First, we need to improve economic policy coordination and surveillance. The spirit of the discussions of the April 2011 G20 Finance meeting shows that there is willingness from all members to go along with a Framework which, while respecting economic sovereignty, can yield better results for all of us. After the February 2011 G20 Finance meeting when we agreed on a set of indicators for assessing major imbalances, in April, we agreed on indicative guidelines to identify systemic economies that run imbalances. The next step is to come to an action plan whereby each country of the G20 would take economic action and economic policy that would reduce imbalances and support growth. This process can lead to a win-win solution for all the countries of the G20.

Second, we need to reduce the need to accumulate foreign reserves. The accumulation of reserves can be justified in order to deal with the volatility of capital flows but it has also some drawbacks. It bears an opportunity cost and can be a source of imbalance. In order to deal with that, we need to improve the liquidity supply in times of crises. We made some progress during the Korean presidency by revamping the facilities of the IMF. We need to assess those financial safety nets and improve them if necessary in particular to deal with systemic crisis. We also need to improve coordination between existing international and regional arrangements. We have the experience of the euro area with the European Financial Stability Facility and the role it plays with the IMF. This will bring us to work on the optimal level of reserves and the development of local currency financial markets.

Third, we need to better monitor and understand international capital flows. The multiplication of unilateral measures to respond to capital flows should not lead to a new financial protectionism. At the same time, we should offer the possibility for countries faced with a surge of capital inflows to use the appropriate instruments. For the French presidency of the G20, the right way to go is to create a multilateral framework which would deal both with recipient countries of capital flows and with the source countries of capital flows. Surveillance should be evenhanded and enhanced regarding spillover effects of economic policies: in an economically connected world, the policies that are decided in one country have an impact on other countries. This is one of the objectives of the IMF »spillover reports«.

Fourth, we need to ensure the emergence of new international currencies. We have already discussed a lot about the inclusion of new currencies in the composition of the SDR basket and there is clearly now a consensus among the G20. The seminar we organized in Nanjing in March 2011 thanks to the Chinese government was a substantial contribution to this consensus building. Its success is due to the fact that it was the first seminar of its kind, as a gathering of G20 members, non-members, academics and representatives of the private sector. We now need to agree on the path to go there. In the longer term, the IMF should reflect the role of the SDR more appropriately so that the SDR is a useful instrument. We don't think that it can be an international reserve currency as the dollar, the yen or the euro: it will take a lot of time to do that. But, the SDR can be an important instrument to deal with liquidity crisis and to provide the necessary, safe assets that are needed for some countries.



2011 will be an important milestone in the reform of the international monetary system as was decided at the April 2011 G20 Finance meeting with nine detailed objectives. We are aware that one presidency will not be able to deal with all the issues regarding the international monetary system. But, we feel that if we do not start today, then the world is condemned to other crises, other bubbles, other sudden stops, which will be detrimental to global growth and social welfare.

1.4 Strengthening the International Monetary System

Rishi Goyal, Deputy Chief, Strategy, Policy and Review, International Monetary Fund[4]

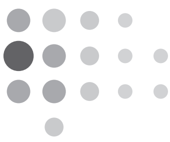
The current international monetary system has survived for over 40 years and has underpinned strong growth in cross-border trade, a core objective of the system. This growth has in turn contributed to raising incomes and generating employment across countries, and thus has helped to create the conditions for equitable development.

Rising cross-border trade as well as capital flows has resulted in economies becoming increasingly connected to one another. This cross-border connectivity can yield several advantages. For instance, when a shock hits a part of the system, a member can turn to others, thus dissipating more easily the effects of the shock. On the other hand, a shock to a large economy can be transmitted via the same connections broadly and rapidly across the entire system. So, even though stability may be perceived to have increased at the country level owing to a larger number of links and greater volumes of trade across different countries, the stability of the system as a whole may not in fact have increased.

With cross-border finance in particular being concentrated around a handful of economies—the U.S., the U.K., some European countries, Japan, and a few other financial centers—shocks to these core economies could have widespread and debilitating impacts. This was evidenced in the recent crisis, when a shock in one corner of the global financial system rocked the entire system. Recent analytical work at the IMF confirms the importance of financial channels; shocks propagating through these channels have particularly large effects in the near term compared to shocks that work via real or trade channels.

With global interconnections serving as conduits through which shocks can propagate, the question arises as to whether the frameworks and cooperative mechanisms exist to provide the necessary policy space to deal with shocks as and when they occur. The events of the past couple of years highlight the importance of this question.

4. IMF research referenced in this article is from International Monetary Fund, 2011, »Strengthening the International Monetary System: Taking Stock and Looking Ahead,« www.imf.org/external/np/pp/eng/2011/032311.pdf



There are four problems that need to be addressed to enhance the stability of the international monetary system. The first is that there are *inadequate mechanisms for adjustment*. The lack of adjustment to real imbalances has been highlighted for many years, but it applies also to the buildup of financial imbalances across the system. When adjustment occurs, it is asymmetric: it can be relatively large and abrupt in small deficit economies, whereas in large deficit economies that are reserve currency issuers there is much greater ability, and much more policy space, to finance deficits. Surplus economies also do not face automatic pressures to adjust.

The lack of adjustment creates risks for the global economy. A disorderly unwinding of imbalances—whether financial or real—would have significant destabilizing effects, adversely affecting in particular the most vulnerable sections of society. And, as economies recover from the crisis, it is important to note that not all of them can pursue an export-oriented growth strategy. If they attempted to do so, the system would be characterized by excess supply, limited demand, and potentially deflationary pressures. Growth needs to be rebalanced, which implies making the necessary adjustments to growth models, if it is to be sustained and strong.

A second problem is that there is *no comprehensive framework for dealing with volatile capital flows*. The data on capital flow episodes from the early '90s until now show that inflow episodes, i.e., surges of capital flows to both emerging markets and advanced markets, started at different times in different economies, reflecting various pull and push factors. However, the ends of these episodes—sometimes sudden stops—tended to be synchronized.

During the '97 crisis, the 2001 recession and the post 9/11 period, and the 2008 crisis, a large proportion of inflow episodes came to an end. Roughly 50 percent of episodes stopped in the '97 crisis and the 2001 recession and 9/11, and about 80 percent of the episodes stopped together in the 2008 crisis. Currently, a number of inflow episodes are ongoing. Based on the above-mentioned sample, roughly 60 percent of emerging markets are now recipients of large inflows, though only about 10 percent of advanced economies are also recipients by the same definition.

The volume of capital flows has also been volatile. Across advanced and emerging markets, and from one quarter to the next, there are very large changes to the volumes of gross inflows and outflows, often as large as 50 percent annual rates of change.

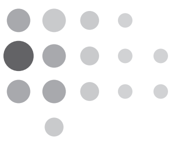
These flows reflect cyclical considerations in part. But a structural shift in portfolios may also be underway from advanced economies to emerging markets. Given the very large and deep financial markets in advanced economies, even a small reallocation of portfolios can result in very large inflows to emerging markets and can cause problems of macroeconomic management and adjustment.

All of these factors highlight the need for a dialogue among the sources or originators of these capital flows and the recipients of capital flows, in particular as turning the clock back on capital flows is unlikely. A framework for dealing with the size and potential synchronized stops of capital flows should enhance the stability of the system.

A third issue relates to the global financial safety net and, in particular, to *inadequate mechanisms for systemic liquidity provision.* The global financial safety net, which is the set of buffers to facilitate orderly adjustment to shocks, comprises the foreign exchange reserves of central banks, as well as regional and international arrangements for official lending. At nearly $10 trillion, the reserves of central banks (self insurance) vastly overshadows the amount of multilateral financial safety net resources available. This is inefficient. Moreover, central bank reserves are concentrated among a handful of economies, rather than being more evenly distributed or available to enhance the ability to absorb shocks. Reserve currency issuers are also very few in number.

The inadequacies of the global financial safety net were illustrated clearly in the crisis. Central bank swap lines had to be introduced early in the crisis in late 2007. The initial magnitude was roughly $600 billion, but this cap was subsequently removed between the U.S. Federal Reserve and the Central Bank of Switzerland, Bank of England, Bank of Japan and the European Central Bank. The shortage of reserve assets also prompted the opening of other swap lines and ad hoc arrangements, such as renminbi swap lines from the People's Bank of China for trade between China and its partners.

In all, a very large number of countries were involved in bilateral swap lines, many of which were ad hoc responses to the crisis and which points to the limited capacity of the system to withstand large shocks. If the



world continues to be fragile and susceptible to large shocks, we need to strengthen the cooperative mechanisms for providing adequate liquidity as and when shocks hit and are transmitted rapidly.

A fourth problem relates to *structural challenges in the supply of reserve assets*. The current system is centered on a very narrow set of reserve assets. For instance, though the U.S. economy is roughly one quarter of the global economy, it dominates global financial markets. Nearly one-half of foreign currency debt securities, over one-half of cross-border loans and deposits, about two-thirds of foreign exchange reserves and over 85 percent of foreign exchange transactions are denominated in or involve U.S. dollars. This concentration allows for large economies of scale, and thus efficiencies, in transactions. But it could also be a problem in that shocks to these core assets can transmit very rapidly throughout the system.

Over time, the global economy may move to a multi-polar system. Rapid economic growth in emerging markets should result in a greater convergence in incomes. Financial reforms and capital account opening should also facilitate some convergence in financial depth across countries. But it is not yet clear whether this transition to a more multi-polar, and possibly multi-monetary, system will be orderly. Nor is it clear that the new steady state will be more stable, that is, whether it will be one where policy discipline would be enhanced and adjustment more symmetric or whether for instance exchange rate movements would be very volatile.

To summarize, the current international monetary system has brought many benefits in the past four decades, including strong growth in trade and incomes. Further strengthening of the system and enhancing systemic stability requires overcoming four problems: (i) inadequate adjustment mechanisms, reflected in persistent external current account imbalances; (ii) the lack of a comprehensive framework for dealing with volatile capital flows; (iii) inadequate systemic liquidity mechanisms since, even though the global financial safety net has been enhanced in the last two years, it is not clear that the safety net is sufficient to cope with large systemic shocks; and (iv) structural challenges related to the limited supply of reserve assets.

1.5 A G-20 Developing Country Perspective on Good Global Governance to Reform the International Financial and Monetary System

Ambassador Jorge Argüello,
Chair: Group of 77 + China and
Permanent Representative from the Mission of Argentina to the United Nations

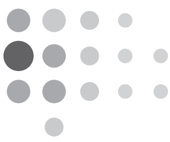
Argentina is wearing two hats at this very moment, as chair of the G77, on the one hand, and as a member of the G20, on the other. There are many opportunities this year to bridge between these two realities. That's the target toward which I was pointed by my president when we took office at the G77, and I should say that we are in constant contact not only with the French presidency of the G20 but also with the UN Secretary-General's office. Our objective is to interact in such a way as to have the best possible dialogue during 2011.

The reform of the international monetary system is a topic that encompasses a wide range of issues: reserve currencies, exchange rates, capital flows, and the global financial safety net among others.

First, we are convinced that the adverse impact of the world financial and economic crisis on developing countries has highlighted longstanding international systemic fragilities and inequalities. Moreover, the recovery is still uneven and uncertain and there is no guarantee that a relapse will not occur. As Mr. Strauss-Kahn mentioned to G24 members recently, we still need to be cautious while assessing the future.

The crisis has affected developing countries not only in economic terms by the presence of barriers to trade and financing, but also because of some of the anti-crisis measures taken by some developed countries that have led to a loss of jobs and created difficulties for governments to finance social programs that address poverty and the provision of basic services. This threatens the attainment of the Millennium Development Goals (MDGs).

This crisis, which arose entirely from regulatory and other institutional failures in the developed countries and in the international economic and financial system, compels us to insist upon more substantial reforms of the international financial architecture in order to achieve a fair and more equitable international economic system.



In that regard, we recognize the urgent need to enhance coherence in governance and the consistency of the international monetary, financial and trading systems. It also underscores the importance of ensuring their openness, fairness, and inclusiveness in order to compliment national development efforts to ensure sustained economic growth and the achievement of internationally agreed development goals, including the MDGs.

Significant changes over the last decade in the international system have to be reflected in the structure of the international monetary system. Formerly, when the International Monetary Fund (IMF) was a credit cooperative, and all members drew resources from it from time to time, they all had an interest in resources being available on reasonable terms and conditions. Over the years, however, the Fund has turned into an institution consisting of two distinct groups of countries, industrial country creditors and developing country debtors.

However, because political and economic changes have not been appropriately reflected in the decision-making structure of the Fund, this structure has become dysfunctional, and the governance of the Fund and the legitimacy of the Fund's policies have been increasingly questioned. Too often, the member countries see programs more as an inevitable imposition aimed at serving the economic and political interests of other parties rather than as a result of an exercise in monetary cooperation in which full participation gives them a sense of ownership.

The IMF's legitimacy, relevance and effectiveness in implementing its mandate depend critically on addressing the imbalances in voice and representation. The ongoing review of the IMF's mandate must go hand in hand with ambitious steps to improve the Fund's governance and legitimacy. Changes in the IMF's mandate must be anchored in broad-based consensus and applied in the spirit of mutual cooperation and understanding.

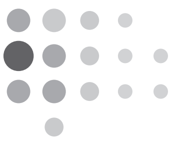
The IMF needs a more representative, responsive, and accountable governance, which is essential for all other changes involving the role of the Fund. In that regard, the existing quota formula is biased against developing countries and has to be improved. This calls for a quota realignment in international financial institutions to create an equitable voting power distribution between developed and developing countries without diluting the quotas and shares of individual countries.

In that regard, we need to broaden and strengthen the participation of developing countries in international economic decision-making and norm-setting bodies. We stress to that end the importance of making tangible progress to accelerate reform of the international financial architecture to reflect the reality of the 21st century. It is important, for example, to ensure that developing countries are as protected while the instruments of climate finance are developed under the United Nation Framework Convention on Climate Change (UNFCC) and not by Bretton Woods institutions.

This reform must address the objectives for which the IMF was created. First, to ensure financial stability; and secondly, to ensure access to liquidity for those countries that actually need it. The IMF should retain its primary mandate, which is to help countries with difficulties in their balance of payments. Several other topics are related to this fundamental issue. The increased allocation of special drawing rights could play an important role in global liquidity. Moreover, the potential expansion of special drawing right could also be a positive contribution to global stability, equity, and economic resilience, helping to mitigate the inequality bias of the current global reserve system.

For that reason, we, the developing countries, are asking for a new and significant general SDR allocation in the current period to meet liquidity needs and promote development as a first step, to be followed by regular and periodic allocations of SDRs. The expansion of SDR allocations is an effective and low-cost measure to quickly boost global liquidity, thereby providing countries in need the means to meet their external financing gaps and to implement countercyclical policies to mitigate the impact of financial crisis. SDRs can be held as assets in reserves at no net cost to be converted into hot currency if and when needed by government. Besides, in contrast to IMF loan financing, there are no conditionalities on SDRs.

Another key element in this context is the reserve system. In that regard it is necessary to consider possible alternatives in order to diversify global reserves. It is necessary to have a more efficient reserve system, which also takes into account the role of SDRs. It is also important to stress the need to strengthen the surveillance on developed countries' economic policies and their impact inter-alia on international interest rates, exchange rates and capital flows, including private and public financing in developing countries. In particular, the prospects of sustained low interest rates in the advanced countries have contributed to a surge in capital



flows to some emerging markets, putting upward pressures on exchange rates and creating overheating pressures, incurring risks of increased vulnerabilities and reversals.

There is a general concern about the resurgence of volatility in food prices. We consider that the international financial institutions should pay special attention to these matters in particular in financial markets, to ensure they are prepared to assist affected countries, and especially the poor, in coping with related crises.

In this context, developing countries must have the necessary policy space for pursuing tailored and targeted responses to the crisis, in accordance with their development needs and priorities. In addition, there is a need for a reformed lending and financing paradigm, including the establishment of new credit facilities as necessary, and the prompt end to conditionalities that curtail the individualized options available to developing countries and unnecessarily exacerbate financial, economic and developmental challenges faced by these countries.

The recent financial crisis has shown that orthodox economic policies were powerless to prevent a crisis. It is now suggested that more accommodating macroeconomic policies, inclusive and pro-poor policies and greater government involvement might do a better job in helping protect countries from financial turmoil. This crisis has indicated once again the need for a fundamental reform of the international financial system in order to secure greater stability and prevent virulent crises with global ramifications.

In conclusion, good governance at the international level—in particular in the international monetary and financial system—is fundamental for achieving a sustained and equitable economic growth. I would like to reiterate in this regard the importance of promoting global economic governance by addressing the international finance, trade, technology and investment patterns that impact on the development prospect of developing countries in order to ensure a dynamic and enabling international economic environment.

The international community has now the opportunity to take all necessary and appropriate measures to find an adequate response to the financial and economic crisis, one that takes into account the interests and specific needs of the developing countries. And I would like to add that we are optimistic about the possibilities that this near future is offering us.

1.6 Reforming the International Monetary 'Non-System'

Jomo Kwame Sundaram,
Assistant Secretary General, Department
of Economic and Social Affairs, United Nations

It is no secret that the international monetary system has basically been a 'non-system' for the last four decades. In particular, the push for capital account liberalization in the last couple of decades has changed many relations, processes and dynamics, exacerbating many problems.

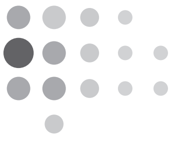
The question of equity and the overall structure of governance arrangements are being discussed, not only by the G20, in the International Monetary and Financial Committee (IMFC) and the Development Committee, but also by the UN. The President of the General Assembly has identified global economic governance as a major priority of his presidency. This subject was also identified several years ago by German Chancellor Angela Merkel, Indian Prime Minister Manmohan Singh and a number of other people as a major issue going forward.

The original spirit of Bretton Woods gave rise to particular arrangements and means, which were devised to address challenges in the international monetary system as perceived then, especially after the Crash of 1929 and the Great Depression that followed. Unfortunately, these arrangements have become ends in themselves, which pose a significant problem because we have often forgotten what the ends are. The question of Special Drawing Rights (SDRs) and the future of the global reserve currency are pertinent for this discussion as well.

For some time, many economists, Robert Lucas[5] among others, have noted the significant net flow of funds from capital-poor countries of the South to the capital-rich countries of the North, with about half these flows coming to the United States. Meanwhile, developing countries get less than a fifth of these funds, contrary to the neoclassical economic presumption that capital account liberalization would facilitate the net flow of funds from the capital-rich to the capital-poor.

Although everybody focuses on China in discussing con-

5. 1995 Nobel Laureate in Economics at the University of Chicago; known for his work on rational expectations and the »Lucas paradox«, which tries to explain why capital flows from developing countries to developed countries.



temporary global imbalances, there are other countries with large trade surpluses. There has been little discussion of this, although it will persist for obvious reasons, even if the current oil price spike is temporary. The biggest surplus is accounted for by the major oil exporting countries, led by Saudi Arabia; not unimportantly, the Gulf Council countries are important players in this regard.

The huge trade surpluses of Japan and Germany are justified by the implausible argument that their imbalances and related surpluses are required and excusable because they are aging societies. While it is true that aging societies face special challenges requiring special measures, these have very little to do with current account surpluses. Clearly, what we need is a more evenhanded approach to the issue of global imbalances.

China's huge surplus with the rest of the world is actually of fairly recent origin, dating from around 2004. Previously, China had a huge surplus with the US, but at the same time, had significant deficits with much of the rest of Asia (of developing Asia, at least) as well as with Africa.

The case of China is also significant, because of its twin surpluses. It is important to recognize that China's huge reserve accumulation is not simply about self-protection[6]. There are other factors involved, and there is an interesting debate going on in China about the main orientation (foreign or domestic) of production, and the distributional implications of these changes. We should be sensitive to these debates and take note of them.

The issue of commodity price volatility has to be distinguished from the related but distinct question of price *levels* as well as from the question of food security, because commodity price volatility affects other non-food commodities as well.

Food security is a very serious concern. For example, it has been estimated that, as a consequence of the commodity price spike of late 2007 and early 2008, over 100 million people became severely undernourished, while the recent price increases since late 2010 are estimated to result in over 44 million people going hungry.

6. I do not like the term »self-insurance,« which many of my colleagues adopt because there is no insurance element in reserve accumulation; it is simply for deterrent protection, not unlike the logic of deterrent military arms buildup.

There is also grave concern that the 'financialization' of commodity futures and options markets, as well as the interaction among stock, commodity and currency markets, have exacerbated volatility in all three and other related markets with very grave consequences.

Under the G20 French presidency, discussion of innovative finance has been revived. This was initiated over half a decade ago under the previous French president, together with President Lula of Brazil, but the discussion has now taken on greater significance in the face of serious doubts about the likelihood of raising adequate climate finance. In the summer of 2009, President Sarkozy, then UK Prime Minister Gordon Brown as well as the European Commission all made similar estimates on climate finance requirements before the Copenhagen climate Conference of Parties (CoP), but the commitments made have not materialized since and progress seems uncertain.

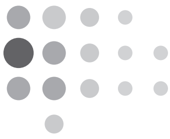
Climate finance needs to be revised and disbursed in an equitable fashion, and the relationship between public and private financing must be recognized, including the failure of some market instruments already in use—as acknowledged by *The Financial Times* and many others. The establishment of the Green Climate Fund and its Transitional Committee at the Cancun CoP in late 2010 has given some badly needed momentum, but its fractious leadership continues to plague the process.

There are still many challenges in reforming the international financial and monetary system for equitable development and shared societies. There has been a great deal of discussion at the United Nations with the crisis in 2008-09 (facilitated by then UN General Assembly President Father Miguel d'Escoto) and in other fora.

Many people have raised concerns regarding the shadow banking system in the context of the American debate on the Glass Steagall Act[7] and the Volcker Rule[8]. It has important international dimensions as well, with the Financial Stability Board (FSB) expected to make recommendations in this regard. However, the Basel Committee has been quite silent on shadow banking issues while the Basel III proposals are not considered to be either real sector friendly or

7. Also known as the Banking Act of 1933, it legally separated commercial and investment banking in response to the collapse of a large portion of the US commercial banking system.

8. The Volcker rule, introduced following the financial crisis of 2008, separates investment banking, private equity and proprietary trading (hedge fund) sections of financial institutions from their consumer lending arms.



development friendly, which raises important concerns.

There is skepticism among many G24 countries[9] on the extension of the Fund's jurisdiction and mandate. At the Hong Kong annual meetings in 1997, however, the Fund proposed to restrict the use of capital controls. The early 2011 belated IMF embrace of capital flow management measures, or capital controls, proposed a completely unnecessary amendment to Article 6, Section 3, of its Articles of Agreement, which would give the Fund much more discretionary power than it needs over member governments in implementing their right to capital controls, thus effectively reducing governments' own discretionary powers. Thus, the early 2011 Fund proposal was to enhance its own powers, but this time ostensibly to help governments exercise rights they already have under Article 6!

Another major issue highlighted by the crisis is fiscal sustainability. John Williamson has emphasized the importance of trying to achieve fiscal balance: in this regard, developing countries would benefit from greater international cooperation on taxation. Achieving truly inclusive global cooperation has so far proven particularly elusive, however. On the one hand, the OECD has invested considerable financial and staff resources in tax cooperation issues, with a view to establishing global leadership in this area, extending well beyond its limited developed country membership. Yet, as people such as Vito Tanzi, former Director of the Fiscal Affairs Department at the IMF and a former Undersecretary of State in the Italian Ministry of Economy and Finance, have noted, there are inevitable questions about how a body with such a small and privileged decision making membership can successfully lead in developing an inclusive, balanced and truly developmental framework for international cooperation on taxation with a sense of universal »ownership«.

The United Nations, on the other hand, has the natural leadership role on international tax cooperation, but has never been sufficiently resourced to fully meet that responsibility. There are positive developments, including the imminent return to a United Nations capacity-building presence in that area, and this is one area where the UN can work effectively with the OECD, the IMF, the World Bank, as well as regional and other bodies to fulfil that leadership role with a developing country focus, while recognizing the technical and policy work of others in the field. This will add extra credibility and convening power to international tax cooperation developments, including in the development of what may become de facto 'norms' on double taxation, transfer-pricing, exchange of information and other international tax cooperation issues. By taking its appropriate leadership role in this area, while working cooperatively with others, the United Nations can help ensure that initiatives towards greater international tax cooperation fully internalize the voice, priorities and realities of developing countries, and best support their sustainable development.

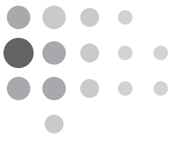
Another major concern is the need for a sovereign debt restructuring mechanism (SDRM). Although there were many objections to Anne Krueger's original IMF SDRM proposal, it should be revisited with a critical eye, so that the baby is not thrown out with the bathwater, as it was then.

There are also concerns with the overall coherence of the system. In this regard, for example, the World Trade Organisation's (WTO) General Agreement on Trade in Services has rules under its Financial Services Agreement which have serious implications in reducing terms of 'policy space' by requiring financial globalization, including capital account liberalization. Many decisions already made in Geneva have implications for what is widely presumed to be the preserve of Washington in terms of international finance. Thus, the system's overall coherence remains a challenge.

Finally, at the global level, there are challenges that need to be addressed, and in a sense, President Roosevelt did try to address them. He made a very specific commitment in 1944 to call the conference at Bretton Woods the »United Nations Conference on Monetary and Financial Affairs« even before the UN had been formally set up in San Francisco. The original promise of Bretton Woods sought to create the conditions for world peace through sustained and stable growth, especially employment creation, postwar reconstruction and post-colonial development, all very much related to develop a shared society at the global level.

For that reason, we should revisit the spirit of Bretton Woods: President Roosevelt was not just concerned about monetary and financial stability, but had a much greater vision of a truly inclusive shared (international) society after the 'war to end all wars'—to which I hope we are able to rise, in our times, from the wreckage of our recent and ongoing global crises.

9. The Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24), established in 1971 to coordinate the position of developing countries on monetary and development issues at the International Monetary Fund (IMF) and the World Bank, and to ensure the increased representation and participation of developing countries in negotiations on reform of the international monetary system.



1.7 Seven Essential Characteristics of a Good International Monetary System

Yi Gang, Deputy Governor, People's Bank of China

On the improvement and reform of international monetary system, I would like to make three points.

First, what is a good international monetary system? If we want to make reforms and improvements to the international monetary system, they must promote the characteristics that such a system should have. I suggest the following seven characteristics of a good international monetary system:

1) It should promote development, which means that the system can facilitate trade and investment.

2) It should provide correct incentives for those who work hard, so their efforts can pay-off. This means, whether the country is big or small, and regardless of its region or religious makeup, et cetera, it should provide the right incentives.

3) It should be able to do the adjustment when the balance of payment is imbalanced. International history suggests that countries compete for different reasons, some based on mercantilism (and a positive balance of trade) others to make their money cheap. The system should be able to provide a mechanism to adjust each of these kinds of imbalances.

4) It should be able to provide a safety net so that during a crisis it can provide the necessary liquidity to deal with the crisis.

5) It should have an accurate representation of the world and reflect the world economic fundamentals.

6) It should be stable and resilient against all kinds of shocks—economic, political and otherwise.

7) It should contribute to maintain the stability of exchange rates and effective regional arrangements.

If we consider human history for the last 100 or more years, we have experienced the gold standard, the Bretton Woods system and also the post-Bretton Woods (Jamaica Accord). Each of these different versions of the international monetary system can address some problems better than others. A desirable system should find an efficient balance between the strengths and weaknesses of the various systems.

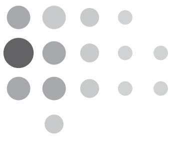
The second remark I want to make is that if we know what a good international monetary system should look like, the next step is deciding how to reform the current international monetary system accordingly. Before we answer that question we have to ask, »What are the vulnerable points, the shortcomings of the current system? We need to focus our surveillance on those points in order to prevent another crisis. The Lehman Brothers crisis of 2008 shows that a lack of financial supervision is a vulnerable point that can trigger systemic risk.

Another example is the sovereign debt crisis of Europe: for a long time, surveillance and supervision of the advanced economies was largely ignored, then suddenly they built up high budget deficits and accumulated too much government debt, producing a sovereign debt crisis which has also caused systemic risk.

A third example concerns global liquidity and capital flows. And if we provide too much liquidity globally, we risk triggering abrupt capital flows in or out, which can be dangerous. Some say that liquidity is a term that's not defined clearly enough. Roughly speaking, global liquidity, as the term is used in IMF and Bank for International Settlements (BIS) research papers, refers to the total supply of the main reserve currencies. Global liquidity has two dimensions: one is the quantity of the money supply; the other is the price, e.g. the interest rate. If the quantity of supply is very large while the interest rate is very low, it means there is abundant liquidity globally.

The fourth vulnerable point concerns imbalances. We know that the accumulation of a trade surplus, the accumulation of a trade deficit, can produce dangerous external imbalances. If we can identify these vulnerable points, we can focus our surveillance to prevent a crisis from happening. But this is difficult: sometimes there is a focus on one dimension combined with a neglect of other dimensions that can then produce instability.

For example, in 2008 and 2009 the sovereign debt crisis occurred. With institutions like the International Monetary Fund, the capacity of surveillance is limited. It is impossible for surveillance to detect every vulnerability, every time, so we have hard choices.



In my third remark, I will comment briefly on broadening the SDR basket. Broadening the SDR basket is a good idea but we also have to look closely at the two IMF on this: 1) the basket of currencies should consist of the largest exporters. (This means that trade, especially export, is the most important consideration for currency to be in the basket), and 2) the currency should be freely usable. Keep in mind that the IMF is not using the term »fully convertible,« but »freely usable« which means that it's freely usable for payments, settlements of trade and maybe some Foreign Direct Investment (FDI) transactions.

The obvious candidates among the currencies are the BRICS countries. We should look to both the BRICS countries and the IMF for criteria. For most of the BRICS countries, the first criterion—export—is already satisfied, but the second criterion is rather weak. But a lot of countries are working on it and there has been rapid improvement.

If we put the BRICS countries into the present SDR basket, or even if we consider more countries to make up the SDR basket, we find that the new basket would decrease the volatility of the present basket in terms of variance and standard deviation. The broader basket would also have better representation, which reflects world economic fundamentals.

I think in terms of commodity trade and export, and in terms of the valuation and the resilience of the SDR, this would be beneficial. I know that it takes time and we have to follow the rules. There is no hurry, but I suggest to IMF, we're starting to calculate. We shadow the SDR, which means that the IMF should calculate the simulation by using data so that we can accumulate statistics and evidence to inform future discussions and consideration of this issue.

2. The Changes Necessary to Create a Stable and Well-Functioning Monetary and Financial System

2.1 The Role of Surveillance in the Reform of the International Monetary System

Jack Boorman, Former Director of the Policy Development and Review Department, and Counsellor and Special Advisor to the Managing Director, International Monetary Fund; Member of the Palais-Royal Initiative

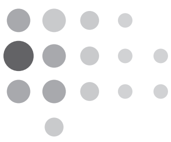
The recent financial crisis and the resulting recession have once again focused attention on problems in the international monetary system. Virtually everyone agrees that major elements of that system need to be reformed. But there are different diagnoses of what is wrong with the current system and the changes that are needed to create a more stable, sustainable and equitable system.

The weaknesses in the current system that require the most urgent attention lie primarily in two areas. The first concerns ineffective surveillance by the IMF and confusion over the responsibility for surveillance as a result of the emergence of the G20 that has proclaimed itself »the premier forum for international economic cooperation«. Second, there are major problems with the current governance structure—both within the IMF itself and, more generally, in the global governance structure for international economic and financial policy cooperation. First: on surveillance.

The Fund staff itself has identified many of the weaknesses in the surveillance process in its many reviews of surveillance and in its recent papers on the Fund's mandate. The Independent Evaluation Office (IEO) has also contributed importantly to these discussions—perhaps most notably in its recent report on the IMF's performance in the run-up to the recent—and still ongoing—financial and economic crisis.[10] The weaknesses pointed to in these works are familiar—and they are present in both the Fund's bilateral surveillance with individual member countries and in its multilateral surveillance.

For example, in its last Triennial Review of Surveillance in 2008, staff pointed to insufficient attention to risks around the baseline scenarios developed to assess countries' prospects—and too little attention to low-probability but high cost risks; insufficient integration of macroeconomic and financial sector analyses; a somewhat myopic country focus that gives insufficient atten-

10. See »IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-2007« Independent Evaluation Office. International Monetary Fund, 2011.



tion to cross country dependencies and spill-over effects; weaknesses in exchange rate analyses and in the candor with which the results of those analyses are presented; and differential treatment of member countries—or lack of evenhandedness—in the surveillance process. To their credit, the staff has been fairly blunt about these problems and has pushed for change in a number of areas.

The IEO's assessments have been more hard-hitting. The IEO faults the Fund for analytic weaknesses, including the familiar failure to better integrate macro and financial analyses; insufficient attention to money and asset markets, as well as weak balance sheet analysis; and weaknesses in the Financial Sector Assessment Program (FSAP) process—including the failure of stress tests to capture second round effects or the impact of liquidity shocks. But the IEO goes further, criticizing the tendency to what it calls »group-think« in the Fund, and undue readiness to accept the received wisdom about the efficiency of markets and the capacity of market-discipline and self-regulation to stave off problems in the financial sector. The IEO is also much more critical of organizational impediments—the familiar silo-mentality said to persist in the IMF and what it sees as internal governance problems. It is also—and understandably—more candid on the political constraints that exist in the institution.

Multilateral surveillance has also come in for its share of criticism. The World Economic Outlook (WEO) is seen to have stayed far too long in a sanguine state about the vulnerabilities that were building up in the global system and to have focused too narrowly on the obviously problematic persistence of global imbalances in the system, while giving too little attention to the problems developing in the financial system. The Global Financial Stability Report (GFSR) gets somewhat higher marks for seeing the emerging risks in the banking system earlier, and for flagging issues stemming from the growth of the derivatives markets and securitization. But it is faulted for not pursuing those concerns. Several observers have pointed out that these weaknesses are a symptom of the failure to integrate macro and financial analyses and have concluded that that can be corrected only by a much tighter integration on the work that goes into the production—and presentation—of these two flagship reports of the institution.

There is merit in virtually all of these criticisms. However, greater emphasis should be put on two other problems that have received less attention than they require if surveillance is to be substantially strengthened. The first goes to the issue of getting greater traction and greater effectiveness—i.e., real policy adjustment—from the Fund's surveillance. The second is the sine qua non of getting that greater traction: namely, changes in the governance structure within the IMF, as well as in the global economic and financial system.

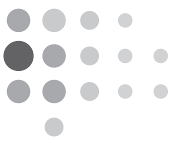
The need for greater traction is all too obvious. Current account imbalances have been permitted to accumulate for extended periods -and at clearly unsustainable levels. Neither bilateral surveillance of individual countries' policies nor the multilateral surveillance exercise undertaken by the Fund in 2007 curbed the growth of those imbalances. Only the recent crisis reduced the imbalances—and then only temporarily. They are expected—by the IMF and others—to continue to grow in the years ahead.

Similarly, and obviously related, exchange rates of the major currencies have fluctuated excessively over long periods of time and have clearly deviated from fundamentals as a result of inadequate fiscal, monetary, exchange rate and other policies, or as a result of market forces—the latter driven by expectations about those very policies. Financial excesses have developed unchecked—especially in the United States, often driven by inappropriate fiscal and monetary policies. The resulting expansion of global liquidity has generated large swings in capital flows, often overwhelming countries' ability to preserve macroeconomic and financial stability. International reserves have grown—and continue to grow—to problematic levels, not least costing the accumulating countries more than the value of the self-insurance they may be seeking.

All of these issues were raised in the surveillance process—even if not with an effective portrayal and urgency associated with the risks they involved. But little adjustment was made in the policies of the major involved countries as a result of that surveillance. A Group put together by Michel Camdessus, Alexandre Lamfalussy, and the late Tommaso Padoa-Schioppa—known as the Palais-Royal Initiative, addressed the problem of ineffective surveillance by the IMF and made a number of important suggestions to help strengthen the system.[11]

The most relevant of those suggestions are the following:

11. See »Reform of the International Monetary System: A Cooperative Approach for the Twenty First Century«, The Palais Royal Initiative, January 18, 2011.



Suggestion 1. IMF member countries should undertake to ensure that their policies are conducive to the stability of the global economic, monetary and financial system—and do this by taking account of the impact of their policies on other countries or on the system. The Report suggests that Article IV of the IMF Articles of Agreement be amended to reflect this strengthened commitment and to ensure that »firm surveillance« by the IMF applies not only to exchange rate policies but also to all economic and financial policies relevant for both domestic and global macro-financial stability. In the same spirit, Article VI should be amended to provide the IMF with the mandate it needs to effectively monitor and assess capital movements and restrictions on such movements imposed by member countries. Its role in this area should be similar to the prerogatives it has regarding current account restrictions. The assessment of capital flows should also include analysis of developments and policies in the source countries that are driving those flows.

Suggestion 2. In support of surveillance over each country's or group of countries' compliance with the obligations under the Articles, the IMF should adopt norms for members' policies that draw on the advice and experience of all IMF members and other available expertise. The norms might cover, for example: current account deficits or surpluses; real effective exchange rates; measures to deal with capital inflows and outflows; changes in relative size and composition of reserve assets; inflation rates; fiscal deficits; and government debt ratios. Norms might also be established with respect to financial sector soundness and the effectiveness of banking supervision. Norms should be established in such a way that they function as alarm signals, with appropriate thresholds defined for each of them whenever possible.

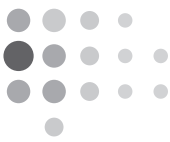
Suggestion 3. Persistent breach of a norm would trigger a consultation procedure and, if needed, remedial action. This is key to getting traction—or putting teeth—into the surveillance process. The purpose of the consultation would be to ascertain the underlying causes and potential consequences of deviation from the norm, both for the country itself and for the good functioning of the international monetary system. The assessment would have to look at all relevant factors, including economic policies in the country concerned and in other countries. If the assessment concludes that a persistent deviation from the »norm« is not justified by any relevant specific circumstances and is a source of serious disturbance for the good functioning of the system, it should be followed by policy recommendations.

Suggestion 4. For systemically relevant countries whose policies do not appear to meet the norms, compliance with obligations should be explicitly ruled upon by the relevant organ of the IMF. All countries would be subject to the same obligations; and compliance with these obligations would generally be assessed in the context of IMF bilateral surveillance. However, a more stringent process would apply to countries whose policies are seen by the IMF as having a potential impact on the stability of the system. Moreover, oversight of compliance with IMF obligations should be more transparent than is currently IMF practice in order to increase the accountability of those engaged in the surveillance process.

Suggestion 5. The IMF should develop positive incentives for countries to remain in full compliance with the requirements of the strengthened surveillance system. Such incentives could include automatic qualification for liquidity facilities (such as the flexible credit line -FCL and precautionary credit line -PCL) and access to the voluntary SDR market[12]

Suggestion 6. Finally, and probably most controversial, consideration should be given to including in the surveillance framework the possibility for the IMF to impose appropriate graduated remedial actions if a country has persistently violated one or more obligations. The process might entail more in depth analysis of what the breach of the norm might imply, initial informal meetings with the country concerned, possibly a special consultation, a review by the ministerial body overseeing the IMF, and, ultimately, if no action is taken by the concerned country, moving to the next phase of consequences. The latter might include, e.g., intensive follow-up reviews and public reports on the country's policies and its global spillovers; financial penalties; freezing part or all of the country's voting rights in the IMF; and/or restrictions on capital flows to countries in current account deficit or with an unsound financial sector. The activation of WTO procedures and trade sanctions, based upon IMF's assessment, could also be considered.

12. For example, by allowing a member to sell SDRs against freely usable currencies without having to demonstrate a balance of payments need and without recourse to the mandatory procedure called designation.



The G20 has already taken up the issue of norms or indicators and has moved some distance in considering limits to current account imbalances. However, the issue of sanctions for breaches in any such norms has not yet been addressed.

Governance Issues

Better and stronger rules and procedures cannot by themselves bring about the changes needed to promote more effective surveillance. That will only occur if significant changes are made both to the governance of the IMF and, more generally, to the overall governance structure for global economic and financial cooperation. Fortunately, there is already agreement about some of the needed changes in the IMF. The recently agreed quota increase moves in the direction of recognizing the dramatic changes that have taken place in the relative economic and financial positions of member countries in the global system.[13] Similarly, the decision to move to an all elected executive board and to increase the representation of emerging market countries in the executive board, holds the promise of creating interesting possibilities for a new constituency structure. Hopefully these and other changes will help increase the interest and engagement of members in the institution and bolster the level of their participation. Only greater engagement by senior officials will create the environment for the reforms elaborated above to have their intended effect.

Beyond governance reform of the Fund itself, the global economic and financial governance structure needs to be strengthened. This issue, too, is addressed in the Palais-Royal report.

As the report states, there is a clear need for a decision-making structure that combines legitimacy and effectiveness by giving a formal framework to the relationship between the pertinent Heads of State, the associated Ministers, and key International Financial Institutions. While the G20 is an improvement of the G7/8, it lacks the legitimacy needed to be fully effective. It also risks demeaning the IMF's surveillance responsibilities by essentially taking surveillance of the G20 countries out of the IMF.

An effective surveillance body needs to be relatively small, and something around 20 members may be about the right size. Clearly a body of 180 or 190 members, such as the membership of the IMF, cannot work. The only means to combine the need for universal representation to provide legitimacy and limited active participation to assure efficiency is a constituency system. This has served the IMF and other international organizations reasonably well over the years and should be the structure employed at the global level.

Thus, to ensure both effectiveness and legitimacy, consideration should be given to a governance structure for the international monetary system based on a single three-level architecture, ensuring universal representation through a system of constituencies.

The three levels would be comprised of:

First, the Heads of Government or State, meeting sparingly (e.g., once a year) except in times of crisis;

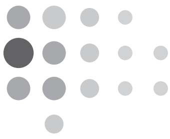
Second, the Finance Ministers and Central Bank Governors, taking strategic decisions related to the functioning of the international monetary system in the framework of a »Council« as envisaged in the Fund's Articles of Agreement. This Council would be activated to take over and effectively merge the functions of the IMFC and those of the G20 ministers and central bank governors, as far as the latter's role in the global economic, monetary and financial domains is concerned. The Council would prepare the meetings of the Heads of Government insofar as they address economic and financial issues.

Third, Executive Directors—at a very senior level—would oversee the work of the IMF and its managing director, with clear accountability to the Council.

These organizational changes would require an adjustment of the existing constituencies in the IMF and of the number of chairs at the three levels. However, those changes will need to be made in the Fund in any case under the governance changes already agreed for the Fund.

This should be combined with a lowering of the voting threshold on most important decisions in the IMF from 85 percent to 70-75 percent, as well as the extension of double majorities to a few other decisions, thus ensuring that decisions affecting key aspects of the institution command the support of the majority of members.

13. However, the increase is insufficient from the perspective of providing sufficient resources to the Fund and bringing the Fund closer to the model of a lender of last resort.



To facilitate institutional coordination, the BIS, the FSB, the WTO, the World Bank and possibly other organizations could be invited to meetings of the Council.

The Palais-Royal report also suggests that, in order to give a stronger voice to the global interest of the system, consideration should be given to establishing a Global Advisory Committee (GAC) made up of eminent independent personalities. Such a body could provide independent advice to the key organs of the IMF (e.g., the IMF Council, Executive Board, and the Managing Director) in the fields of surveillance, management of international liquidity and reserves, and other matters.

The changes proposed here represent a significant change in the way in which the global system has operated to date. The long delays that have characterized the modifications to the system that have been made to date have been harmful to the system. Thus, these further changes are urgently needed if there is to be a reasonable chance to confront the challenges facing the system today. They also hold the promise of making the international monetary system more democratic and more equitable.

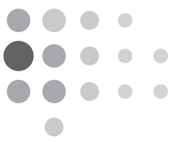
2.2 What Is Necessary To Ensure the Participation of Developing Countries in a Multilateral Effort to Reduce International Imbalances

Jan Kregel, Senior Scholar and Program Director,
Monetary Policy and Financial Structure Program,
Levy Economics Institute

The reform of the international financial system appears to be a perennial post war problem. Most of the current reform proposals seek to resolve a problem that has perplexed economists and governments since the creation of the Bretton Woods system: the problem of the role of the US dollar. Initially it was the problem of »dollar scarcity« in the postwar period, and then it became the problem of excessive dollar creation, reinforced by the rise of the Eurodollar market in the 1970s. In a rather long professional career I cannot recall a period in which there has not been a proposal to replace the role of the dollar in the international financial system.

In considering these various proposals, it is interesting that in the 40 odd years that the question has been under discussion not one of them has managed to generate any international traction or multilateral support. Now, if one is to assess these particular proposals from the point of view of the topic of this publication, that is, support for equitable development and shared societies, the place to start is with an assessment of how the original Bretton Woods discussions tried to deal with those particular issues as a benchmark for assessing current difficulties and to see how the proposals that have been put forward to solve those difficulties might include measures that would provide the basis for equitable development and the sharing of that development.

My reading of history is that the architects of Bretton Woods were concerned about three basic problems. One was the collapse of international trade and in particular the currency turmoil that we now know as the »beggar-thy-neighbor« problem, that is to use competitive currency devaluation to gain commercial advantage over one's trading partners. The second was the problem of hot money flows, in particular from those countries with rising political instability and repression, and then war expropriation. The third problem was the high and sustained levels of unemployment that plagued the United Kingdom (UK), the United States (US) and parts of Europe starting after the First World War.



The 1944 conference at Bretton Woods clearly did not seek to solve all three of these problems. In fact, Bretton Woods, as it eventually emerged, only sought to solve one of them and that was the problem of exchange rate instability. I will return to that problem below since one of the difficulties that current reform proposals are seeking to address is the so-called volatility of the dollar exchange rate. At this point, I simply want to draw attention to the similarity of the problems then and now.

Basically, the intention was to design an international financial system in which the value of national monies should be stable so that exchange rates would be stable and provide support for the expansion of multilateral international trade to allow countries to gain the benefits of freer trade and the benefits of increasing productivity without having them offset by competitive adjustments in exchange rates.

Now let us consider the problem of capital flows. This problem is dealt with in Article VI of the IMF Agreement: Obligations Regarding Exchange Arrangements. It is based on the principle that it would be preferable if large capital flows could be limited—if the objective is a stable exchange rate system. In particular Article VI gives members of the IMF the right to control capital flows. The impact of international capital flows is also a current concern of modern reform proposals.

Finally, there is the question of persistent unemployment. Here the reference point is the British proposal better known as Keynes's proposal for an International Clearing Union rather than an exchange stabilization fund, which was the US preference and which eventually prevailed in the final form of the IMF. One of the characteristics of the Keynes proposal was that if countries were to be able to pursue full employment policies in an integrated multilateral system with fixed exchange rates it would be necessary to devise a system in which domestic policy autonomy—or what we now call autonomy in terms of designing national development strategies—was present concurrently with a process of more or less symmetric adjustment of international payments imbalances so as to allow exchange rates to remain relatively stable.

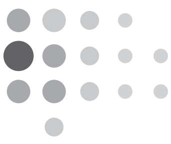
The interesting point about this question is that it presumes that individual countries should be free to pursue divergent national development strategies. At the time of the original Bretton Woods conference this was of importance for an additional reason: the presence of a number of countries following state-led development strategies, but also because of the needs of diverse policies for developed and developing countries.

Current discussions are not a replication of the prior concerns as the problem of unemployment no longer factors into this debate. But the question of coordination versus diversity of national development strategies has remained. And here the discussion has moved in the opposite direction, away from diversity and towards increasing multilateral coordination. The proposals of the Eminent Persons Group of the »Palais-Royal Initiative[14]« on the redesign of Article IV surveillance to require more coordination of national policies are directly concerned with this issue. And the question that they raise is how much national autonomy countries would still have within that particular framework. In particular we must today consider the question of developing countries' development strategies, a question that was not of major concern at Bretton Woods due to the scarce participation of developing countries in the process of drafting the Articles of Agreement (another perennial problem!). Indeed, Bretton Woods was a meeting primarily of developed countries, and it considered the problem of the appropriate international adjustment process mainly from the point of view of adjustment amongst countries at a similar, advanced, level of development.

As noted above the problem of unemployment was in the end not directly addressed in the Agreement. The scarce currency clause was added in order to provide some semblance of symmetric adjustment, but it has never been invoked and never became part of the conditionality of the Fund. Development issues were likewise ignored and only came under consideration in what was to be the third pillar of the Bretton Woods system: the International Trade Organization. The Havana Charter, which lays out the organization of the ITO, does contain a long and detailed section not only on the problems facing developing countries and the difficulties that they would have in entering into what eventually became the General Agreements on Tariffs and Trade (GATT), but also contains a section on the support of employment.

In the end, the development issues that would have provided for the autonomy of national development

14. See »The Role of Surveillance in the Reform of the International Monetary System« by Jack Boorman, page 19



strategies for developing countries proved to be something distinct from the problems of unemployment facing developed countries. The autonomy to follow such policies dropped out of discussions in the multilateral institutions because the Havana Charter was never approved, and the third pillar of the international financial architecture, the ITO, was never created. As a consequence the issues that would have responded to the objective of our discussion in this publication, the equitable development in shared societies, all effectively fell out of the multilateral process centered around Bretton Woods.

In the end what remained of the Havana Charter process was simply the General Agreements on Tariffs and Trade. Prolific Canadian economist Harry Johnson used to refer to the GATT as an institution for the preservation of tariffs and trade restrictions. He argued that since tariff reductions were based on a quid pro quo process, you have to have a tariff before you can bargain it away, and as a result countries would be discouraged from completely eliminating them.

The corollary to this in terms of developing countries is that in order for any sort of trade agreement to have an impact on your economy you have to have something to trade. And because of their scarce participation in international trade at the time most developing countries chose not to participate in the GATT agreements, which were replaced by what became preferential agreements, and then subsequently through the Global System of Trade Preferences.

So the way in which developing countries could maintain autonomy in terms of their domestic strategies was either through non-participation in the system or some sort of special treatment within this system. At the end of the 1970s the concept of special and differential treatment for developing countries entered the GATT universe.

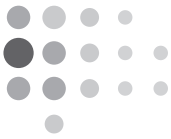
Indeed the discussions around the failed adoption of the Havana Charter suggested that developed countries considered that it made little sense to set up a system in which countries were supposed to be bound by common rules while regulation allowed a very large proportion of the world economy exemptions from those conditions.

If we now return to our current problems, what problems do we have from the original post-war list? I've already mentioned the volatility of the dollar and international capital flows. The problem of employment and the problems of development are also still present and we still have the problem of the design of an effective adjustment mechanism for international imbalances. And with respect to the latter it is interesting that the adjustment mechanism dealing with the imbalances is now very clearly a question of imbalances created by autonomous decisions over national development strategies. The challenge is that it is not likely any sort of currency reform dealing with the dollar is going to eliminate these sorts of problems. Indeed, will any sort of reform of the IMF system of surveillance—e.g. making it broader and bringing in more elements—make it possible to reduce the difficulties that are caused by these challenges? I would argue that this is highly improbable.

In order to make this argument, I'm going to jump to the strong case. That is to ask the question: would the Keynes proposal for a Clearing Union provide a better mechanism for dealing with these issues? If you remember, the Clearing Union proposal was for a notional international unit of account. The SDR is not the equivalent of this notional currency, but many people believe that it is very close. The idea was that surpluses and deficits across countries, what we now call international imbalances, would be adjusted by bookkeeping entries in the accounts of countries denominated in this notional unit of account. There would be no international trading in this currency, that is, it could not be held privately or used by private individuals to make payments. And for that reason it resolved some of the problems that were caused by international capital flows or international hot money flows. That is, if private financial institutions could not trade this notional currency then they could not move it across borders.

There was also an internal mechanism that was supposed to solve the problem of stability of exchange rates and at the same time provide the possibility of autonomy in terms of national development strategies. This was a mechanism of symmetric adjustment, that is, the requirement that adjustment is the responsibility of both surplus and deficit countries with charges applied to surplus countries if their positive balance exceeds some predetermined limit.

Now it seems that the discussions currently going on in the G-20 concern how to identify those notional limits and whether there are indicators that can be stipulated



to identify the point at which a country has gone beyond an acceptable imbalance, thereby making it incompatible with currency stability.

The difficulty here is one that has already been seen inside the Eurozone. If you recall Ireland used to be an underdeveloped, depressed economy. But, from 1990 to 1995 Ireland's economy grew at more than 5 percent per year and from 1996 to 2000 at more than 9 percent a year. In 2003 Ireland's per capita income was higher than the United Kingdom's. But, for the European Commission Ireland was considered to be growing too rapidly and requested to take measures to slow their expansion. Now this is something that is extremely difficult for a government to do if it is an underdeveloped area that is simply trying to catch up. This is the equivalent of being penalized for succeeding in what you are supposed to be doing.

And the same kind of problem would apply to virtually every developing country that would be part of Keynes's Clearing Union. Let us take the example of China. The Clearing Union would be saying to China, »I'm sorry, you are doing too well. Your development strategy is too efficient and therefore we are going to assess you a fine and ask you to implement policies to retard your development.« And it seems to me highly unlikely that this sort of adjustment mechanism would get any sort of traction with developing countries. But this is also precisely what would occur under the current proposals for multilateral surveillance and increased uniformity of economic policies to reduce international imbalances.

In the absence of acquiescence of rapid developers to this kind of treatment, the question becomes what sort of mechanism could be devised in order to create some sort of compatibility with currency stability, since most people argue that one of the basic difficulties is the volatility of the dollar as the world currency. And clearly the introduction of the SDR does not solve the problem. Even if all reserves were held in SDRs it would not change the fact that the Chinese development strategy would be pursued in exactly the same way that it is currently done now with the same impact on international imbalances and volatility between the SDR and national currencies.

So I would suggest that the conundrum that we face is much more difficult than the one that was faced in 1944. That is, if we do want a system in which we have a semblance of international monetary stability, and this does not mean going back to fixed exchange rates, but to exchange rates that are appreciably more stable than the dollar has been in the past, then there has to be some sort of compensation mechanism between developed and developing countries, which would require something similar to Prebisch's suggestion at the first UNCTAD conference of the creation of a compensation fund. Prebisch proposed a compensation fund in order to offset what he believed was the negative impact of the declining terms of trade on the revenues developing countries could generate from expanding their commodity exports. And he suggested that a simple calculation could be made as to the size of that disadvantage, and developed countries should provide monetary compensation to offset it.

In the case we are currently discussing it is clearly not a question of declining terms of trade, but of a sensible quid pro quo for developing country participation in a multilateral control over development policies to reduce international imbalances. That is, if we are going to ask developing countries to contribute to international stability by growing less rapidly or shifting strategy from stabilizing exchange rates, or to change from a strategy that is export-led to one which is more domestically demand-led, this will come at a cost to the developing countries in terms of foregone income growth which should be offset by the developed countries. That is, if reduced international imbalances are advantageous to developed countries because they provide greater global stability, then they should be willing to meet part of the burden. If developing countries are asked to contribute by adjusting their development decisions, then there should be a quid pro quo; that is, the developing countries should not be the only ones who pay. The developed countries should also contribute. In this way we might convert the new international system into one that has a shared and equitable division of benefits and costs.

2.3 On the Role of the European Union

Antonio de Lecea, Minister for Economic and Financial Affairs, Delegation of the European Union to the United States

The European Union—with its increasingly interconnected economies, both within the EU and globally—provides a good example of how to cater to the need for autonomy in the creation of policies, while remaining interconnected and increasing integration by creating common policy instruments and defining the governance of those instruments.

The European Union (EU) countries opted for free and non-discriminatory capital mobility in the late 80s. They agreed to allow for the free flows of capital between member states, as well as with the rest of the world. EU countries reaped significant benefits from this policy. Free capital movements are at the heart of the EU's growth, both in the core countries, and even more so in the peripheral member states. The countries that were lagging behind benefited significantly from this open system. At the same time, free capital movements facilitated the development and integration of new financial markets which, again, benefitted both core and peripheral countries. In order to reconcile policy autonomy with the need to address interconnectedness, we created fiscal and structural monitoring and policy coordination mechanisms. This system not only brought stability and some fiscal discipline to the EU but was also a source of global stability.

We must acknowledge that it was not enough to prevent unsound autonomous fiscal policies in some countries, and that it also allowed for the creation or persistence of macroeconomic imbalances in some Euro-area countries. At the same time, there was little pressure from the markets to correct the imbalances. These countries managed to finance both private and public imbalances easily and cheaply. Easy finance hindered the corrective fiscal and structural adjustment that is necessary in order to make that system stable.

When financing from the markets seized up, these underlying imbalances came to the surface with great acuity. Some countries were forced—immediately and painfully—to correct accumulated fiscal imbalances and to hastily do their overdue homework as regards structural reforms to restore competitiveness and growth. In the meantime, the European Central Bank (ECB), with the help of the US Federal Reserve (The Fed), provided a liquidity backstop. The Euro area, in coordination with the IMF, quickly created a sovereign backstop mechanism, coordinated with the IMF, to help member states with difficulties. The ECB also improved and strengthened the surveillance process and policy coordination mechanism so as to avoid the recurrence of significant imbalances.

What lessons can we draw for the reform of the international monetary system? We see three major ones. The first lesson is that ensuring sound and sustainable macroeconomic policies is crucial in our efforts to strengthen the international monetary system. Both instruments and governance must go in that direction.

In this respect, as referred to by Mr. Boorman[15], it is of crucial importance to enhance IMF surveillance, both bilateral and multilateral, particularly surveillance of spillovers from systemically important countries or groups of countries.

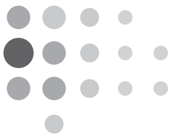
The second lesson that we draw is that the international adjustment process needs to be improved by moving to more market-determined exchange rate regimes that reflect underlying economic fundamentals. Exchange rate and capital management systems that enable countries to hedge against necessary reforms just create time bombs; time bombs for the countries themselves as we have seen in Greece, and in some cases regional time bombs. When those countries are systemically important, they also create time bombs for global financial stability.

The third lesson is that we should improve the traction of the IMF's surveillance of members' policies. The IMF had made a number of recommendations to address global imbalances, and members did not follow them with policy action. Similarly the European Commission persistently made recommendations to our member states to adjust their policies, but they did not always pay heed to those recommendations.

It is thus crucial that we improve the traction of surveillance of members' policies, and that surveillance focuses on financial systemic risks that were to a large extent overlooked before the crisis. It is also important to deepen the multilateral dimension of surveillance because of the interconnectedness and systemic importance of some of the actors.

Before concluding let me focus on the management of capital flows and liquidity. A better understanding of the

15. See »The Role of Surveillance in the Reform of the International Monetary System« by Jack Boorman, page 19



trends, size and composition of capital flows and of their main driving factors is necessary to develop appropriate policy responses. We welcome the recent IMFC conclusion that the IMF will deepen its analysis of global liquidity, the experiences of member countries with capital income management, the liberalization of cross-border capital flows and the development of domestic financial markets. So far we do not have an international institution that explicitly monitors capital movements. We believe that this task should be assigned to the IMF. The IMF should receive the mandate to monitor capital flows and devise a framework or guidelines on how to deal with such flows. Monitoring capital movements by the IMF, in collaboration with relevant organizations, would provide for a more timely and thorough picture on possible risks and on how to address them.

The EU is strongly in favor of developing recommendations or guidelines to cover both source and receiving countries on a symmetric basis in order to provide guidance on policies to deal with capital inflows. Such guidelines should have a comprehensive scope and emphasize the importance of macroeconomic and prudential policies and structural measures as the primary capital flow management tools. The final objective should be for countries to aim at a carefully sequenced liberalization of their capital accounts without excluding capital flow management.

On global liquidity management and the role of reserves and the regional and global instruments, we should be pragmatic and focus on deliverables. Enlarging the SDR basket is one area where we can make progress. A limited number of currencies of systemically important countries could be added to the SDR basket. However, we need to be clear that such additions must follow transparent criteria as set out by the IMF. Criteria such as capital account convertibility and exchange rate flexibility could be laid down in a clear roadmap. We remain open to discussing all the roles for the SDR, but believe that the SDR is not the remedy to all the current problems of the international monetary system.

We also support the joint work on the development of metrics of the adequacy of reserves in the context of IMF surveillance and are open to discuss how to further strengthen financial safety nets in line with the G-20 Seoul mandate. The crisis has shown how the IMF and regional financial mechanisms can cooperate to efficiently manage crises while respecting each other's independence and mandates. The EU stands ready to share the lessons that we draw from the experiences of successful collaboration with the IMF.

2.4 Fixing the International Monetary System—Caught Between A Rock and A Hard Place?

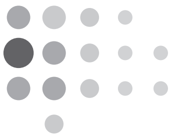
Pablo Pereira, Former Executive Director for Southern Cone Countries to the IMF

The world economy stands at a crossroad. A global depression has been averted, but the global financial crisis is far from over. Risks are tilted to the downside and new «aftershocks« are waiting around the corner. Today, the gravest threat that the global economy is facing comes from the wave of austerity that is now sweeping the world. Belt-tightening policies have failed. The belief that slashing spending will create jobs because fiscal austerity will improve private-sector confidence is 'delusional economics'. The 'confidence fairy' does not exist. As the excess leverage has shifted from the private sector to the governments, the economic recession has been the key driver of debt explosions. The time for action is fast running out.

To understand what is really going on, we need a new economic paradigm. We need to be aware that this is not a financial crisis. This is a systemic crisis, a crisis of global capitalism that could mark the end of an era of credit expansion based on the dollar as the sole international reserve currency. Major macroeconomic imbalances have characterized the world economy. They are closely related to the nature of the current International Monetary System (IMS[16]) based on the use of the US dollar as the major reserve currency and instrument for international payment. This IMS has served multiple purposes fairly well, but has also proved to be unstable, incompatible to global full employment and inequitable. Tellingly, globalization comes in an asymmetric structure. It favors countries at the center of the financial system and penalizes the less-developed countries at the periphery.

Yet, the crisis has brought forward a new multipolar economic order, where emerging market economies will play a large role on a par with advanced economies in driving global growth. We will be facing the unprecedented task of managing the declining role of the dollar and integrating highly dissimilar economies into the core of the IMS, ensuring financial stability and sustained global growth. This transition could be risky and bumpy. It will require truly cooperative actions, well beyond the efforts led so far by the G-20 countries.

16. The IMS is the set of rules, official institutions and arrangements that governs payments between countries and exchange rates among currencies.



As problems in the IMS are not addressed, the global economy will become more and more vulnerable. On the one hand, those countries at the center of the crisis face a 'decade of debt' compounded by a sluggish, jobless recovery. It is not only the heavy legacy of the crisis, but also their fault lines that have now come to the fore. Rising income inequality as a result of pro-corporate policies, changes in taxes that resulted in upward redistribution of income, weak safety nets, an aging population and an unfunded pension system, will all place new brakes on growth. On the other hand, the era of cheap capital is close to an end. So far, money is not going where it is needed and much of it has wound up where it is not wanted, creating a 'currency war'. Carry trade inflows[17] have also caused new asset price bubbles and rising commodity prices. However, soon the developing world will have to deal with too little capital, not too much. Over the next two years, global banks face a maturing debt of $ 3.6 trillion. Likewise, banks still face significant deleveraging pressures, and larger capital buffers will be needed. This coincides with higher sovereign refinancing requirements. In 2011, Japan faced the largest public rollover, equivalent to almost 56 percent of its GDP, second only to the US with refinancing needs of around 29 percent of GDP. The Euro area sovereigns need to cope with rollover rates above 15 percent of GDP. Debts are likely to continue to mount as economic conditions remain impaired and debt-servicing costs climb. Hidden debts are mushrooming too, whether in regional or local administrations or in the form of government guarantees.

Failure to tackle the debt-overhang in advanced countries through debt restructuring processes and adequate burden sharing from creditors will result in a new world of scarce capital (or capital hoarding). An era of financial repression and financial protectionism is all the more likely. Advanced countries will restrict outflows of capital as a defense against rising interest rates for corporations and consumers. Governments will resort to financial protectionism to insulate their economies from rising capital costs, using: i) direct lending to governments by captive domestic audiences (i.e. pension funds) forced by multiples layers of regulation (i.e. capital account restrictions and exchange controls; high reserve requirements as a tax levy on banks; regulation requiring that institutions hold government debts in their portfolios); ii) explicit or implicit caps on interest rates, particularly on government debts[18] ; iii) tighter regulation and prudential regulation on cross-border capital movements to force a 'home bias'. Taken together, both the fault lines of the global economy and an era of tighter capital will have significant consequences for developing countries, the current engine of global growth. Given the inequities in the IMS, rising real interest will asymmetrically impact developing countries, constraining investment demand and therefore global economic growth.

Efforts to boost today's global recovery must anticipate this new era in which an enduring lack of global demand and capital scarcity will place new brakes on growth. In this context, we claim that strengthening the role of the SDR (Special Drawing Rights[19]) through large and regular SDR allocations in the oncoming years could critically ease the above tensions, facilitating an orderly transition to a multipolar world. Interestingly, a move in this direction will benefit both advanced and developing countries at the same time.

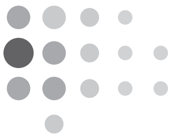
All advanced countries need weaker currencies to jumpstart their economies, sustaining domestic demand through exports. So far, by dramatically increasing the supply of dollars (quantitative easing), the US has managed to enhance the competitiveness of its exports. But a weak dollar policy will be insufficient to produce job growth. Its ability to stimulate the economy is constrained by three factors: 1) the willingness of the rest of the world to hold dollars is impaired; 2) financial innovation is now unraveling; 3) the capital base of banks remains damaged, so the monetary stimulus provided by the US Federal Reserve Bank cannot be passed on to customers or businesses. As such, the U.S economic slowdown seems inevitable.

The prospects of the Eurozone and Japan are equally bad. The Eurozone failed to resolve the problem of divergence within the union. Debts have soared but competitiveness has declined as the credit boom supported consumption

17. The »Carry Trade« refers to a transaction in which someone borrows at low interest rates and invests in an asset that yields a higher interested rate, thereby making money on the difference. Currently, near-zero interest rates in the US allow investors to borrow dollars and invest in risky assets everywhere. If the US dollar depreciates, investors are borrowing at negative interest rates. Making a profit is then easy, but volatility increases.

18. Ceilings on banks' lending rates were a direct subsidy to the government in cases where the government borrowed directly from banks. The interest rate cap could be in the context of fixed coupon rate nonmarketable debt or it could be maintained through central bank interest rate targets.

19. The SDR is a reserve asset created in the late 1960s to support the expansion of world trade and financial development. It is an unconditional right to access to free usable currencies (US dollar, Euro, Yen and Sterling) that the IMF can allocate to all countries in proportion to their quotas or capital contributions to the Fund. SDRs are costless, unconditional and transferable between countries.



and asset price bubbles. The continuous appreciation of the Euro during the early 2000s has increased the loss of competitiveness. The muddle-through approach so far taken has increased chances of disorderly debt workouts. A debt reduction is unavoidable, but this will do nothing to restore competitiveness in the European periphery. The only feasible alternative for the Eurozone is to engineer a weaker Euro. Japan is in even bigger trouble. It proves to be highly vulnerable on account of its heavy dependence on foreign trade (in itself dependent on a weak Yen). After the devastating effects of the last earthquake, Japan could be also heading to a fiscal crisis. Its high public deficit, anemic growth and persistent deflation are a recipe for disaster. Japan desperately needs a weaker Yen to drive up the confidence in its economy.

We claim that large and regular allocations of SDRs could facilitate an orderly depreciation of the four currencies of the SDR basket at the same time. The multilateral provision of global liquidity will do the job ('replicating' quantitative easing policies) without altering the behavior of the financial sector[20]. This time, money will go to responsible—democratic governments, not to the financial sector, which created this crisis. At the same time, allocations will automatically compensate developing countries (although not fully) offsetting the global deflationary bias (lack of global demand) and attenuating their financing needs for development in a world of scarce capital. Ensuring that developing countries will continue to be the engine of global growth will be critical.

Revamping the role of SDRs would not be a magical solution, but it could help the transition to a multipolar world. It is critical at this juncture to engineer a global economic growth strategy in which SDRs could play a role as a supplemental financial mechanism. Indeed, SDRs would offer a truly cooperative solution without arbitrarily confining countries' policy choices. The time to act is now. There are not many options left.

20. Quantitative easing has exacerbated speculative behavior of market participants. The clearest one is the carry trade on the dollar, creating new asset price bubbles and financial volatility—instability.

3. The Policies Needed to Correct Social Inequality and Establish Shared Societies at both the National and International Levels

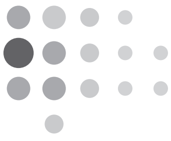
3.1 How to Promote Equitable Development and Shared Societies

Kim Campbell, Prime Minister of Canada, 1993, Member, Club de Madrid

What do we mean by »shared societies«? The term was chosen deliberately by the Club de Madrid to avoid the idea of integration, which suggests one dominant group to which others adhere or subscribe. It was to create a sense of equality, the notion of sharing, so that even if you are a newcomer to a society, you can genuinely be admitted to that society as opposed to always being in some ways seen as an outsider. That was the origin of the terminology.

Ninety percent of the countries in the world have minorities of at least 10 percent, and many of those minority situations are complex. My own country, Canada, with an aboriginal population, with founding French and English and a very large and diverse population of immigrants, is a very interesting example of a society for which the goal of being a shared society is a very real one. We often speak of the shared society as an inclusive society, and I remember when I was a Minister of Justice, one of my priorities was inclusive justice, and that led me to deal with policies, particularly with respect to women and the law, aboriginal people, and gay rights.

So inclusivity is a value, but it is also, arguably, a precondition for prosperity and security. It sounds »nice« but, in fact, it is something that is very pragmatic and deeply rooted in the goals that we have for all of our societies. I can compare it in some ways with the way we think about the advancement of women, which has also been an issue I am deeply involved in. I often say that you won't get the advancement of women if you argue for it on the basis of truth, beauty, and justice even though truth, beauty, and justice would certainly argue for that. It is much more helpful in getting people to change policies and change their thinking to make the arguments like the business case. I just participated in the Wall Street Journal Executive Task Force on Women in the Economy. There is research now that shows the



bottom line value of women in senior management and on corporate boards—that is, the business case. We know the value of women in development is long established, that the education of the girl child is a key to economic development. The World Values Survey has linked the advancement of women directly with the level of modernity at any society.

So with shared societies we also have to look beyond what we think is the value that it is just and important to include people, to the very strong pragmatic »survival« rationale underpinning this issue.

The Club of Madrid, a group of former presidents or prime ministers who are deeply committed to democracy and democratic values, looks at issues relating to those values. We think that the conversation about diversity and the notions underlying shared society is one of the most important conversations we could be having in the 21st century because it addresses the world of the 21st century. This is a world where many of the sources of instability in a globalized world relate to shared societies, the diversity of societies where there's poverty, terrorism, crime.

Our 2005 Summit on Democracy, Terrorism and Security concluded that terrorism is not a result primarily of poverty; it is primarily a result of alienation. Prime Minister Patterson referred to the problem of crime[21]. Organized crime has been identified as the single greatest factor undermining democratic development in the world. When you have disparities in terms of distribution, of access to the mainstream of a society, you get the seeds of criminal behavior. Mobility of labor and migrations of populations looking for economic opportunity account for many of the social divisions in this world. Whether you come to terms with it by working to integrate new labor forces or you live with the fiction that people are »guest workers« and will go »home« in a few generations, makes a big difference to the other aspects of your society.

So there are three main messages I'd like to deliver. The first is that shared societies are consistent with economic productivity. We commissioned a review of the major economic literature on this subject[22] and it is clear that economic productivity and the values of shared society are related. In the autonomous community of Madrid, for example, very clear evidence exists that the contribution of immigrants to the economy of the autonomous community is much greater than either the amount of money that these immigrants send home in the way of remittances or the cost of immigrant services. There is very clearly a net benefit to the community, which works very hard to integrate immigrants because when people feel at home, they will participate positively in the economy and make those contributions.

Secondly, there are many examples of the way in which enlightened policies in terms of shared societies maximize the economic potential of a community, but shared societies must also be dealt with in an integrated way. That is why the conversation about the international monetary system, about international financial regulation, would benefit from discussing how to encourage international reform efforts to take the objectives of shared societies into account.

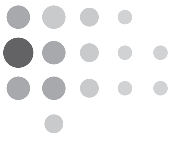
Thirdly, in terms of the international monetary system, we need to look behind the numbers. What do the numbers mean? What do they mean in terms of behavior, in terms of policies that result in society? What are the social outcomes of the decisions that are made at high levels of the international financial institutions?

We need to ask the right questions. We need new paradigms. We cannot simply look at things the way we looked at them in 1944, and we have to find the resources to answer those questions. For example, the Club of Madrid has looked at the creation of a shared societies' index. How can we look at assets of a society and come up with some way of comparative evaluation?

The Club of Madrid has an annual meeting every year, a general assembly of our members, and we always have a conference with it. In 2003, our conference looked at the impact of IMF conditionalities on transitional democracies. I remember when we announced this topic, the senior officials of the IMF were very nervous and

21. See »How to Promote Equitable Development and Shared Societies« by PJ Patterson, page 5.

22. Michael A. Valenti and Olivier Giovannoni. »The Economics of Inclusion: Building an Argument for a Shared Society,« The Economics of Shared Societies, 2011, 6:35-62. http://www.clubmadrid.org/img/secciones/The_Economics_of_Shared_Societies_Publication.pdf



unhappy and afraid that we were going to be all over them and be mean to the IMF and beat them up. They actually were thrilled by the meeting. It was a revelation to them. Three of our members, former prime ministers of Poland and South Korea, and a former president of Brazil, discussed the realities of their situation in dealing with these issues. In one case, the Prime Minister lost power even though she did implement difficult reforms.

We then had a follow-up meeting a few months later in Washington at the request of the IMF. We found it interesting that people had never thought about the political challenges that their demands were creating, the conditionalities that they were setting, were imposing on governments, and particularly on governments that were not deeply rooted or institutionally grounded democracies, countries that were struggling to create new political systems and new ways of doing things.

In 2005, in Prague, our conference focused on the Central and Eastern European transitions. One of the things we concluded from that meeting was that EU accession was infinitely more important for the changes in the democratic transitions of those countries than we had even thought. We all knew they were important but it is important to remember that reform is incredibly difficult, even in mature democracies. It is dramatically difficult in countries where states are weak or in a state of transition and therefore, it is very important that international institutions do not create disincentives to reform but be one of the supports. International institutions can often provide carrots and sticks. They can often provide incentives for countries to make the changes that are needed.

The Club of Madrid believes that the case has been made to address shared societies from all different perspectives. Now it is important to look at how some of the international financial institutions affect the issue through their policies. Is the IMF the body that can implement some of these policies by looking beyond the numbers, looking at the social impact of its decisions? Would that be mission creep or rather a way to ensure the results they are actually seeking to achieve? I'm not an advocate of mission creep, but I think these are the kinds of conversations that we can have and that people here are very well equipped to have.

I think organizations need to partner to think in new ways, and the Club of Madrid offers itself and the insight and the experience of its members, its convening power, which is one of its most powerful resources, to try and bring people together to think differently in the 21st century about how what we do affects the ultimate goals that we're trying to achieve and whether things that we are doing are counterproductive.

The perspective of Jomo, UN Assistant Secretary General for the Department of Economic and Social Affairs,[23] about the spirit of Bretton Woods is extremely powerful and very important when he argues that the means have become the ends. We have to go back and remember what the ends should be. The ends are stability and growth, but we are a very different world from 1944. Even in 1944 they didn't anticipate the Cold War, but we went through a period where the world was living in a kind of »aspic« of great power control. We are now in a very different world, mobile populations, new aspirations by groups, the Muslim world being only one of them.

I think it is time to go back to the spirit of Bretton Woods and ask, what is the goal or the end? If it is stability and growth, then we have to take advantage of the resources that the 21st century gives us in terms of technology, in terms of the capacity to get together, in terms of the value of our experience to try to address these 21st century issues, and to try and find ways of ensuring that shared societies are the societies that the vast majority of people in the world have an opportunity to live in.

23. See »Reforming the International Monetary 'Non-System'« by Jomo Kwame Sundaram, page 15.

3.2 The Challenge to Create More Democratic and Equitable Societies in the Arab World

Samir Radwan, Minister of Finance, Egypt, 2011
(6 February 2011 — 17 July 2011)

Now I have to put the action where my mouth is, and I can assure you this is a very tenuous situation because every time I take a decision or declare an action I must ask myself, »Hey, is that what you said few years ago?«

What has been happening in Egypt is really a fantastic tale, which defies the imagination of everybody, including myself. When the revolution started on the 25th of January, we thought »young people, lovely people«. We started to look at them as a lost generation, which had broken with their parents, with their families, and found refuge in the virtual world, in Facebook, in Twitter, and so on.

But then we started to discover that these young people have much more depth than we had ever imagined; that they have been looking at their parents' problems but rejecting their parents' attitude towards solving them. They came with fresh ways of looking at things. And I don't know how to describe to you what has been happening, except to say that it has been a process of short-circuiting time. In 18 days you had a change in government. The government has gone. The parliament has gone. The president has gone. You know, all the institutions that were there have gone.

And then these people, once they discovered their power, started to say, Fine, now we have demolished the past. How about the future?« And they started building up this future, fashioning this future. Okay, they don't have all the knowledge. They don't know exactly what a price index is, how you measure a property line and so on, but they have their hearts in the right place. So I think about what has been happening and I find it extremely impressive that you have had all these changes and these young people didn't fire a single bullet. A president brought to trial in the Middle East? You must be dreaming. A president's family on trial? You must be dreaming. A confiscation of the wealth of those people? You must be dreaming.

But this has been happening in a peaceful way. So I think it got us all reflecting about the ethos of Egypt, an old country that has maintained its existence because of its resilience. Every now and then it erupts to correct the line, »No, no, no, you have really deviated too far. Come back.« For any student of history, that's a fascinating chapter to read or indeed to work on.

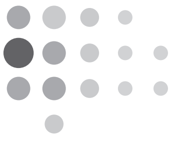
So where are we now? I think you can take where we are at three different levels. At one level are the difficulties that a minister of finance has to deal with because, at the end of the day, it's the minister of finance that has to foot the bill. And the bills have been accumulating. People's desires were accumulating, some of which are absolutely fair, some of which are totally mad. But you have to face the music.

So these are problems of trying to bring the society back to some sort of consensus. One of the first ideas I had was to turn to an old friend of mine called Juan Somavia (Director-General of the International Labour Organization), to whom I said, »Look, can you come and help with these wage problems and so on? Can you send me some people?« He rang me from Paris and said, »No, no, no, I'm coming myself.« That was a really fantastic opportunity to show to the people of the revolution that we mean business, going to the core, because the core was what? They had three demands: One, jobs. But they didn't just want any jobs, their second demand was for decent jobs that paid decent wages, and third, they demanded dignity. Dignity was very important. And dignity impinged on things like the security forces, the way the police treated people, and on the judiciary. So now we are actually trying to respond to these three demands: decent jobs, decent wages and dignity.

And of course, there will be a price to pay. That's why we meet with our colleagues at the World Bank, the International Monetary Fund and the development banks. I must tell you that I am very impressed by the degree of support we have been getting from everybody. Everybody's supportive. That's not to say everybody has written a check, but everybody is extremely supportive.

What are the lessons for others, because now Tahrir Square has become a Mecca (no offence intended to Saudis), but it has really become the Mecca for everybody to come and visit Tahrir Square to get inspiration.

One regret I have, of course, and I told our young people, is that they haven't deposited the slogans of the Egyptian revolution with the WTO because everybody else



is using them free of charge. So in Yemen they're using them, in Libya they are using them. For a short spell in Saudi Arabia they used them. It's a small price to pay if we can see this region finally really revolting against the image that we had, the image of a sleazy part of the world, dependent on rent from oil and really letting the world go by, throwing money at every problem.

I think this region, and in particular Egypt, has proven that this is not the right approach. The right approach is to go back to the fundamentals. And here we have started; we embarked on a democratization process. Anybody who was in Egypt during the referendum must have been impressed. The turnover was absolutely overwhelming, and Egypt is continuing the process. We will have elections for the parliament in September, followed by the election of a president and a totally new, tailor-made constitution, not additions here and subtractions there to suit whoever is ruling, but a coherent and systematic constitution.

My job as Finance Minister is to manage the post-crisis economy, which I have done to some extent but also at some cost to the budget deficit, and to stimulate that economy, because we have 650,000 people, young Egyptians who come to the labor market every year. And these people need jobs. They demand jobs. They demand housing. They demand to get married and make a family. These are the demands we have to listen to.

I believe that the potential of the Egyptian economy is so tremendous that these demands can be fulfilled with just two conditions. One, that we have some sort of fairness in the distribution of income built in the economic and social policies. This is no polemic. This is no handout approach in a populist sort of policy, but a rigorous policy that regenerates growth so that we can take care of distribution to the bottom 40 percent. That's one.

Second and most important is to guarantee that reform, and for this we must have democracy. People have to have a voice. And if you don't want to give it, they take it. They found it in Tahrir Square. They know their way to it and no power will stop them from getting there.

3.3 Building Shared Societies: Undercutting the Foundations of Fundamentalism

Ebrahim Rasool, Ambassador to the
United States from the Republic of South Africa;
Premier of the Western Cape, 2004-2008,
Member, Club de Madrid

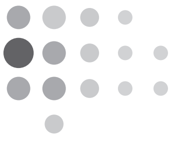
I fundamentally support the thesis that shared societies are critical to the way we conceptualise a far better world. The obstacles and challenges to this vision are located in the DNA of Globalization itself, because, by nature, Globalisation is a double-edged sword.

Globalization has created unprecedented material growth, but also unprecedented poverty and inequality. It has produced far greater scientific and technological advance than in any preceding era, but often at the expense of the environment and natural world, as seen in the mutating weather patterns and the pressure on water and food security. Globalisation holds enormous possibilities for human advance, yet manifests itself by creating vulnerability for the majority in the world.

What I would want to tease out is another manifestation of the ambiguous nature of Globalization. The world welcomes the instantaneous mobility of capital and goods across continents and time zones. Yet, much of that which militates against the idea of »shared societies« is our reluctance to welcome a similar mobility of people. The migrating patterns of people in search of ways out of poverty and towards opportunity mean that on an equally unprecedented scale, we encounter »the other« with whom we share very little except a common humanity. Among all the other unknowns, of a globalized world »the other« emerges as an unknown, often to be feared.

This is exacerbated by the way in which globalization develops and transmits new knowledge and information. The unseen victim of this information revolution is systems of traditional knowledge, humankind's traditional anchors in culture, faith and language, and socialization through family systems.

Not only are we encountering »the other« at a far more fearsome rate, we are also collectively victims of a great uncertainty emerging from the battle for relevance of our faiths, cultures and traditions. All of this makes inclusive, shared societies more needed, yet the vision becomes more elusive.



The perfect storm created by the convergence of these crises—the economic, environmental, human, and identity—create a world at once filled with possibility and with danger. We witness the rise of ideologies of certitude, acts of extremism, and the emergence of fundamentalist belief systems, and we know that we have not done enough to lay the foundations for inclusive, shared societies.

Firstly, we have not appreciated the scale of the problem and have neither understood it sufficiently nor diagnosed it correctly. We have sought legislative and doctrinaire solutions to migration, and military solutions to fundamentalism. Secondly, we have sought to keep »the other« out, or treat them as temporary problems, all the time demonizing them and creating caricatures of them, while not grappling with how we will assist each other in countenancing »the other.« We've not rethought our town planning nor have we rethought citizenship and national identity in an ever-changing demographic landscape.

In fact, the »host« has often used migration debates to try and reassert an historical and romanticized idea of their national identity and character, into which the migrant must assimilate. This has led to a battle in which mutual uncertainties, mutual distortions of identity and mutual erosion of traditional culture and faith have competed.

To appreciate the magnitude of the challenge, we must understand that 90% of countries in the world have a significant minority community of over 10%. To understand this further, 25% of the world's Muslim population live in a minority context. Unless we understand the implications of these statistics, we will not understand what is driving the ideologies of certitude in the world and why they manifest themselves so violently, intolerantly and exclusively.

We simultaneously need to defuse these ideologies and their extremist manifestations as well as examine the inherent intolerance of preexisting conceptions of »Americanness«, »Frenchness« and »Britishness.« It is in the combination of such reflections that the solution to marginalisation, alienation and instability lie.

At this very moment, we see the lid of repression being forced open in the Middle East and North Africa. Suddenly, those societies, too, have to grapple with both creating shared societies, as well as democratic, human rights-oriented societies. This creates both an urgency and an opportunity in the world.

How do we create inclusive, shared, democratic and free societies both in the North (Europe and North America) and in the South? Now that Europe and North America no longer have the luxury of giving the Middle East and North Africa a triple bypass (of democracy, freedom and human rights) in order to secure the security of Israel and other strategic resources, we can deal with the world in a more thorough and comprehensive way.

The opportunity that has opened up requires careful work in the whole world. The movement of people across the world requires that we rethink the demand for assimilation in Europe and North America in favour of integration. The former implies inclusion into a preexisting conceptualization of a dominant and pervasive culture, religion and language, whereas integration has some respect and place for the emergent culture, religion and language, while receiving respect for, and inclusion into, a larger national identity.

This allows for people to carry multiple identities, some residual—religion, culture, language—and some emergent, arising from their insertion into a new nation. This smoother transition of identity will have the effect of making the accompanying uncertainty less anxious and will make it feel less of a betrayal of original markers of identity. The seductive voice of fundamentalism will be less alluring.

Simultaneously we must seek to work collaboratively on the 3 major crises we face: the economic, the environment, and the human, if we are to build inclusive and shared societies. The possibilities of success are there albeit in the distance, but if we don't get to work on them now, they will only become more catastrophic in the short term.

3.4 International Financial Institutions' Role in Identifying and Addressing the Causes of Growing Inequality

Peter Bakvis, Director, International Trade Union Confederation, Washington D.C. Office

A key obstacle to equitable and sustainable growth and development is the current economic orthodoxy, which has downplayed the importance of distributional issues. This has been evident in the approaches of global financial institutions towards developing countries over the past three decades. »Downplayed« may in fact be too mild a description; »ignored« or even »intensified« may be more accurate.

If one looks at the progression of Gini coefficients of countries that underwent structural adjustment programs sponsored by the international financial institutions (IFIs) during the 1980s and 1990s and at least until the middle of the last decade, Gini coefficients increased in a vast majority of cases. Labor share of income fell in most countries in large part because wages did not keep pace with productivity increases. These changes have been amply documented by international agencies, including in the past few years, the IFIs. One positive development is that the IFIs are at least beginning to acknowledge the phenomenon and pay attention to it.

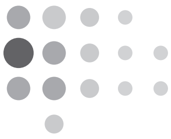
The World Bank a few years ago put out some interesting data showing that in 46 out of 59 program countries, inequality had increased between 1990 and 2004. The Bank seemed to be willing to admit that it was due at least in part to its own policies. One can safely state that not only was growing inequality at least partially a result of IFIs' policies, but to some degree the IFIs actually encouraged inequality. Less than a decade ago, one frequently heard IMF and World Bank officials talk about the need to »incentivize« productivity, and claiming that greater earnings differentials—i.e. income inequality—were necessary to make people strive harder. Today one can see the results of such policies. They certainly explain a large part of the recent upheavals in the Middle East and North Africa, where a combination of lack of jobs, gross inequality that has increased over the years and lack of democracy eventually led to social explosion.

It is important to recognize not just the kind of social frustrations that build up through growing inequality but that high inequality is not consistent with stable and sustainable economic growth. One can look at some of the recent research that the IMF has produced on the linkages between inequality and instability. Both the director of research and the managing director of the institution have referred to the results of this research in recent papers and speeches. The Fund has come to the conclusion, as have a number of academic analysts, that global imbalances between high current-account-surplus economies and high deficit economies are due in part to internal imbalances.

In a country like China, where wages have not kept up with productivity, there is not a sufficient consumption base to buy the goods the country produces. China has developed an economic model with a high degree of export-orientation, counting on external markets to absorb the production that its own consumers cannot buy. That's one side of the imbalance. The other side of the imbalance is a high-deficit economy such as the United States where consumption was maintained in the face of declining real incomes by allowing financial institutions to overleverage, lend to low- and medium-income consumers so that they can keep up their consumption levels.

G20 Summit statements and the IFIs have recognized that large imbalances are not sustainable in the long run. There is therefore a strong economic rationale for paying attention to the internal income inequalities that are at the root of global imbalances. It is not just the social tensions that build up, although of course that is another important consequence, as was evident in the Middle East and North Africa.

The good news is that we do see some progress in a few countries that have recognized high levels of inequality as an important national problem that must be addressed through deliberate and focused actions. One of these countries is Brazil. It developed an innovative system of cash transfers to low-income households with school-aged children, increased minimum wages, and made some efforts to achieve a tax system that is more progressive. Brazil has also made efforts to improve respect for workers' fundamental rights, thus allowing working people to negotiate improvements in their wages and working conditions. Although the results have not been dramatic, the Gini coefficient in Brazil began to fall around the middle of the last decade after decades of increase. One of the most unequal economies in the world is now less so thanks to some policies which are seriously starting to address the problem.



There may also be some positive developments in China, though it is too early to tell how widespread they will be. There has been a lot of labor unrest in China since last year, and that was responded to in many cases by allowing wages to start catching up with productivity increases. Minimum wages have also been increased in many regions. Perhaps there is the beginning of a recognition of the importance of building up domestic demand in that country as an alternative to relying on now stagnant economies that were the traditional export markets. And increasingly, one hears expressions of concern emanating from China about the possible social consequences of allowing income and wealth inequality to reach extreme levels.

However, much more has to be done, and the IFIs should take a stronger leadership role in identifying and addressing the causes of growing inequality. There are a few interesting initiatives that are beginning. The IMF and the ILO have undertaken joint work in developing new employment and social policy proposals, including the practical application of the »social floor« concept. The ILO-IMF joint work relies strongly on tripartite work with the social partners, including the trade unions, and the International Trade Union Confederation (ITUC) is providing support to our affiliates. The initiative has begun in three pilot countries—Bulgaria, Dominican Republic and Zambia—and a fourth may be added in North Africa.

The ITUC believes that an important element will be measures that lead to wages catching up with productivity increases, improving social protection, and real steps for ensuring the defense of workers' rights in all contexts. Workers cannot negotiate wages to keep up with productivity and cannot lobby for better social protection if they are repressed, which is still the case in the vast majority of countries in the Middle East and North Africa.

Achieving more progressive taxation will be very important in Central and Eastern Europe where there have been substantial increases of inequality. Most of the countries in the region have adopted flat taxes in recent years. Flat taxes are an idea developed by conservative economists in the U.S. about 20 years ago, but never applied in their home country. However they have been implemented in a dozen countries in Central and Eastern Europe. Flat taxes are harming the capacity of those governments to generate sufficient revenue to finance what is needed for a well-functioning market economy with good social programs, and they are also accentuating inequality. It is important for the IMF and the World Bank to encourage those countries to create tax systems that generate sufficient revenue for a modern developed economy and lower inequality. Flat taxes cannot produce those results.

There are a lot of other changes that the IFIs need to undertake. The World Bank currently produces an annual publication called »Doing Business,« the Bank's highest circulation report, which grades countries according to a number of criteria. A country that requires any sort of tax or social contribution by business gets bad marks. It makes absolutely no sense for the Bank to be telling countries, as it frequently does, that it is important to build up social safety nets, but on the other hand that it cannot require any sort of tax from business, which is exactly what it does through »Doing Business.« For the World Bank to be proffering such anti-tax advice is not just nonsensical, but simply irresponsible when one realizes the kind of fiscal crises that many countries around the world find themselves in.

The IMF needs to change its attitude towards the idea of debt restructuring, for example in European Union countries such as Ireland, Portugal, and Greece, where unemployment rates have skyrocketed and reached or surpassed 15 percent. Working people are the principal victims of recessions that have been created by IMF and European Commission policies to pay unsustainable debts. Debt restructuring, that is making private financial institutions assume part of the burden of resolving the problems of which they have been a root cause, has to take place. The alternative is unacceptable: even higher levels of unemployment, poverty and inequality.

Finally, the global community should be more concerned about the perspective of declining official development assistance (ODA) for low-income countries. The World Bank recently issued a report that stated that, because of the fiscal crises; ODA could decline by 20 to 25 percent in many countries. These countries are squeezing their budgets, and ODA is one of the expenditure items that countries are reducing significantly.

It will not be possible to attain the Millennium Development Goals (MDGs) if there is not enough assistance for the poorest countries that have insufficient domestic resources for financing MDG-related programs. The world community must develop innovative sources of finance. Many organizations, trade unions, development NGOs, environmental groups and others are proposing

financial transaction taxes (FTTs). Several governments are also supporting FTTs. They are a means for generating substantial revenues from a currently under-taxed financial sector for attainment of the MDGs, meeting climate change commitments and repairing some of the damages cause by the financial crisis, notably through job-creation programs. The IFIs should join in the movement for promoting, designing and coordinating the implementation of FTTs around the world.

3.5 Policies to Correct Social Inequality and Establish Shared Societies

Isabel Ortiz, Associate Director, United Nations Children's' Fund (UNICEF)

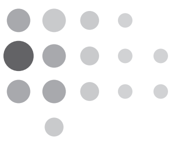
If we consider how income is distributed globally, we find a world in which the top 20 percent of the population enjoys more than 70 percent of total income, contrasted by 2 paltry percentage points for those in the bottom quintile, using Purchasing Power Parity (PPP) adjusted exchange rates, that is, the most conservative estimates. Using market exchange rates, the richest population quintile gets 83 percent of all global income while the poorest 20 percent of the world gets only 1 percent. Very disturbing is the prevalence of children and youth among the poorest income quintiles, as approximately 50 percent are below the $2/day international poverty line. More on this can be found in our recent publication »Global Inequality: Beyond the Bottom Billion—A review of income distribution in 141 countries«, just published by UNICEF.

In historical perspective, if we look at the evolution of Gini indices measuring inequality, using World Bank data from 1820s onwards to 2002, what we find is a steep increase in income inequality in the 19th century, some stabilization after the 1930s crisis up to the '70s and another steep increase of income inequality in recent times. While there is evidence of some progress, it is too slow—it would take more than 800 years for the bottom billion to achieve ten percent of global income under the current rate of change.

Business as usual is not an option. We need to change the development model. Some have denominated this current situation as a kind of global apartheid, and if we were to think in these terms, clearly, apartheid will not change by a series of small, remedial policies. We need to really seriously rethink policies and bring equity to the development agenda.

Below is a summary of the United Nation's development agenda. On the left side you can find the 1980s-90s orthodox policy advice, and on the right side, a UN agenda focused on equity—development for all—consolidated in the UN Policy Notes for National Development Strategies[24], which fits with the Shared Societies' message.

24. UN Policy Notes for National Development Strategies: http://www.un.org/en/development/desa/policynotes/



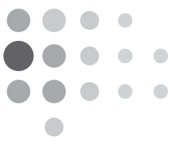
1980s-90s Orthodox Policy Advice	UN Development for All-Shared Societies
Growth priority through deregulation, free markets, minimalist governments, residual social policies	Growth and equity through active promotion of national development. Social and economic development integrated
Anti-inflationary measures as core monetary policy	Accommodating macroeconomic framework; e.g. employment targeting instead of exclusive focus on inflation targeting
Fiscal balance/ discipline, minimal taxation	Fiscal space for development and redistributive purposes
Cuts in public expenditures, avoiding fiscal deficits	Public investment for development; need to expand governments' fiscal space
Export-led growth	Developing domestic markets, selective export policy
Privatization of public assets services, minimalist government	Building state capacity to promote development, public investment, technology policy

In the 1980s and 1990s, there was the idea that growth should be a priority through deregulation of free markets, minimal governments, and a kind of residual social policies. These ideas are old, but somehow remain alive. Often, economic decisions were and are taken without considering their social impacts; if negative impacts, these may be mitigated but social progress cannot be achieved by this approach. We must consider the importance of growth and equity together, through the active promotion of national development, to consider social and economic development in an integrated manner.

Focusing on social policies, so important for the Shared Societies project, I would like to highlight that in the 1980s and 1990s we experienced minimalist social policies, very often targeted only to the poorest (left column). If we are to change the highly unequal global distribution of income, we'll have to move on from minimalist approaches and think of social policies as an investment in people. We'll have to start thinking in universalism, »for all« as it has been the historical experience of many highly developed countries, including the late industrializers, and generally bring redistribution back into the agenda in a very powerful manner, as UN agencies have proposed in recent years (right hand column). We need to address issues like employment, exclusion and discrimination as central to an equitable development agenda for the 21st century.

1980s-90s Orthodox Policy Advice	UN Development for All-Shared Societies
Residual social policies as a cost (minimal, targeted to the poor, safety nets) to people	Social policies as an investment in people. Universal policies (for all), redistribution back in development
Commercialization of social services, cost recovery (fees for services)	Public services, e.g. UNICEF School Fee Abolition Initiative
Labor flexibility, productivity	ILO Decent work agenda
Social Protection: pension reform	ILO, WHO, UNICEF and all other UN agencies call for a Social Protection Floor
Human Rights: endorsed but not implemented	Empowering people through rights and standards, a UN mandate
No interest for culture and values (intangible)	Important for tackling exclusion, discrimination (UNICEF, UNESCO, UNFPA)
No attention at sources of conflict (»political«)	Conflict prevention (UNDP)

There are strong arguments for equity. Social justice is the first one—I don't need to expand. But equity also contributes to growth. Inequality is economically dysfunctional, consumption is currently concentrated in the top income quintile in all countries, a situation similar to the 1930s, when a small elite was privileged and the majority was poor. This situation was highly inefficient, corrected by the New Deal and later post-war policies, that raised people's incomes and therefore domestic demand, enhanced human capital and productive employment in Western countries as well as in Japan, Australia and New



Zealand, which experienced a prosperity never seen in history. Likewise, the export model has led in 2011 to a situation of global excess capacity, in the context of depressed world markets and lack of demand. The world produces more than we can consume, the surplus produced by China and others cannot be absorbed because income distribution is so unequal, and in a situation of global crisis fewer have capacity to purchase. There is a strong need to develop domestic markets in developing countries—raising the incomes of the poor.

Additionally, inequality is dysfunctional for political stability. Poverty and gross inequities tend to generate intense social tensions and violent conflict. Governments that pursue equitable policies can ensure the political/electoral support of citizens.

Such an equitable development agenda is realizable. The starting point is to consider social and economic development to be integrated. Employment-generating growth can be promoted through active investment, industrial and agricultural policies, infrastructure and socially-responsive macroeconomic policies. The world can and should focus on a social protection floor—including social services and social transfers— a floor below which nobody should fall. And we also need to tackle social inclusion, addressing discrimination, prejudice, abuse, lack of voice, powerlessness, and try to generate an environment of tolerance, nonviolence and solidarity, reducing the sources of conflict.

When thinking of this equitable economic and social agenda, the question invariably arises: where is the fiscal space for countries to develop their own policies? Fiscal space exists even in the poorest countries. There is a national capacity to fund economic and social development even in the poorer countries, but this may require moving away from orthodox approaches. The main options include: (i) Improved taxation, (ii) Reprioritization of expenditures, (iii) Debt management, including debt financing for those who can, as well as debt rescheduling and debt relief, (iv) More accommodating macroeconomic frameworks (e.g. tolerance of some inflation, fiscal deficit, (v) Fighting illicit financial flows and (vi) Use of reserves for national development. All countries are different, and they will have different options, but in any case fiscal space exists.

The management of the current global economic crisis is not helping an equitable development agenda. In a first phase (2008-10), most countries embarked on fiscal stimulus plans and countercyclical policies to sustain development. This approach was generally positive; at the UN, we estimate that about 25 percent of the fiscal stimulus plans were invested in social protection measures. However, in a second phase (2010 onwards), most countries are focusing on fiscal consolidation—a new term for an old concept, fiscal adjustment.

In a recent and controversial study by UNICEF[25], we found that about 44 percent of developing countries are contracting public expenditures in 2010-11. Most of the adjustment is done by (i) Reducing subsidies (e.g. food subsidies, at a time when food prices are increasing), (ii) Cutting/capping the wage bill (including salaries of teachers and health workers at the local level), and (iii) Further targeting social protection systems to the poorest (this is, reducing overall expenditures on social protection by focusing on the poorest only). It is difficult to see how this will contribute to the UN Millennium Development Goals, which should be achieved by 2015, let alone how these policies will contribute to much needed equitable outcomes for social development, economic growth, nation-building and political stability.

We need to promote policy options for social and economic recovery—a recovery with a human face, for all. Contracting public expenditures will have not only negative social outcomes, but also negative economic and political impacts. In high-income economies, the destruction of the welfare state will lead to a continuous reduction of global demand, unemployment and increasing inequality. In developing economies, it will interrupt development processes that urgently require reducing poverty, expanding internal markets and reducing conflict. The speed at which adjustment is happening at the moment can be re-considered by other types of socially-responsive macroeconomic policies to ensure employment and the protection of children and vulnerable populations. This should be debated in open, national dialogues, to ensure a Recovery for All.

25. Prioritizing Expenditures for a Recovery with a Human Face: A Rapid Review of Public Expenditures in 126 Countries. http://www.unicef.org/socialpolicy/index_56435.html

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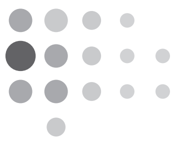

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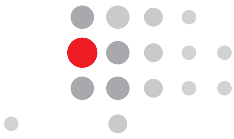

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