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The Direct Contribution of the International Financial System to Global Poverty

Ross P Buckley*

The international financial system has made a major, direct and sustained contribution to global poverty for the past 30 years. It has worsened it.

It has done so in two main ways. First, the analytical framework and perspective the International Monetary Fund has brought to its role in developing countries has served to promote and entrench poverty. Secondly, the socialisation of private sector debt which the IMF has orchestrated or been complicit in has directly contributed to poverty in many countries.

Contribution of the Analytical Framework of the IMF to Global Poverty

To understand how the IMF has contributed to global poverty, one needs to understand (i) how the Fund came to have, as one of its major roles, the directing of economic policy of countries in crisis; and (ii) the beliefs that guide the Fund’s staff in this role.

The Fund was established to assist nations with technical advice and short-term loans to manage the fixed exchange rate regime that was a core component of the post-war architecture. With the floating of most major currencies in the 1970s this initial role largely disappeared. By the late 1970s the Fund was an organisation in search of a substantial role. It found it with the debt crisis that engulfed Africa and Latin America in late 1982.

Debtors needed new money to at least service the interest payments on loans they could no longer repay. Creditors wanted assurance that the debtor’s economic policies that had

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contributed to the crisis had been changed. National sovereignty made direct commercial bank involvement in the setting of local economic policies a political impossibility. The IMF was the answer to this problem. The Fund was ideally placed, as an apparently independent international financial institution, to determine and monitor the economic policies, going forward, of the debtor nations.

The focus of the IMF reform programs was to enable debtors to generate sufficient foreign exchange resources to service their debts. The policies imposed to achieve this typically included:

- reductions in the budget deficit to limit inflation, and the need for foreign borrowing,
- limits on domestic credit expansion to control inflation,
- exchange rate devaluations to discourage imports and encourage exports, and
- generally a much reduced role for government and a much increased role for markets.

Other policies included (i) higher income and sales taxes, (ii) higher charges for state-produced goods and services such as electricity and water, (iii) privatisation of state-owned companies, (iv) deregulation of the labour market, and (v) reform of tariffs and import quota regimes.

The combined effect of this suite of policies was that the 1980s were a decade in which net capital flows from these nations were northbound, a decade in which infrastructure crumbled, a decade in which life expectancy fell in Sub-Saharan Africa. This entire

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process became known as ‘structural adjustment’, a “stunningly bland name”\textsuperscript{5} for policies with a stunningly high human cost.\textsuperscript{6}

This should, however, be unsurprising. For the principal focus of the IMF had been to ensure the debtor nations could earn sufficient foreign exchange to service their debts. The IMF’s main goal in the 1980s was to ensure the survival, not of poor people, but of the international financial system.

Asia’s crisis in 1997 was fundamentally different from the 1980s debt crisis: most debt was private, not public or quasi-public, and it was not a crisis caused by over-consumption. The Latin American nations had borrowed to fund general government budgets. The East Asian governments had not been similarly seduced. Their fiscal policies were prudent. Asia’s crisis was primarily a crisis of inadequate local prudential regulation and lack of confidence in the region by global capital. It was a contractionary crisis – the exodus of global capital and region-wide loss of confidence meant a steep decline in economic activity.

Notwithstanding all of these differences, the IMF ventured into Asia dispensing the policy prescriptions it believed had worked in Latin America in the 1980s – prescriptions of budgetary tightening and austerity. Austerity is always bad policy for a contractionary crisis. It is utterly ineffective in encouraging contracting economies to expand. At the time Joseph Stiglitz was the Chief Economist of the World Bank and he repeatedly spoke out to highlight the fundamental error in the Fund’s response to the Asian crisis.\textsuperscript{7} Stiglitz sought expansionary policies. With hindsight Joe Stiglitz was right, but when it mattered most, the IMF wouldn’t listen to him.

In 1998 the Reserve Bank of Australia approached the U.S. Treasury to deliver essentially the same message as Stiglitz: the fiscal policies of the Asian economies had been mostly prudent, this was a contractionary crisis, and expansion was needed, not the

\textsuperscript{5} Green, \textit{Silent Revolution - The Rise of Market Economics in Latin America}, p. 11.
\textsuperscript{6} See Bello, \textit{Dark Victory: The United States, Structural Adjustment and Global Poverty}.
higher interest rates and budget tightening being prescribed by the Fund. The U.S. Treasury took the message on board and managed in turn to persuade the Fund. So, about 15 months after the onset of the crisis, the IMF began to agree to more expansionary policy settings. While the Fund eventually came around, the crisis was deepened by its initial misdiagnosis, and considerable otherwise avoidable human suffering resulted.

In the meantime, Malaysia had adopted more successful strategies, especially in their impact on the poor. Malaysia refused IMF funding and advice and set its own course. The policies Malaysia settled on were in sharp contrast to the Fund’s. Malaysia imposed capital outflow controls to keep foreign capital within the country, and pegged the ringgit to the U.S. dollar. Malaysia was thus able to ease monetary policy and pursue expansionary fiscal policies, without being hampered by severe capital outflows. Malaysia had created as close to a laboratory experiment as one ever gets in economics. Thailand and Korea were seeking to exit the Asian Crisis using the Fund’s policies, while Malaysia was charting a different course. (Indonesia’s high debt levels meant its problems were quite different).

All three economies recovered from the crisis, but Malaysia’s recovery was more rapid, and its poor were harmed far less by its recovery policies than were the poor in countries following the IMF approach. In the words of Kaplan and Rodrik, “compared to IMF programs, we find that the Malaysian policies provided faster economic recovery… smaller declines in employment and real wages, and more rapid turn around in the stock market.”

Yet the Fund’s mistakes in East Asia, so clearly highlighted by Malaysia’s taking the road less travelled, paled in comparison to its egregious errors in Argentina. The Fund had toasted Argentina as “the best case of responsible leadership in the developing world.” Argentina’s severe recession, which commenced at the end of 1998, was the

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product of policies which the IMF had developed or with which it agreed. The crisis deepened until late 2001 when Argentina had to default on its external debt. The IMF emerged from Argentina’s collapse with its credibility in tatters. Never before had a country that had so faithfully followed the Fund’s policies collapsed so severely.

At this point the Fund had few friends. Criticism of the Fund’s policy prescriptions had been sustained, fierce and unrelenting from the left ever since the early-to-mid 1980s, principally for the impact of its policies on the poor and because the Fund was seen, by the left, to be the handmaiden of the G-7 nations and particularly of their banking sectors. More recently, for perhaps the past 15 years, commentators from the right joined battle in criticising the Fund for having lost its mission, purpose and relevance. Commentators from both sides of politics and from developed and developing nations argued for the Fund’s fundamental reconceptualisation or closure.

In the late 1990s the Fund sought to respond to its critics. In 1999 it replaced its Structural Adjustment Policies (SAPs), with Poverty Reduction Strategy Papers. PRSPs were to be a new tool for poverty reduction, debt relief, and access to funding from donors. Instead of focusing on macroeconomic stability and growth like SAPs, PRSPs, as their name suggests, were to put poverty reduction at the core of the nation’s economic policies.

However, the change from SAPs to PRSPs was more to rescue the Fund from its crisis of legitimacy than to respond to the needs of the poor in poor countries. If programs were truly national creatures, tailored to each individual nation’s needs, one would expect some PRSPs to exhibit strategies that differ from the standard policy prescriptions of the past. But this is not the case – the PRSPs of different countries are strikingly similar. The macroeconomic policies under PRSPs have

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essentially been a continuation of the policies under SAPs, and PRSPs don’t contemplate alternative approaches to poverty reduction.\textsuperscript{13}

In short, the massive gap between Fund rhetoric and policies remained.\textsuperscript{14}

**The IMF and Poverty in Africa**

In 2000, Michel Camdessus, the Fund’s Managing Director said,

> the greatest concern of our time is poverty … it is the ultimate systemic threat facing humanity. … If the poor are left hopeless, poverty will undermine the fabric of our societies through confrontation, violence, and civil disorder. We cannot afford to ignore poverty, wherever it exists...\textsuperscript{15}

The IMF has its own internal evaluation division, the Independent Evaluation Office, and in March 2007, the IEO released an Evaluation Report, “The IMF and Aid to Sub-Saharan Africa”\textsuperscript{16}

The Report concluded that there were differences of views among the Executive Board of the Fund about the IMF’s role and policies in poor countries, and that lacking clarity on what they should do on the mobilization of aid, … and the application of poverty and social impact analysis, IMF staff tended to focus on macroeconomic stability, in line with the institution’s core mandate and their deeply ingrained professional culture.\textsuperscript{17}

In other words, some seven years after the replacement of Structural Adjustment Programs with **Poverty Reduction** Strategy Papers, IMF staff were unclear on the priority to give to poverty reduction and how to achieve it, and so sought to attain what they knew how to attain: macroeconomic stability. In the first year or two of

\textsuperscript{13} G. Dor, ‘G8, Tony Blair’s Commission for Africa and Debt’ *Global Policy Forum*, 7 July 2005, 1; and R. Gottschalk, ‘The Macroeconomic Policy Content of the PRSPs: How Much Pro-Growth, How much Pro-Poor?’ The Institute of Development Studies, University of Sussex (February 2004), p. 3.


\textsuperscript{15} Camdessus, ‘Development and Poverty Reduction: a Multilateral Approach’.

\textsuperscript{16} Independent Evaluation Office of the IMF, ‘The IMF and Aid to Sub-Saharan Africa’.

\textsuperscript{17} Ibid., vii.
the introduction of new priorities and programs this would be understandable, though regrettable. After seven years it is ridiculous. In most settings, one would expect such non-performance to result in the sacking of senior staff.

The Report also found that the Fund’s policies have accommodated increased aid “in countries whose recent policies have led to high stocks of reserves and low inflation”, but “in other countries additional aid was programmed to be saved to increase reserves or to retire domestic debt”.18 Yet virtually no sub-Saharan African countries have strong foreign exchange reserves and low inflation rates. So extra aid was routinely channelled by the Fund into foreign exchange reserves or into the repayment of debt. This has two flaws:

1. It diverts extra aid away from healthcare, education or other social welfare expenditures, and

2. It risks being a ‘self-fulfilling prophecy’, as diverting aid flows into reserves and debt reduction is likely to dissuade donors from giving more aid.19

This is a perfect illustration of the damage that the Fund’s obsession with the macroeconomic profile of a country can do. The Fund believes that the best way to help a nation is to ensure that its inflation is tightly constrained, its government kept small so as not to crowd out private sector activity, and everything possible is done to promote its exports.

Yet there is an ever-increasing body of evidence that suggests that less rigid inflationary controls give developing economies more room within which to grow, and that government is often the only potential delivery system for many essential social services in these nations.20

18 Ibid., 32.
Changing this fundamental belief system of the IMF will take time. It is a massive undertaking to get thousands of staff to reconceive how they see the world. However, there is one change that can be implemented almost immediately, and that is to stop the socialisation of private sector debt.

**The Socialisation of Private Sector Debt**

One of the depressingly consistent themes in the aftermath of each financial crisis is the socialisation of private sector debt – a consequence which the IMF either engineers or to which it acquiesces.

After the debt crisis broke in 1982 the creditors persuaded each nation to represent all debtors within its borders in the rescheduling negotiations and to bring all the debts of those debtors under its sovereign guarantee. The first step was necessary. The second was not.

Bringing all debts under the sovereign guarantee improved the security of the creditors. It was also an utterly unjustifiable charge on the common people of these countries as these loans were ultimately serviced by higher taxes and lower social services.

Fifteen years later the nature of the crisis in Asia was quite different, but the resolution of it was the same – the poor in the debtor countries were exploited – this time by a process engineered by the IMF. The IMF organised bailouts of Indonesia, Thailand and Korea which were in fact long-term loans made on condition they be used to repay creditors.21 These loans thus became debts of the nation and the bailouts were of the creditors, not the

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debtor nations at all.\textsubscript{22} It was years before bailouts were generally understood to be “a welfare system for Wall Street”\textsuperscript{23} as the funds flowed directly through to creditors.

To make matters worse, the creditors with debts due typically held short-term bonds – and short-term debt is particularly destabilising for developing countries. So the IMF bailouts encouraged precisely the type of debt that a stable system would discourage.

The idea was that the nations would again take responsibility for the indebtedness of corporations, use the bailout loans to pay off the foreign creditors, and later recover the debts from the corporate debtors. The Indonesian government recovered some 30 per cent of the value of the loans it incurred on behalf of the banking sector.\textsuperscript{24} The other 70 per cent became a charge on the Indonesian people.

After Argentina’s economic implosion, the international financial community, with the assistance of a compliant Argentine government and the IMF, found two ways to socialise private indebtedness. The first was the now familiar IMF bailout, in this case a massive US$40 billion loan to Argentina in late 2000, that was required to be used to repay a mix of public and corporate debt so that private sector debt was in effect replaced by debt of the nation.\textsuperscript{25} The second was a new way to achieve an old end: having the people repay corporate debts. This technique was known as “pesofication”.

Under pesofication, dollar-denominated bank loans and deposits were redenominated in pesos. Banks were required to convert their assets (such as loans) into pesos at a one-for-one rate and their liabilities (such as deposits) into pesos at a rate of 1.4 to 1. This

\textsuperscript{22} Calomiris and Meltzer, ‘Fixing the IMF’, 88.
\textsuperscript{23} In the words of a senior G-7 official, quoted in C. Denny, ‘IMF sheds no tears for Argentina’, The Guardian, 29 April 2002.
generated huge losses for the banks for which the government sought to compensate them by a massive issue of government bonds of doubtful value.26

Thus the circle was completed in the usual way in such crises – the ultimate burden fell on the public purse. In the words of Pedro Pou, President of the Central Bank of Argentina until mid-2001, “The government has transferred about 40 per cent of private debt to workers … We are experiencing a mega-redistribution of wealth and income unprecedented in the history of the capitalist world.”27

To require the people to repay corporations’ debts, through increased taxes and reduced government services, is immoral. It is a massive interference with the market system that the IMF professes to support. In each of these crises, the market, through the mechanism of bankruptcy, would have allocated the costs of the poor lending and borrowing decisions upon the lenders and borrowers. The IMF, either as architect or complicit partner, in each case allocated the costs of these poor decisions to parties who had nothing to do with them: the common people of the debtor nations.28

The IMF must stop facilitating bailouts in which anything other than sovereign debt is repaid – if poor countries choose to bail out their corporate sectors they should do so openly, and certainly not through the subterfuge of an IMF orchestrated bailout package. For national governments to assume corporate debt in desperately poor countries rewards the rich in those countries at the direct expense of the poor. It is a practice the IMF must stop orchestrating.

**What the IMF Says About Itself**

In 2001 the IMF established its Independent Evaluation Office. The IEO’s Summary of Major Findings, Lessons and Recommendations in its Evaluation of the IMF’s Role in

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27 As cited in Gaudin, id.
Poverty Reduction Strategy Papers and the Poverty Reduction Growth Facility, July 6, 2004, states, inter alia, that:

- “most PRSPs fall short of providing a strategic road map for policymaking, especially in the area of macroeconomic and related structural policies”
- “On balance, joint staff assessments do not perform adequately the many tasks expected of them”, and
- “Success in embedding the PRGF in the overall strategy for growth and poverty reduction has been limited in most cases – partly reflecting shortcomings in the strategies themselves”.  

For an international organisation these words are straight shooting. So why, given its rhetorical commitment to fighting poverty, does the IMF more often promote poverty than reduce it?

**How Do We Get the Fund to Effectively Reduce Poverty?**

For Joseph Stiglitz, the answer to this question has four parts. In his view, the Fund’s economists: (i) “frequently lack extensive experience in the country”, (ii) are not nearly as good or bright as they think they are, (iii) tend to use poor economics, and (iv) “close themselves off from outside criticism and advice.”

Notwithstanding the respect I have for Joe Stiglitz, I wonder whether he has this quite right. One doesn’t need to be among the brightest graduates of a first-rate university to know that austerity will make a contractionary crisis worse or that Argentina cannot peg its currency to that of the U.S. dollar indefinitely without it becoming overvalued. Any good undergraduate economic student knows these things.

Stiglitz’s explanations, written in anger at the suffering he had seen the IMF’s policies cause, are too pat. I agree that the Fund’s fly in - fly out model tends to deny their experts the local knowledge they need to craft appropriate policies, and reinforces their tendency to make unwarranted assumptions about the strength or even existence of local

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29 Available at [www.ieo-imf.org/evalcomplete/eval_07062004.html](http://www.ieo-imf.org/evalcomplete/eval_07062004.html).
institutions such as the rule of law. I also agree that the Fund tends to close itself off from outside criticism and advice.

But on the other issues, it is not that the Fund’s experts are not bright enough or use outdated and poor economic models. The core problem is that the IMF has become a fundamentalist organization. It subscribes utterly to market fundamentalism – the belief that markets will always best allocate resources and provide needed services. For with fundamentalism, evidence becomes marginalised. This is why the IMF can divert donations intended for schools and health clinics in Africa into the repayment of external debt or into foreign exchange reserves – because the Fund staffers really believe that if they get the macroeconomic profile right, the market mechanism will fix the country’s problems. This is why the IMF can require poor African countries to privatise their healthcare systems and stop subsidizing much needed drugs for their people – because the staff really believe that if you just let the market handle healthcare, it will do the job right. This belief trumps the consistent experience in Africa that privatisation of healthcare results in good hospitals for the small, affluent middle classes in the cities and bad or no care in rural areas.31

None of this would matter so much if the Fund’s role was continuing to shrink, as it did for much of 2000 to 2008, when more and more developing countries simply refused to borrow from it and accept its policy prescriptions; and if the Fund’s staff was continuing to shrink, as it likewise did, quite dramatically, in those years.

However, as in 1982, the Fund has been rescued by another crisis. In managing the global economy through the Great Recession, the G20 needed an organisation through which to channel extra lending, and to which to delegate certain roles, and it chose the IMF. The result is that by 2014 the concessional lending capacity of the Fund will be ten times

greater than it was before the crisis. The role of the Fund has thus been expanded greatly and its staffing numbers are now growing as strongly as before they declined.

The Fund’s recent rhetoric has been that it has learned from its errors in Asia in the late 1990s and has revised its policies so that there is now considerable scope for counter-cyclical and expansionary policies. And at the height of the recent crisis some countries were permitted to run moderately expansionary policies – while most OECD nations were enacting aggressively expansionary stimulus packages. However, by 2010 the IMF’s deeply ingrained beliefs were reasserting themselves and pro-cyclical contractionary policies were once again the norm. A study chose 13 IMF agreements with poorer nations as a representative sample, and found that in 2009 fiscal expansion was on average 1.5% of GDP, but for 2010 the average was a contraction of 0.5% of GDP. An Oxfam study in July 2010 found that one-half of African countries and three-fourths of other developing nations with IMF programs in place were being required to reduce spending in 2010, precisely when expansionary policy settings were needed to offset reduced export revenues.

In summary, the IMF’s policy stance and its belief in markets appears undimmed by the largest financial crisis in 80 years.

So the job of changing the animating beliefs of the Fund remains before us. The recent reforms to the voting and membership shares in the Fund in favour of developing countries are too minor to have any substantial effect.

One of the Fund’s essential difficulties lies in the narrow backgrounds of its staff. The World Bank, to fulfil its remit, needs economists and finance professionals, but it also needs engineers, scientists and experts in social policy, development and many other fields. This diverse mix of people gives rise to strong debates within the Bank which have assisted it in reassessing its roles and how best to fulfil them. The Fund, on the other hand, draws its staff from essentially two sources: national central banks and PhD programs in macroeconomics (and even then the graduates of certain faculties are much preferred over those from other, more liberal, faculties).

Yet the skill set and attitudes required to be successful in a central bank are utterly different from those required to redirect and turn around the economy of a failing nation. In the corporate world, technocrats who are effective in highly structured corporations rarely, if ever, have the entrepreneurial zeal and instincts that characterise those people who make careers out of rescuing failing companies. Why should we expect this to be any different at all at the sovereign level?

As long ago as the 1990s, Walter Wriston, the former Chair of Citibank, said, “once the IMF got into the business of advising governments on policy it created more trouble than it cured.” This should be unsurprising, as the IMF was never intended, and thus never designed, to advise governments on policy generally. Its original remit was exchange rate policy. Its staffing profile made perfect sense given its original role. Yet its role has changed, utterly, while the profile of its staff, and more importantly their prevailing mindset, remain unchanged.

Strong and visionary leadership, over a sustained period of time, plus further and more radical reforms to the voting rights of member countries, will be required if true reform of the IMF is ever to be achieved. Until that happens, whenever developing nations have to go to the Fund for assistance, history tells us that the price they will pay will be high indeed, and will fall principally upon the poorest of their people.

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