



Dialogue on
Globalization

BRIEFING PAPERS
FES NEW YORK

**Towards A Socially Responsible and Democratic
Global Economic System:
Transparency, Accountability and Governance**

CHRISTOPHER RUDE AND SARA BURKE

1 Background

The present global economic crisis has given a renewed mission to international financial institutions (IFIs), from the International Monetary Fund (IMF) and World Bank to the Basel Committee and other regulatory bodies such as the Financial Stability Forum—now renamed the Financial Stability Board (FSB). As recently as the early autumn of 2008, the IMF in particular seemed threatened with extinction. As a result of inappropriate, procyclical macroeconomic policies prescribed during the last major economic crisis of 1997-1999, a legacy of mistrust tainted its relationship with borrowing countries, and those that could do so spent the intervening years building up reserves to prevent ever having to borrow from the IMF again. By 2007 the Fund's loan portfolio had dwindled from over \$100 billion to less than \$10 billion—most of that owed by just two countries, Turkey and Pakistan (many at the IMF reportedly joked that without the Turks and Pakistanis they would be out of a job). The collapse of the world financial system beginning in autumn 2008 changed all that, as many countries to date have again been compelled to borrow, including Georgia, Ukraine, Hungary, Iceland, Latvia, Pakistan, Serbia, Belarus and El Salvador.

This renewed mission for IFIs, following as it does the period of mistrust that preceded it, has sharpened the need and the call for policy space in developing countries and has reinvigorated debates about reforming their governance, in particular reforming the twin pillars of transparency and accountability upon which good governance is seen to rest. The initiative to press for greater transparency and accountability in financial institutions has also gained traction at national levels, given the key roles that the world's major central banks have played behind-the-scenes during the crisis. This is particularly true of the US Federal Reserve Bank because the institutions it regulates are systemically critical, a fact laid bare by the rapid international spread of financial contagion following the collapse of Lehman Brothers and American International Group (AIG) in September 2008.

Since that collapse, academic institutions and think tanks have held a number of conferences and published many papers examining the governance of financial institutions—both national and international—and the coordinating bodies, such as

the G-8, and now G-20, that have *de facto* taken charge of reshaping the global economic architecture. These are evidence of a transparency and accountability movement afoot within governments, civil society and even in the financial institutions themselves. But there are sharp differences in the way the concepts of transparency and accountability are used. For example, within the logic of a central bank, the concept of “transparency” is not the same as the transparency citizens expect of an elected official; the accountability of a money manager to his client is likewise not the accountability of the same money manager to his regulator. The dual goals of this paper, therefore, are to propose guidelines that encourage consistency in discussions of transparency and accountability and to promote the idea that ultimate aims for the reform of international and domestic financial institutions must be socially responsible and democratic in order to be both legitimate and effective.

2 Two Propositions for Understanding Transparency and Accountability Reforms

At the recently concluded 2009 Annual Meetings of the IMF and World Bank in Istanbul, Turkey, IMF Managing Director Dominique Strauss-Kahn made apologies to a “Town Hall” gathering of over 200 members of civil society organizations for the slow pace of reform within his institution. Urging patience, he said: “We are making changes to governance with greater transparency, but change may not be at the pace you like”.¹ Following the blinding speed at which governments, central banks and IFIs—including the IMF—organized themselves to bail out the global financial system, such excuses for incremental reforms to the institutions that make up this system serve to sharpen the challenge for reformers. The two essential questions are: 1) What is an acceptable pace of reform? And 2) how much more transparency and accountability is necessary to indicate genuine reform? In partial response to these questions, consider the following two propositions:

- Transparency without full accountability is non-democratic and therefore empty.

¹ All direct quotes in this paper are from the authors' meeting notes.

- Accountability without full transparency is a contradiction.

Transparency without accountability is empty because the simple release of information does not automatically make a financial institution politically responsible to another state institution or authority, much less to citizens, the ultimate “stakeholders” in a democratic sense. **Accountability without transparency** is contradictory because neither a national nor a global institution can be held to account unless it gives a full accounting of its activities to the citizens its policies ultimately affect. Accountability without full transparency is therefore empty of meaning in a democratic framework. This implies that neither transparency nor accountability exists—again, in a meaningful, democratic sense—in increments or by degrees, but must be fully realized. Creating “more open” books can simply mean that hidden information stays in those that remain closed, while the open books become props for public relations. Full accountability implies the ability to sanction the institution, if it should fail to be accountable to its citizens. Accountability without sanctions for institutional failures is not meaningful if the objective of reforms is to create more socially responsible and democratic institutions.

While a call for full accountability and transparency to be realized on the same fast track we saw with the financial bailouts may not be politically feasible, the ultimate aim of reforms should nevertheless be clear and always at the forefront of reform proposals. All too often full democratic reforms are either absent altogether from reform proposals, or are considered worthy but unattainable—and therefore able to be put off for years of meaninglessly incremental change. The necessity for anchoring reform strategies in a clearly defined democratic conception of transparency and accountability—with the tactics and outcomes that implies—is that it allows reformers to assess milestone reform proposals with a critical eye to attaining the ultimate goal.

3 Key Challenges to Reforming Domestic and International Institutions

Radical reforms are clearly necessary in both domestic and international financial institutions to move toward a socially responsible and democratic global economic system. To highlight the chal-

lenges, consider two claims made by the domestic and international financial institutions that govern the global economy. Central banks claim to be transparent if they follow and meet simple and previously announced policy goals, including in particular a commitment to use monetary policy to fight commodity price inflation but not asset bubbles. Similarly, multi-lateral institutions like the IMF claim to have increased their transparency if they release more and timelier information about their activities and policy goals, meet with their critics, and make incremental changes to governance, even when such actions do not produce meaningfully reformed policies and—more importantly—outcomes.

DOMESTIC CHALLENGES

The concept of “central bank transparency” originated in the United States, where it refers to a specific set of policies—promoted first by Alan Greenspan’s and then Ben Bernanke’s Federal Reserve—that many other central banks subsequently adopted in the 1990s, according to which central banks follow and then meet simple and publically declared policy so as not to destabilize the economy or upset the financial markets. This sort of transparency commits to fighting inflation and promoting unregulated financial markets. The **macroeconomic argument** is not a new one and is based on a vertical long-run Phillips curve (implying no trade-off between inflation and early unemployment) and rational expectations. Since unclear or misleading signals about a central bank’s intentions with regard to inflation upset the economy—pushing away from its equilibrium level of non-inflationary full-employment—the better policy, the argument goes, is for each central bank to state its commitment to price stability in clear terms, in the form of an explicit inflation target if possible, and then to use its limited policy tools (usually a short-term interest rate) to achieve this one goal.

Using monetary policy to achieve other goals—such as the breaking of asset bubbles before they grow excessively large and burst on their own—only confuses the markets and is unnecessary because financial markets are rational. The best policy, according to this framework, is to tie inflation targeting to publically-declared rules—commonly known as “Taylor” rules—stipulating how much

nominal interest rates will be adjusted when actual inflation rates diverge from target rates—and to implement interest rate changes through announcements. The **microeconomic argument** favours financial market deregulation. Since the idea is that financial market diversification achieves an optimal allocation of risk-bearing, the best policy is not supposed to stand in the way of the market, but rather let it evolve and innovate in its own unregulated way. The markets would not have invented or used derivatives, the argument goes, had they not been profit-enhancing and thus efficient. If short-term interest rates are predictable and steady, “free”, “unregulated” financial markets and institutions will do their job of allocating capital efficiently.

This kind of transparency should not be confused with that of a fully and democratically accountable central bank. The policies just described have been widely adopted by so-called “independent” central banks. Central banks—-independent or otherwise—have never been accountable to their national parliaments, senates, or houses of representation for the content of their policies, but the central banks with the greatest responsibility for handling the crisis—the Federal Reserve, Bank of England and the European Central Bank (ECB—did not even answer to their finance ministries or treasury departments.² According to the conception of transparency prevalent in central banks, the US Federal Reserve was transparent when in March and then again in September 2008 it used the sweeping and non-reviewable emergency powers given to it under section 13(3) of the Federal Reserve Act to take over the distressed assets of Bear-Stearns and then AIG—provided it report such operations and disclose the assets and liabilities involved on its balance sheets, which it did.³

² The Federal Reserve gained its independence from the US Treasury Department in 1951, with the signing of the US Treasury-Federal Reserve Accord. The Bank of England gained control over its operations in 1997. According to the treaties which created the Eurozone, neither the ECB, member national central banks (NCBs) nor members of their decision-making bodies may seek or take instructions from any external body. Also, neither the EU institutions and bodies nor the governments of EU member states may seek to influence the ECB or NCBs.

³ Federal Reserve Act, Section 13, “Powers of Federal Reserve Banks,” Subsection 3, “Discounts for Individuals, Partnerships, and Corporations,” Washington,

This is transparency without democratic accountability. The Federal Reserve’s commitment to the “inflation fight” and financial market liberalization caused it to do little to contain the obvious excesses and imbalances that had built up in the US financial markets ahead of the crisis, fueled by its previous low-interest policies. Once the crisis was underway, the response was further easing and lending on an unconditional basis. First a swift and rapid reduction in interest rates and then a flood of vast quantities of short-term dollar liquidity in the wake of the September 2008 US banking crisis—an increase in liquidity more than necessary to push dollar interest rates to zero, which US banks did not invest but absorbed as excess reserves and which cost the banks very little in terms of new regulations.

The only way of explaining the Fed’s apparently contradictory behaviour is to note the conflict of interest involved. The policy asserting that “asset inflations should be ignored in favour of a clear focus on containing consumer price inflation, while asset deflations cut into profits and are destabilizing” makes sense only when we acknowledge that the institution is captured by the very financial interests it supposedly regulates. A central bank with this sort of transparency will willingly bail out its financial system when it gets into trouble, but it prefers to place no limits or controls, particularly if they are quantitative, on the investment and trading activity of any market participant other than the usual need for “sound” risk management and diversification—all the while, maintaining its own autonomy and secrecy.

An independent central bank’s commitment to inflation fighting and financial market liberalization is an empty transparency because it lacks accountability to anyone other than market participants, and even then there is no authority to discipline the institution should it fail to be sufficiently “transparent”. The signals go only one way: from the central bank to the market. The purpose of this kind of transparency is solely to increase the effectiveness of the central bank’s monetary policy, not to promote accountability. Within the logic of the independent central bank as practiced by the Federal Reserve—a practice that predominates in the global system—what accountability there is, is

Board of Governors of the Federal Reserve, 2008, webpage).

solely to the private sector and in particular its concentrations of greatest capital.

INTERNATIONAL CHALLENGES

The problem of incomplete transparency and accountability can be seen in international, multilateral institutions like the IMF as well. In the wake of the 1997-98 Asian Financial Crisis, the IMF adopted a model of greater transparency according to which it began releasing more timely information on its lending policies and intentions. This is similar to central bank transparency in the assertion that financial markets process information efficiently and become unstable only if there is misinformation about the true state of the underlying economy or a government's commitment to a given set of policies, that is, the borrowing country's commitment to the IMF's conditionality. When the IMF decides to make public its assessment of a particular member state's condition, the transparency has a twofold effect. It disciplines the offending member state and educates other member states on the consequence of violations. According to this outlook, transparency limited in this way is an ideal kind of surveillance because it keeps debtor nations in line, thereby helping to stabilize financial markets.

The IMF's policy of greater openness and transparency in the wake of the Asian crisis served another purpose as well. This was to quell the criticism received for its handling of the crisis, especially with regard to Indonesia. There is a similar defensiveness in the IMF's public account of its more recent history with Argentina, but here there was no policy to defend: in the final analysis Argentina met all of its financial obligations, including that to the IMF.

The transparency practiced by the IMF since the Asian crisis is thus without democratic accountability: despite incremental reforms to the voting weights and rights of IMF member countries, and even under reforms discussed at the October 2009 annual meetings, high-income countries retain preferential voting weights while the US retains its effective veto, exercised through the Treasury Department. This distribution of voting rules and weights limits the influence of the Fund's principal borrowers—the emerging markets and developing countries. Equally important, although there is now US\$250 Billion in Special Drawing Rights avail-

able for borrowing without conditionalities, a part of which will go to developing countries that cannot afford to take on new debt, the majority of IMF loans retain the historic conditionality that has been an essential feature of the loans the IMF granted to Georgia, Ukraine, Hungary, Iceland, Latvia, Pakistan, Serbia, Belarus and El Salvador since September 2008. In these cases, pro-cyclical, contractionary fiscal and monetary policies were imposed, demonstrating that punitive conditionality remains at the heart of the IMF's present practice.

To illustrate, consider the following October 2009 response by IMF Strategy and Policy Review Department Deputy Director, Ranjit Teja, to a question about the IMF's rationale for ongoing fiscal austerities. The question referred specifically to a 17 June 2009 *New York Times* report that Latvia's Minister of Health had resigned rather than carry out an IMF-directed 30% cut to the public health budget because of the damage he claimed the cuts would have inflicted on patients and hospitals⁴. Mr. Teja asserted that he could not comment on any specific country's situation, but explained that the long-term "exit" strategy for much of Eastern Europe—entry into the European Union and adoption of the Euro—is not an objective the IMF would imperil by failing to enforce the required austerities [regardless of the social consequences].

Mr. Teja's relative candor shows that limited transparency without democratic accountability remains an essential feature of the IMF because it is captured, or constrained, by the major industrial countries that control it. Its conditionality remains a disciplining mechanism whereby powerful countries in the North use balance of payments and more recently capital account crises to "stabilize" the South and in which the United States, as stated earlier, has veto power. The first step toward a global economic system that is open and democratic, one that serves the needs of all countries and all citizens, is to acknowledge this reality.

⁴ "Latvian Health Official Resigns Over Cuts", David Jolly, <http://www.nytimes.com/2009/06/18/business/global/18lat.html> [Bhumika Muchala, Third World Network, posed the question at the 2009 IMF/World Bank Annual Meetings Civil Society Policy Forum.]

4 Towards A Socially Responsible and Democratic Global Economic System

It is not possible to separate disputes about transparency and accountability in governance from disagreements about whose voices should be heard, registered and followed. Governance is more than a mere set of rules for decision-making: at issue are the policies pursued, the interests served and the balance of both discernable and hidden power relations shaping governance. In the domestic arena, a socially responsible and democratically accountable central bank would not limit itself to giving aid and assistance only to banks and other financial institutions. Rather than simply protecting the interests of creditors, its objective would be to give full assistance to debtors as well, including, for example, providing loans to households in danger of foreclosure so that they can stay in their homes. In the international arena, a socially responsible and democratically accountable global monetary fund would function differently than the current IMF: emergency loans would be given but without austerity measures. Of course, for this to be possible the new Fund would have to have the capacity to create money—via an unlimited and proactive use of SDR's—leading perhaps to a new world reserve system. Also, the new Fund would not oppose but rather favour sovereign debt forgiveness.

On the table are a variety of ideas about governance reform that may have some effect on shaping present and upcoming debates about global economic governance and its coordination with national and regional systems. One example imagines what governance would look like if the present IMF were to reform its decision making process to resemble the UN's Security Council—a body envisioned by its designers as able to respond quickly to a crisis. Voting would be by open ballot, unlike its present closed IMF structure. The world body of nations would elect representatives from clearly defined regions, as the General Assembly now elects non-permanent members who serve two-year terms. And there would be permanent representation for the major economic powers, who would also hold the ability to veto.

An obvious advantage of this model is its pragmatism and efficiency: if organized in this way, the institutions that govern the international financial system would reflect the existing power balance of

the underlying world economy, thereby giving the largest and most powerful countries and their business interests the most influence. The chief flaw of this model is its lack of legitimacy of representation. The global economic crisis has *already* pushed the international financial architecture in a more inclusive direction, as the G-8 has given way to an evolving G-20 process—even though some of the newly admitted members complain that its inner workings are not sufficiently transparent.

Contrast this with a model of IMF governance in which the decision-making process resembles the General Assembly. Each country would have a seat and a vote although negotiations would be led by blocs based primarily on region but also on political and economic interest. The presidency would be elected yearly from regional groupings, thus giving more countries an opportunity to lead the assembly. The advantage of organizing the international financial system on this basis is its legitimacy: each nation is treated in the same way regardless of its current economic status and political power. The disadvantage is that one-year terms of leadership make it difficult to forge and carry out effective and coherent medium and long term policies, and its sheer size and complex political divisions make it challenging to reach decisions.

Developing countries have great sympathy for this model. After all, why should voting weights be economically determined in such a way as to give the advantage to those already most powerful? The challenge here is that the dominant powers—and even some developing countries with “emerging markets”—do not wish to see such an assembly reformed to make its decision-making process more efficient. Instead the dominant powers have largely preferred to keep critical decisions within their own control, arguing that *this* is the only efficient solution.

In fact, the original quotas for the IMF were designed to keep its leadership under the control of the dominant powers emerging from World War II. As recounted by Raymond Mikesell, the economist responsible for devising the quotas in 1946, his task was less economic than political: to “give the largest quota to the USA, approximately 2.9 billion dollars, then the UK including its colonies were to receive about half the US quota, the Soviet Union

just under that and China somewhat less.”⁵ It is important to ask whether the dominant economic theories for the past 30 years, which failed to predict this crisis and have thus far failed to devise a socially responsible way out—one for citizens and not just for finance—are worth trusting. Its creators devised the original IMF to manage economic imbalances they saw as occasional, aberrant. But haven't we seen in the interim that these imbalances are endemic to the way the global economic system is organized, that the BIS and UNCTAD were among those who warned of the danger, and in fact, that the IMF's conditionality was a policy that exacerbated these very imbalances?

The initial challenge in working toward a global economic system that is socially responsible and democratic, then, is facing up to the actual balance of powers that control existing institutions and their governance. The IFIs—the IMF, World Bank, FSB and BIS—do not work for themselves but rather report to the central banks and finance ministries that together form the nation-based, sovereign backbone of the international financial architecture on which the IFIs depend. Reformers are wise to ground their strategy in this understanding. The advantage will be gained in working to hold domestic institutions accountable to citizens—and then insisting that the central banks and finance ministries hold the IFIs accountable—rather than in directing the majority of reform efforts and resources into accredited engagement with the IFIs themselves.

The next challenge is to anchor reform milestones in a strategy that aims at social responsibility and democratic accountability. If reforms in transparency and accountability are not meaningful in increments or by degrees, the challenge will be to insist upon a process that propels reforms on to the ultimate goal. What should be rejected in milestone reform proposals is the “efficiency-oriented” model—whether led by a formally constituted (Security Council) or informal (G8/G20) elite—that concentrates its power into an effective decision-making group but is ultimately, democratically unaccountable.

Some progressive reform proposals for global economic governance are based on a constituency, or delegated, model of democracy in which decision-making power is entrusted to the representative seen as best able to advocate for the needs and views of its constituents. The idea here is that since global institutions do not arise out of a pre-existing global democracy—they cannot be democratically sanctioned by citizens for failures in accountability. The argument also boils down to one of efficiency: accountability can be best operationalized within a system in which constituent countries hold their power-wielding representatives accountable.⁶ The chief problem with such a compromise-model is not the utilization of constituencies per se, but rather the likelihood of their permanent institutionalization at the expense of the *demos*.

When a delegated- or constituency-based model of democracy is at the core of reforms, support should hinge upon the inclusion of timely mechanisms—not merely to review progress, but to enact further progress toward full participation within a representative body. The idea is not to reject more inclusive models as “inefficient” or “unoperational”, but to advocate for them and for ways to make them effective. For example, democratic bodies such as parliaments regularly meet in both formal and informal consultative committees that discuss issues and make recommendations, but the committees do not make decisions. This is done officially, within the fully representative assembly.

But as important as such formal access is, in the final analysis, meaningful changes in policies are the only reliable indicators of an increase in democratic governance. Accountability implies the capacity of ordinary citizens and nations to sanction the central banks, ministries of finance, IFIs and other related bodies for their failed policies ahead of the recent global financial and economic crisis and to replace them with different policies. The national and international financial institutions that currently govern the global economy have been captured by narrow economic interests. It is

⁵ Mikesell, Raymond F. 1994. “The Bretton Woods Debates: A Memoir”, *Essays in International Finance*. [Quoted in Dennis and Robert Leech’s *Warwick Economic Research Paper #914*, “Reforming IMF and World Bank Governance.”]

⁶ This point is made in the Report on the Civil Society (Fourth Pillar) Consultations with the International Monetary Fund on Reform of IMF Governance, page 30, box 1. See the Annex for Fourth Pillar reference.

high time for them to begin representing socially responsible and democratic interests: in other words, the *general* interest.

When we see a central bank making loans to households in danger of foreclosure instead of just to troubled financial institutions or large companies, or when the IMF or a successor global monetary fund begins lending unconditionally to countries in need and forgiving unrepayable debt, then we will have proof of meaningful change in the governance of these institutions. The model we advocate, the model of governance most likely to produce such policies, is one whose decisions have the legitimacy of fully representative participation and whose mission is social responsibility for people and not just finance, for green and sustainable global development and not just the needs of the wealthy countries and the wealthy in general.

About the Authors:

Christopher Rude is a political economist and long-standing observer of financial markets. Dr. Rude worked at the Federal Reserve Bank of New York for many years and then on Wall Street. He studied economics at the New School for Social Research. He also teaches at the New School.

Sara Burke is a policy analyst with the Friedrich Ebert Stiftung's New York office. Her work focuses on economic and social issues related to the United Nations and Bretton Woods Institutions.

Annex: Resources

Americans for Financial Reform: a coalition of 200 government, labor, investor, community and civil rights organizations campaigning for banking and financial system reform.
ourfinancialsecurity.org

Bretton Woods Project: independent initiative by British NGOs that work with an extensive network to press for increased transparency and civil society participation in World Bank and IMF policies.
www.brettonwoodsproject.org

Center for Economic Policy Research: Washington-based think tank to promote democratic debate on domestic and international economic issues. Involved in important Fed-watching and IMF-watching activities. www.cepr.net

Eurodad: European Network on Debt and Development is a network of NGOs working on issues related to debt, development finance and poverty reduction.
www.eurodad.org

Fourth Pillar: IMF Consultations with Civil Society Organizations on Governance Reforms.
www.thefourthpillar.ning.com/ and www.imf.org/external/np/exr/cs/news/2009/CSO100.htm These consultations were conducted in conjunction with the IMF by New Rules for Global Finance www.new-rules.org

Initiative for Policy Dialogue Transparency Task Force: April 27-28, 2009 Conference on Governance, Transparency and Accountability in Financial Institutions and Regulatory Bodies.
<http://www0.gsb.columbia.edu/ipd/programs/item.cfm?prid=25&iyid=5&itid=1654>

SAFER: Economists' Committee for Stable, Accountable, Fair and Efficient Financial Reform is a clearinghouse and coordinating mechanism for progressive economists and analysts to gather and present views on financial re-regulation and reform; to reach consensus on key issues relating to regulation and reform; to help incorporate this work into the public debate.
<http://www.peri.umass.edu/safer>

South Centre: Intergovernmental policy think-tank of developing countries with resources on the governance of international financial institutions.
<http://www.southcentre.org>

More information is available at
www.fes-globalization.org

The views expressed in this publication are not necessarily the ones of the Friedrich-Ebert-Stiftung or of the organization for which the author works.

Friedrich-Ebert-Stiftung
Hiroshimastrasse 17
10785 Berlin
Germany
Tel.: ++49-30-26-935-914
Fax: ++49-30-26-935-959
Roswitha.Kiewitt@fes.de
www.fes.de/globalization

Friedrich-Ebert-Stiftung
New York Office
747 Third Avenue, Suite 22B
New York, N.Y. 10017
Tel.: ++1-212-687-0208
Fax.: ++1-212-687-0261
http://www.fes-globalization.org/new_york/