FRIEDRICH EBERT STIFTUNG

Fixing Finance is Not Enough

The social consequences of monetary and financial policies

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- »We need courageous leaders who are willing to shift out of the current orthodoxy that austerity is the solution and that the weakest members of society will have to suffer the most because they are the most amenable to such measures. Some of those who are driving policy accept this approach because other options seem more difficult to implement. Some may not really appreciate how hard some citizens are affected. Some fear that they will be creating a situation of moral hazard if obligations are waived, even though many of those implicated in the crisis have been able to avoid any consequences. But do any believe that austerity, which reduces the productivity and spending power of citizens, will really work?«

  Alfred Gusenbauer, Chancellor of Austria (2007–2008); Member of Club de Madrid

- »There has been a growing disconnect between profits and investment. The main factors behind this disconnect are that profits of non-financial corporations have increasingly been used to pay dividends and to invest in financial assets rather than to make productive investments.«

  Raymond Torres, Director, International Institute for Labour Studies at the International Labour Organization

- »Issues relating to inequality or social cohesion should not be considered just as an add-on to mainstream economic policy, but such considerations should be embedded in all aspects of economic policy. In other words, the objectives of public policy include not only growth in output, maintaining employment, and price stability and financial stability, but also social cohesion.«

  Y. V. Reddy, Governor of the Reserve Bank of India (2003–2008)

- The collected essays, from heads of governments and central banks, governmental advisors and experts from the United Nations, Bretton Woods Institutions, OECD, International Labour Organization and academia, raise the level of debate on the role of rising income, wealth and group inequalities, economic fragility and the need to shape policies for a sustainable international monetary and financial system to foster shared societies.

Dialogue on Globalization

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CLUB DE MADRID

Center of Concern

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Preface

Fixing Finance is Not Enough: The social consequences of monetary and financial policies is based on discussions from a September 2011 conference organized by Friedrich-Ebert-Stiftung, Club de Madrid and Center of Concern at the International Monetary Fund on rising inequalities and the need for a sustainable international monetary and financial system to foster shared societies. *Fixing Finance* is the follow-up publication to *New Directions for International Monetary and Financial Policy: Reducing inequality for shared societies*, which was based on discussions from an April 2011 conference at the IMF on democratic reforms to promote equitable development and shared societies. At the earlier conference in April, there were skeptics who asserted that – while conversations about how to create more inclusive social policies and debates about necessary monetary and financial reforms are both important – the two discussions are fundamentally unrelated, therefore little benefit is to be gained from linking them artificially, however well-intentioned the effort. World events changed many perspectives on this issue between the April and September meetings. Ongoing social protests related to the Arab Spring, the anti-austerity movements in Europe and even Occupy Wall Street in the U.S. convinced key advisors in a number of national and international organizations that the two discussions not only should, but *must* take place as part of the same policy conversation if we are to build inclusive economic systems that are also resilient to financial and economic shocks. The present volume organizes discussions from the September 2011 conference into four thematic areas: 1) political challenges to pursuing shared societies, 2) linkages between inequality, the state of the multilateral order and the global financial crisis, 3) what is necessary to embed social policy in monetary and financial policy and 4) the challenge for development.

Section One, on political challenges, features the reflections of Club de Madrid members and former heads of state, Alfred Gusenbauer (Chancellor of Austria, 2007–2008) and Alejandro Toledo (President of Peru, 2001–2006). Chancellor Gusenbauer sees a widening division in society – even among the rich – that does not follow traditional political lines. This is the division between those arguing for more progressive and effective taxation in order to contribute to the well-being of society and the growth enthusiasts who reject greater taxation and advocate austerity measures on social expenditures rather than further restriction on markets. President Toledo follows this line and – from a »strictly business« standpoint – urges those in the business world to reflect on how investing in poverty and inequality reduction, to create a more economically inclusive society, would also lead to larger markets and higher returns. Lastly, French President Sarkozy's economic advisor Emmanuel Moulin reflects upon the role of the G20: »Do we need to change gears? Do we need to change the G20 agenda? Do we need to do more? Is G20 legitimate to tackle the crisis?« His view is that the present global economic situation makes it all the more important for the G20 to work toward coordination to foster global growth, to reform the international monetary system and to regulate the global financial system, but that of particular importance for the social dimension, it must focus on youth employment and social protection floors.

In Section Two, on linkages between inequality, the state of multilateralism and the global financial crisis, Raymond Torres, Director of the International Institute for Labour Studies at the International Labour Organization points out that, while the global crisis was preceded by a long period in which the top income earners took an increasing share of GDP while workers' incomes declined, this situation has not resulted in increased investment. This growing disconnect between profits and productive investment, he argues, needs to be corrected with a set of policies including more well-designed labour market institutions, progressive taxation and social transfers. Michael Kumhof, Deputy Chief in the Modeling Unit of the IMF's research department, notes in his article on the links between income inequality, debt leverage and economic crises, that the U.S. experienced two major economic crises over the past 100 years – the Great Depression of 1929 and the Great Recession of 2007 – in which sharp rises in income inequality and household debt-to-income ratios may have played a catalytic role. In his article on the state of multilateral institutions Brazilian World Bank Executive Director Rogério Studart argues that the present IMF and World Bank are not legitimately multilateral and asks what it will take to build truly multilateral, global institu-

tions that can help us address the risks – from poverty and inequality to climate change – of global challenges that cannot be tackled from a purely national perspective. Following in this vein, Pablo Pereira, former Executive Director to the IMF from Argentina, acknowledges that inequality is at the heart of the economic crisis and argues that the IMF's effectiveness to deal with it has been critically hampered by unresolved issues related to its governance and legitimacy, which has not adapted to the demands of the present multipolar world economy. Former economic counselor to the OECD Secretary General, Jonathan Coppel (now with the Productivity Commission of the Australian Government), notes that global income distribution has not only been shaped by long-term trends such as technological change, globalisation, and economic and social policies, but also by macroeconomic shocks such as the recent financial crisis, in which the effects were concentrated among different groups in society. Solutions, he notes, require direct policy measures that focus on redistribution and inclusive employment policies. Finally, in his article, Rishi Goyal, Deputy Chief in the IMF's Strategy and Policy Review Department, makes three points: that global macroeconomic and financial stability is a necessary, but not sufficient, condition to correct social inequalities, that we do not have effective mechanisms to deal with the kind of shocks we now see to the core – rather than the periphery – of the system, and that fixes have to apply to the system as a whole rather than its component parts.

In Section Three, on embedding social policy in financial and monetary policies, former Governor of the Reserve Bank of India, Y.V. Reddy, draws on his wide experience in financial and monetary policy to explain how social cohesion and inequality can be addressed in monetary and financial policies. Given that income inequality is rising and bad for growth, former Columbian Finance Minister and Undersecretary General for the UN Department of Economic and Social Affairs, José Antonio Ocampo, asks which policy instruments become particularly important. His thinking points to fiscal policy, employment and wage policy (the latter of which is typically ignored in these debates). Then Ulrich Volz, Senior Economist for the German Development Institute, argues that the IMF should focus on five areas: supporting member governments to undertake sustainable development policies, improving monitoring and surveillance to detect vulnerabilities, the development of better crisis prevention facilities and crisis resolution, including a sovereign debt restructuring mechanism, and facilitating economic cooperation and policy experience sharing.

Section Four focuses on the challenges inequality places on development. Jomo Kwame Sundaram, Assistant Secretary General for Economic Development at UN-DESA, asks, »Why should we bother to create a stable and functioning international monetary and financial system?« His reflections point to the rise of finance, its recent success in capturing the greatest share of income streams, and the problems this has created for development. Isabel Ortiz, Associate Director at UNICEF, indicates that the extreme inequalities at present raise serious questions about the adequacy of current development models. Noting that billions were already in poverty before the crisis, and – despite being temporarily supported by fiscal stimulus plans – vulnerable populations were not adequately protected from the global shock even before austerity policies put them in a more vulnerable position. Finally, the UN Development Programme's Assistant Secretary-General and Assistant Administrator, Sigrid Kaag, acknowledges that social and economic inequality is now a core development concern. She urges readers to look beyond the dimension of income toward the significant disparities in access to basic goods and services and to those systematically left out of development progress because of group inequalities on the basis of race, ethnicity, creed, gender, and geographical location.

The underlying message of these various contributions to a discussion on the social consequences of monetary and financial policies is that the linkages are of vital importance. Failure to take steps to correct monetary and financial policies that increase income and wealth inequality has been deleterious to growth, to social cohesion and to economic stability. Furthermore, income concentration in the financial sector has exacerbated governance challenges that have both domestic and international dimensions and that must be tackled multilaterally, in a reformed multilateral system, for the sake of both »traditional« development and sustainable human development for a new era.

The editors of this publication thank all of the authors for their contributions, both to this publication and to the conference that generated it. We are also grateful

to conference participants Chrystia Freeland, Editor of Thompson Reuters Digital, Richard Freeman, Professor of Economics at Harvard University, and Sanjeev Gupta, Deputy Director of the Fiscal Affairs Department, for the provocative and thoughtful ideas they raised during the conference. In addition, we offer warm thanks to our conference co-organizers, Clem McCartney, Rubén Campos and Carla Fernández-Durán from the Club de Madrid and Aldo Caliari, from the Center of Concern's Rethinking Bretton Woods Project, without whose conversation and wisdom neither the conference nor this publication would have been possible. Through our work with them, we now take this effort forward to work toward a global shared societies agenda, a strategy to promote social cohesion and economic inclusion for sustainable development and growth.

*Werner Puschra and Sara Burke**

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1 The political challenge of pursuing shared societies

A Failure of Leadership and a Failure of Policy

Alfred Gusenbauer

The world economic and financial crisis is still with us. We have two big patients – Europe and the United States of America – who so far are not showing much sign of recovery. There may be some green shoots in the US with some better employment figures, but its economy is still very weak. The other part of the story is the sovereign debt crisis in Europe.

What happens in both continents will have an immediate and significant influence on how the world economy is or is not functioning.

It seems to me that there is a failure of leadership both in Europe and in the United States (US), and I will return to that concern presently.

But there is also a failure of policy. This is why it is important to talk about some of the underlying problems rooted in the way our societies work, and compare that to the way they should work if we pay attention to some of the more intelligent analyses that are available to us.

This is the feeling among the Members of the Club de Madrid, now more than 80 former heads of state and heads of government around the world. Together with a small, hard working secretariat, we are quite active and able to cooperate with current national and regional leaders, and therefore able to exercise a certain influence.

On the basis of our experience, both in and out of office, we in the Club de Madrid believe that we need to bring the social purposes of the economy to the centre of our criteria for assessing the potential of different economic policies and strategies, and for measuring economic performance. Social progress, which includes overcoming inequality, is a more real and tangible aim for our economies than some of the false gods we have been pursuing. For example, for many years many people thought that money simply produces more money. The wake-up was quite traumatic in 2008, but we are in danger of going back to sleep again and relying on the same old failed assumptions.

Social progress and economic progress are sometimes seen as opposing rather than complementary goals, which, in our view, is incorrect. A win-win outcome is possible if we focus our policy choices on delivering a higher level of well-being for everyone and improving their quality of life.

The Club de Madrid has been vitally concerned with the issues of social division and social tension, which are some of the biggest obstacles to social progress in many countries, developed and developing, across the world. They leave many people marginalised because they are different, either in terms of religion, race, language, ethnicity and so on. One of our major initiatives is the Shared Societies Project designed to highlight the challenges of inter-group divisions, and to offer approaches and methods of meeting those challenges by building Shared Societies. We have identified 10 policy areas where we believe governments have to make a commitment if they are to create Shared Societies. The 10 Commitments necessary to create Shared Societies are:

- Locate responsibility for social cohesion within government structures;
- Create opportunities for minorities to be consulted;
- Monitor structures and policies to ensure that they are supportive of social cohesion;
- Ensure the legal framework protects the rights of the individual;
- Deal with economic disadvantages faced by those discriminated against.
- Ensure their physical environments create opportunities for social interaction;
- Create an education system that demonstrates a commitment to a shared society;

- Initiate a process to encourage the creation of a shared vision of society;
- Promote respect, understanding, and an appreciation of diversity;
- Take steps to reduce tensions and hostility between the communities.

We are convinced that Shared Societies work. They lead to a stronger sense of well-being, which is not possible where there is no inclusion. It is still difficult to measure the degree to which societies are shared, which is ultimately necessary in order to relate performance on building Shared Societies to other dimensions of a nation's performance. We would like to develop some sort of Shared Societies Index to fill that gap. Some aspects of social well-being have already been measured by other indexes. One of the first was the Human Development Index of the United Nations Development Programme (UNDP). Now you also have available the work by Joseph Stiglitz, who, together with the king of Bhutan, developed the Happiness Index. So there is a lot of reasonable work available that tries to approach the issue.

We are becoming increasingly aware that inter-group relations are closely intertwined with the economic challenges that we face, and the Club de Madrid has published a report entitled, »The Economics of Shared Societies«. The economic rationale for Shared Societies is becoming more and more evident. We believe that general well-being is at least partly dependent on building Shared Societies, and has a positive impact on economic performance. Shared Societies generate economic and other dividends for governments, businesses, communities, families, and individuals. This outlook is confirmed in many ways. The book *The Spirit Level*, by Wilkinson and Pickett, very persuasively underlines the economic rationale for shared societies and clearly says that the most equitable societies over the past decades have also been, in the long run, the most successful ones in economic terms. So there is not a contradiction between social cohesion and economic vitality, but quite the other way around: Each enhances the other.

How does it work? The economic dividends and other benefits of a Shared Society further enhance a society's capacity to be more inclusive and cohesive, which in turn generates more dividends, thus setting up a positive, virtuous circle. If a nation invests in its residents and helps them to achieve their aspirations, self-respect grows. And we know that in a fair and enabling society, the well-being of all members improves. Then the individual is ready to engage with the community and play a responsible part economically and socially.

Recent history has shown that proper social protection assures the individual that society will be there to assist in the case of failure or misfortune, and therefore it is still possible to have a decent life. This environment motivates people much more effectively to take risks, and to enter into entrepreneurial activity and engage in society. And this leads to increased prosperity, which means that there will be more resources available to invest in building a Shared Society.

The individual wants to pursue his or her personal interests, and if given the opportunity, contributes effort, skills, and talents as a productive member of society.

The achievement of this virtuous circle requires governments and the dominant sectors of society to recognise the desire of individuals to belong, and to fulfil their aspirations even if they seem different from other parts of society. It requires government and society to make space for individuals to pursue their personal ambitions in their own way, and at the same time to give them the support they need. When this happens, there is a strong motivation and incentive to integrate into the rest of society.

What are these aspirations? The fulfilment of non-material aspirations is being increasingly recognised as an important aspect of well-being. Greater wealth does not in itself increase our level of happiness. Personal well-being necessitates not only income and services, but also recognition that comes from participation in the economic and social life of the community. The Shared Societies Project is very aware that recognition means accepting all aspects of identity, including those such as language, religion, clothing, and other cultural practices which mark people out as different. Interestingly, when those distinguishing features are recognised they do not disappear, but become private matters which strengthen the personal sense of ease and well-being and lead to greater social cohesion. This is true, by the way, for all of us.

Gallup has identified five essential elements which together make up an overall sense of well-being: career, social, financial, physical, and community. The aspira-

tions of all people are very similar. They want to have a reasonable quality of life, a sense of control over their own destiny, to be accepted and respected by the wider society, and – for parents – the opportunity to give their children a good start in life. It is not the absolute quantity of any of these factors that is important, but the confidence that they will continue to be available.

Amartya Sen underscores this point very persuasively in his work, where he points out that poverty can be understood as the lack of the capacities, tools, or opportunities needed to function as a full citizen, rather than the lack of money and possessions or a shortage of talent or ambition. I think this is a very important definition of poverty because it enhances our understanding of the unquantifiable aspects of the problems in our societies.

This is why we in the Club de Madrid believe that we need to bring the social purposes of the economy to the centre of our economic thinking. But look at the approaches we adopt.

I do not have to tell you that I think the answers we and the IMF have chosen at the present time for the crisis in Europe are wrong. It is a regressive development. The policies squeeze citizens ather than support them. There is also a strong push to dismantle all types of social protection, even though I pointed out early on that a safety net encourages risk taking and economic engagement.

And to make people suffer for a strange goal that, at the end of the day, cannot be fulfilled, doesn't make a lot of sense. To embark on these massive austerity policies will not lead to success. It will lead to a deeper recession, and further recession will even increase the public debt burden of the countries, from which they will not be able to rise. And there are many people in the US who would want to follow a similar path.

Therefore, I think it would be much better to take over the Greek debt to the maximum extent possible on the European level, if we can afford that, and to allow Greece to come back to a path of development. If we duplicate in other countries the austerity recipes applied to Greece, Europe will say goodbye to social cohesion and a Shared Society and, in my understanding, give up its soul. Europe, for many decades, has been different from other parts of the world very much because of it social model – this social cohesion that we were able to develop.

Therefore, we have to engage in a very fundamental political argument in Europe which would not divide along traditional political lines.

This analysis is shared by many Christian Democrats and even by liberals (in the European sense). There is quite a movement across a number of European countries, of rich people who say they want to pay more taxes in order to contribute to the well-being of the society (Warren Buffet in the US being one example). But at the same time, politicians both in Europe and North America are talking about reducing taxes as if it will stimulate growth.

Technically, the solutions are fairly easy. If Europe were able to agree on Euro bonds and a form of economic governance with democratic legitimisation – as well as the recapitalisation of some of the affected banks – that could quite easily improve the situation. You do not have to be a genius to develop those ideas. It has to be acknowledged that the Greek crisis would have been a minor problem if it had been solved in the spring of 2010 because it represented only about 2.5 per cent of the European GDP and 3.5 per cent of the sovereign debt in Europe. This is not an outrageous problem to be solved.

So the problem is a political one. If we are talking about the different types of crises today, perhaps the biggest crisis around the world is the crisis of politics, because political leadership seems to be missing in many, many parts of the world.

In Europe at the moment the situation is deteriorating daily. In 2008 there was enough political leadership to resolve the financial crisis and to embark on bold political measures. Now the situation is growing steadily worse. There is a special art that has been developed within the European Union for muddling through. It seems that we are real experts in that type of activity. But while we muddle, the public atmosphere is tending to go against the European ideal; there is the emergence of nationalism in many countries. Also, in the US many are turning inward, and obviously it will not be possible to come to terms with reasonable economic policies until after the presidential election – and even then nothing is certain.

But now, globally, we need courageous leaders who are willing to shift out of the current orthodoxy that austerity is the solution and the weakest members of society

will have to suffer the most because they are the most amenable to such measures. Some of those who are driving policy accept this approach because other options seem more difficult to implement. Some may not really appreciate how hard some citizens are affected. Some fear that they will be creating a situation of moral hazard if obligations are waived, even though many of those implicated in the crisis have been able to avoid any consequences. But do any believe that austerity, which reduces the productivity and spending power of citizens, will really work?

Shared Societies is an ambitious concept, and it requires political leadership. Therefore, the task of like-minded organisations is, first of all, to identify the intellectual backbone of what can and should be done. At the same time, we also should be active in building up public pressure to provide the space for political leadership to implement some of the elements that make our societies more cohesive.

Right for the Economy and Right for Humanity

Alejandro Toledo

We have tended to respond to the economic crisis which began in 2008 as an exceptional situation and seem to be hoping for a short-term fix, but we need to take a wider, long-term view which takes into account the way the crisis disrupted positive trends in previous years, and also takes into account the deeper issues which lie behind the crisis: reforming the international financial system, on the one hand, and the need to deal with poverty, social exclusion, and inequality on the other.

It is important that we raise the issue of inequality and social exclusion, particularly in relation to the IMF and World Bank. I used to work at the World Bank about 20 years ago, and – because of its history – I would never have dreamed then that a reform debate that deals simultaneously with the financial system and social issues would be taken up in the IMF. We are making some progress.

In the short term, the European Union will not be able to contain the financial crises of Greece, Portugal, Spain, Ireland, and Italy. If the contagion passes from Europe into the United States – a United States that is not too solid economically – it will also affect Latin America. The 66 billion dollars that has been injected into the US economy, and the other 400 billion dollars that was requested, are not having the expected response. For example, unemployment rates have fallen slightly, but they are still very high. It's likely that once again we will have a world financial crisis, and the question we face is whether the institutions of the financial system will be able to put out the fire this time.

If we take a longer view, the crisis that began in 2008 has accentuated the levels of poverty, inequality, and social exclusion in the developing world. My region of 500 million people – Latin America – provides a good example. Latin America, like other developing societies, has been experiencing respectable rates of economic growth. The region has been growing at an average rate of six per cent, and even had nine per cent growth for 10 consecutive years, except for 2009. That is not only because the states are managing their economies more responsibly, but to a large extent, because of an exceptional factor, the high prices of their commodities in the international market.

Around 65 per cent of foreign exchange is derived from exporting raw material, particularly the extractive industries and gas and oil. Of course, the prices of oil, gold, silver, and copper in the international market are currently very high. China is growing at 10 per cent, and China is buying our products, but that is a fragile situation. It makes the region very vulnerable if we don't invest in the minds of our people to give added value to our production or to diversify the economic sectors for growth.

Thirty per cent of the population still falls below the poverty line, as measured in terms of income per capita, though that is not the most sensitive measure of poverty and the impact of inequality. With the growth rates for the 10 years before the 2008 crisis, we were expecting that by 2009 three million people would have risen out of poverty.

With the crisis, not only were those three million people left in the darkened hole of poverty, but three million others fell into poverty. This is a part of the price that we paid for a crisis that this time, by the way, was not produced in Latin America. For the past 30 years we have been seen as a continent that is disordered, disorganised, and prone to hyperinflation and crisis. That was the image we had. With all due respect, however, the crisis of 2008–2009 was not produced in Latin America, and yet we have still had to pay the price.

Looking forward, we are at threshold of another global financial crisis if Europe and the United States don't get their act together. And in this interconnected world, we will all be paying part of the price, too. These are the economics and the financial realities that we need to deal with as part of the global challenge. The world now has seven billion people, and 40 per cent of that seven billion are living below the poverty line.

If we do not have the political will and determination in the short term to reduce poverty and inequality, and to construct a society that is more inclusive, with mutual respect for cultural diversity and sensitivity to the environment, we will have discontent in the world and

social unrest. Social unrest, inequality, and social exclusion could truncate economic growth, undermine democracies, and create a very fragile economic landscape in which financial crisis would be likely. Social unrest is not a good climate for attracting capital investment. If we don't have capital investment, we won't have growth. If we don't have growth, we won't have anything to redistribute, which will lead to a perverse, vicious circle.

Therefore, we need to both reform the international financial system, on the one hand, and deal with poverty, social exclusion, and inequality on the other. The juxtaposition of these two issues shows us that we need to re-engineer the financial system so that it contributes to constructing societies that are more inclusive, with the medium- and long-term objectives of providing sustainability not only to economic growth, but also to *development*, where people would have access to clean water, health care, and quality education.

It also needs to be rooted in valuing and supporting cultural diversity, because in a global world, that is a way to put a human face to globalisation and generate mutual respect for our diversity. I come from an indigenous community, and I'm very proud of it. I don't want globalisation to erase my roots, my identity. I don't want people to give my fish away; I demand my right to know how to fish. For me, globalisation is not a means to undermine culture by, for example, penetrating markets with a universal dish such as McDonald's burgers or Kentucky Fried Chicken. I hope we will never reach that point, because it is not part of my vision of globalisation.

Can we cultivate new leadership in the world that can lead us to the point where citizens and the global society accept ourselves, our cultures, and our diversities, and also improve our quality of life by constructing a Shared Society? This is what has motivated me to join in this dialogue.

But there is a crisis of leadership in the world. In Europe and in United States there is wealth and the ability to communicate with the most eloquent speeches, but most of the time they can't deliver results, so people are getting a little bit frustrated.

Can we look to the business sector? I'm telling my friends who are in the business world in South America, »Listen, the rate of return for your investment is going to be higher if you help to reduce poverty and inequality and construct a more inclusive society. Can you imagine China and India together? That's 2.4 billion people. Investing in poverty reduction and inequality reduction and in the construction of a much more inclusive society is very profitable for business and is good for democracy. You would have 2.4 billion people to enlarge your market who could buy your bread, water, milk, Yahoo. That's 2.4 billion people who currently don't participate in the market«.

And they say, »Yes, we can extend the market«. But they are not too eager to volunteer to increase taxes. In some cases, the opposite is the case. They also say, »No, hold it. I cannot be too generous because I don't know whether price of gold in the international market tomorrow will be the price it is today, 1,900 dollars an ounce«.

That's how it looks strictly from the business perspective, a *strictly* investment-based point of view.

But a Shared Society is rooted in an older premise, that ultimately, economic development and economic growth is a means, not an end. We need to achieve economic growth with a human face, thinking in terms of development, not only of growth.

I am in favour of the Shared Societies' mission not only because it is economically right, but also because it is right in human terms.

If we do have the political will and determination in the short term to reduce poverty and inequality, and to construct a society that is more inclusive, with mutual respect for cultural diversity and sensitivity to the environment, we will be stimulating a benign, self-reinforcing, positive circle. If not, we face growing discontent in the world and social unrest.

Six Weeks Before Cannes – The Role of the G20 in Times of Crises

Emmanuel Moulin

The world economic crisis questions us about the role of the G20: Do we need to change gears? Do we need to change the G20 agenda? Do we need to do more? Is G20 legitimate to tackle the crisis? My view – and I will prove it – is that the present situation makes it all the more important for the G20 to achieve its goals.

When France started the G20 presidency in January 2011, we set up an ambitious agenda to continue the efforts of the G20 on financial regulation, on growth with the framework for a strong, sustainable, and balanced growth, and on development. President Sarkozy added four new priorities to the agenda: the international monetary system, the excess volatility of commodity price, global governance, and the social dimension of globalisation.

Over summer 2011, the global situation changed markedly. A global slowdown took place in the second semester 2011. The IMF announced that it was anticipating a one point downward revision of global growth for 2012. The euro zone was going through a crisis that was addressed by the heads of state as a first step immediately on 21 July 2011. Because the time of democracies and parliaments is not the same as the time of markets, the implementation of this first ambitious agreement took time. And heightened financial tensions drew stock prices down. We have also seen some tensions on liquidity.

This new environment reinforces our choice of focusing on the underlying causes of the current problems, in particular, global imbalances, incomplete financial regulation, and commodity price volatility. This new environment also calls for a strong impetus of G20 leaders in Cannes. At the G20 Summit, we need to strengthen our efforts to build a more ambitious Action Plan for growth and bring a coordinated response to the current crisis in order to achieve a lasting economic recovery. The key issue is growth indeed. It requires a set of collective G20 actions which are listed below.

1. The G20 must bring a coordinated response to foster global growth

We are in a situation where coordination of efforts is key. We are not in the same situation as in 2009, when we only had to focus on stimulus. In London, the G20 focused on stimulus, whereas in Toronto, the G20 focused on fiscal consolidation. Today, we know that for some countries which face strong budget constraints, stimulus is not the adequate response. But at the same time, an overall global policy of austerity or of very quick fiscal consolidations would be very dangerous for global growth. The result is that countries which have room to maneuver to stimulate growth should use them, while countries which are under the pressure of the markets need to consolidate.

Because the current crisis is also a crisis of confidence, fiscal consolidation schemes need to be very precisely designed: the response is not to aggressively and immediately cut all public spending. The response is rather to make fiscal consolidation efforts within a medium-term framework in order to ensure credibility while making sure that these efforts are as growth-friendly as possible. As an example, we should focus on reforms of entitlement schemes and implement fiscal rules because doing so will increase confidence without undermining growth.

There is also a need for a more balanced global growth. In particular, in emerging countries, internal demand is very low and should be stimulated.

All this economic policy should be encapsulated in Cannes into an Action Plan for growth, with concrete commitments and timelines from each G20 member.

2. The G20 must work on the reform of the international monetary system

Global imbalances are also linked to the proper functioning of the International Monetary System, or rather the International Monetary Non-System we are living

in. Yet, we are making progress. For example, the G20 will endorse a common framework to encourage stable capital flows. This is particularly crucial at a time when we face tensions in financial markets, and therefore risks of sudden stops of capital flows into emerging markets.

We also want to make progress towards the internationalisation of emerging economies currencies, including building a path toward the enlargement of the SDR basket. And we want to have stronger financial safety nets, which means we should open discussions about new facilities of the IMF. Finally, we should build global safety nets in order to deal with systemic and/or regional crises, and with countries affected by global volatility as collateral damages.

This obviously brings us to the issue of the resources of the IMF, because we cannot ignore the fact that the ability of the IMF to deal with a new crisis is now limited. In London, the G20 decided to triple the resources of the IMF. We also decided upon a quota reform. It is now very important that all G20 countries implement their commitments. As of now, only 21 countries (including France) have ratified the quota agreement. There is still a long way to go to come to the 85 per cent majority.

3. The G20 must pursue its comprehensive efforts to regulate the financial system

The G20 is now implementing the commitments taken to improve financial regulation. Some jurisdictions have decided to go even further than G20, as the European Union has done with several new legislations. What is important is to make sure that G20 is not promoting the development of non-regulated entities outside the scope of regulation; otherwise, it would create some new factors of vulnerability in the international financial system.

4. The G20 must tackle the global commodity issue

For the first time in the G20, France initiated meetings of agricultural ministers. They took decisions in order to increase the transparency and to improve the regulation of commodity markets. The final goal is to reduce excessive volatility of prices. We took concrete steps to improve physical market transparency with two international databases: the Joint Organisations Data Initiative (JODI) on oil, which will be expanded to other energies, and the Agricultural Market Information System (AMIS) on agricultural goods. They will provide a better view on storage, production, and consumption.

5. The G20 has a responsibility to act in favour of development

Thanks to the Korean G20 presidency, the G20 forum now deals with development, which is a very positive and meaningful step since advanced and emerging economies are now collectively acting in favour of development. We believe that the current environment makes it all the more relevant to deliver on the development agenda.

We have focused the French presidency on infrastructure and food security. We also address the question of the financing of global public goods such as climate and development, especially in the current times of constrained public finances. President Sarkozy is pushing for a financial transaction tax as one possible way. We commissioned a report by Bill Gates on the issue of the financing. Bill Gates concluded that a financial transaction tax is feasible and does not need to be universal.

6. The G20 must take into account and promote the social dimension of globalisation

For the second time in G20 history, the G20 presidency organised a meeting of the G20 labour ministers. We are convinced that G20 needs to include social issues in the G20 economic agenda. I would like to mention two priorities of the French presidency. The first one is the question of youth employment. We will create an intergovernmental working group on youth employment and share best practices among G20 with the support of the international organisations such as ILO and OECD. The second priority is to make progress towards the implementation and expansion of social protection floors. On this issue, we benefited from the report of Madame Bachelet, former president of Chile. In advanced economies, social protection accounts for 20 per cent of GDP, whereas in low-income countries it accounts for only 4 per cent. The crisis has shown that financial

safety nets are very important to smooth the impact of the economic cycle. They are also very useful in eradicating inequalities and can contribute to the re-balancing of the global economy by stimulating domestic demand in some countries.

The French presidency innovated in 2011 in including labour unions in G20 work. We organised not only a B20 summit for business partners, but also an L20 summit for labor unions of G20 countries. Both should make commitments, and their encounter in Cannes should allow the implementation of more socially responsible policies.

7. The G20 must think of updating the governance of international organisations

President Sarkozy is very much willing to make progress in Cannes on the issue of the governance of international organisation. All international organisations should coordinate their actions, particularly regarding the responses to the crisis. They should take all the dimensions of globalisation (financial, economic, social, and environmental). As an example, we are pushing for a close cooperation between ILO and WTO on the basis of cross observers. We also believe that all of the G20 members should ratify the eight basic conventions on fundamental labour rights of the ILO. These are the reasons why President Sarkozy asked Prime Minister Cameron to issue a report on global governance in Cannes.

2 Inequality, the state of the multilateral order and the global financial crisis

Inequality and the Global Crisis: Evidence and Policies

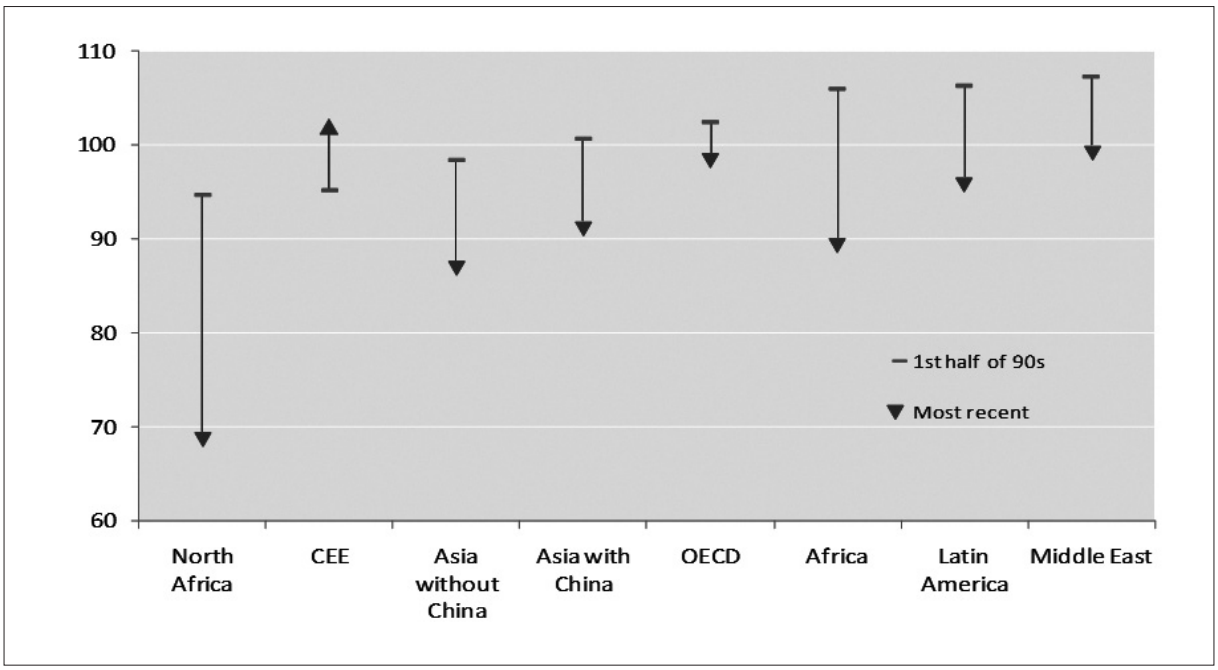
Raymond Torres

Inequality Trends

Labour incomes losing ground, especially for the low-paid

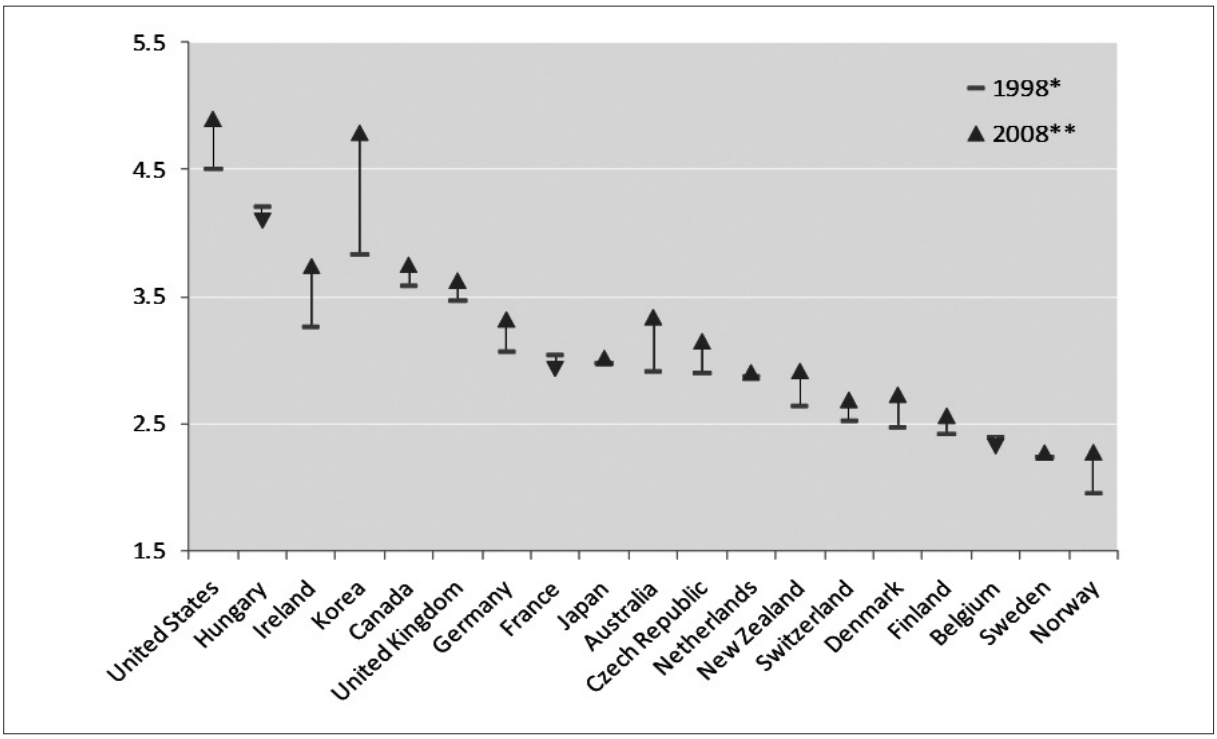
The global crisis was preceded by a long period of wage moderation. At the same time that there has been an increasing share of the top income earners vis-à-vis the rest of the population, the wage share – i. e., the share of labour incomes in GDP – has declined. Since the 1990s wage shares have fallen in the vast majority of countries, even correcting for a number of factors like self-employment income – a trend which is consistent across advanced, emerging and developing countries (Figure 1). Associated with that has been an increase within the labour share. The decrease in labour's share of GDP has been more pronounced for low income earners than for high income earners. Between 1998 and 2008, wages of the 10 per cent higher earners increased faster than those of their bottom counterparts. As such the P9/P1 ratio of gross earnings increased in the majority of countries for which available data exist (Figure 2). Increases have been particularly large for countries which have overall low inequalities such as Nordic countries and some transition economies. The only exceptions to this pattern are Hungary, France and Belgium.

Figure 1: Wage share by region (change between 1990 and most recent year available)



Source: IILS calculations (ILO, 2011).

Figure 2: Change in the P9/P1 ratio of gross earnings between 1998 and 2008



* Data for Belgium and Ireland correspond to 1999 and 2000, respectively.
** Data for Belgium and France correspond to 2007 and for the Netherlands to 2005.
Source: IILS calculations (ILO, 2011).

Inequalities did not boost real investment

The increase in income inequality – and, therefore, the reduction in the wage share and the increase in the profit share – have not translated into more investment. Between 2000 and 2007, capital share in advanced economies grew by 1.5 full percentage points, from roughly 17 per cent in 2000 to 18.5 per cent in 2007. In contrast, investment as a percentage of GDP did not keep pace with profits and remained stable (Figure 3). Indeed, since the onset of the crisis, investment as a percentage of advanced economies GDP has tended to decline little by little. This is the case, for instance, in the United States. In the case of emerging economies, investment as a percentage of GDP has increased but much less than what had been possible on the basis of the increase in profits as a percentage of GDP.

Simple correlations between growing profits and growing investment, accounting for a number of other factors, show that the slope is negative in the case of OECD countries. Moreover, in emerging economies, the increase in profit has not been associated with a proportionate increase in investment. In fact, even in countries or regions where the slope is positive, it is not equal to one; it is always less than one. Therefore, there has been a growing disconnect between profits and investment. The main factors behind this disconnect are that profits of non-financial corporations have increasingly been used to pay dividends and to invest in financial assets rather than to make productive investments (ILO, 2011).

Increasing inequalities or growing profits did not lead to more investment, but they could have led to more employment. However, if we focus on the good employment performance, both for advanced economies and for emerging economies, there are two groups. Some high inequality countries do have high employment – for instance, the United States, but there are low inequality countries with high employment rates. Actually, on average for advanced economies, the employment rate, which is the most important market indicator, is slightly higher than in the case of high inequality advanced economies.

In short, the alleged benefit of wage moderation in growing inequality does more to investment such that, later on greater productivity and employment occurs. In this sense, there has been a growing disconnect.

Inequality: Links With Global Crisis

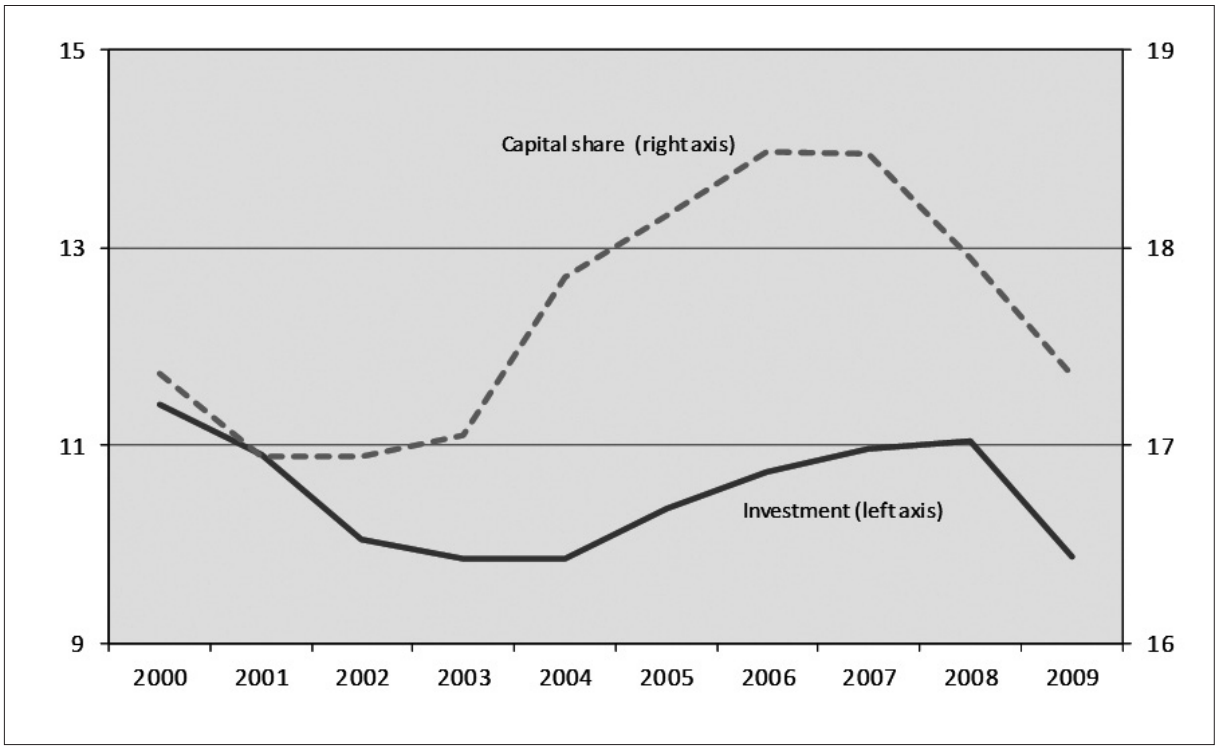
Over the past few decades, with the prevalence of the neoclassical model, income inequality through wage moderation has generally been seen as beneficial for job creation and economic growth. The recent global crisis, however, proved that income inequality has not produced the expected effects on investments and growth. In fact, income inequality in both developed and emerging economies has affected economic growth by reducing consumption demand, through two mutually reinforcing effects: debt-led demand in advanced economies and export-led growth in emerging countries.

In some advanced economies, income inequality caused a build-up of private debt. Those countries that have more inequality also had more increases in household debt as a percentage of household income. Under the dysfunction of financial systems, banks were in a position to provide credit to these households – even though under prudent criteria, such loans would not have been provided.

In the case of emerging economies where the financial system was more tightly regulated, income inequality had a direct impact on weaker domestic demand. So it was crucial for economic growth in these countries to gain wider access to markets of advanced economies, especially those where domestic demand was especially dynamic. This is how the increasing inequality in emerging economies was transmitted into an increased emphasis on export-led growth.

For a while, the coexistence of debt-led growth in certain developed countries with export-led growth in

Figure 3: Capital share and investment developments among non-financial firms in advanced economies (percentages of GDP)



Note: The sample analysed comprises 30 advanced economies.
Source: IILS calculations based on the OECD and UN National Accounts databases, national sources and IMF (2011).

large emerging economies seemed sustainable. The surpluses of the latter countries served to finance the deficits of debt-led countries. And the world economy was expanding fast. However, debt-led demand proved to be the Achilles' heel of the growth process. As US monetary authorities raised interest rates in 2006–07, the relatively small increase in borrowing costs which resulted from this measure was enough to provoke a cascade of failures in loan repayments. This quickly spread throughout the financial system as a result of both the complexity of financial products – which made it difficult to assess the degree of risk – and the close international connections between financial institutions.

The absence of social protection and the deregulation of international capital flows are just two of the main drivers of falling wage shares. Weaker labour institutions, which play a redistributive role, are another factor. Greater coverage of collective bargaining agreements tends to be associated with lower inequality. And yet coverage rates are going down.

The rising incidence of precarious and informal employment has also played a role in the trend increase in income inequality. Finally, tax policies have become less progressive and are therefore less able to redistribute the gains from economic growth – a trend which may partly reflect international tax competition to attract or retain high-income peo-ple. The resulting shortfall in tax revenues has been offset by rising indirect taxation, with typically regressive effects.

So altogether, the recent global crisis has proved that neither the profit-led (debt-financed) growth model nor the export-led growth model is sustainable in the long run, as each fuels social and economic imbalances.

Addressing Excessive Inequality at Its Roots

In this context, the best approach is to correct inequalities at their root, which is in the distribution of income from the market. So, it is necessary to correct the distribution of market incomes rather than leave markets to their own devices and then redistribute incomes afterwards through taxes or social policy.

Well-designed labour market institutions

If labour market institutions are well designed, they permit the achievement of both equity and employment goals. In fact, labour market institutions are, in general, stronger in low inequality countries than in high inequality economies. Also very important is to reduce the duality of precarious employment in the case of advanced economies or informality in the case of emerging and developing countries, since this is a major driver of market income inequalities.

Another element which is extremely important is to protect the labour market transitions, because one of the reasons the bargaining power of workers has declined is that people are scared. There is a lot more pressure from product markets, more international competition, and, therefore, there is a tendency for people to be very cautious in terms of wage claims. One way to reassure workers is to protect them from labour market transitions, so in case they lose their jobs, there are a number of programmes they can use to try to find new employment. We have learned a lot about how that can happen also in emerging economies. For example in India, the employment guarantee schemes have been a very interesting innovation. In Brazil, there have also been very interesting employment programmes which developed since the crisis in particular.

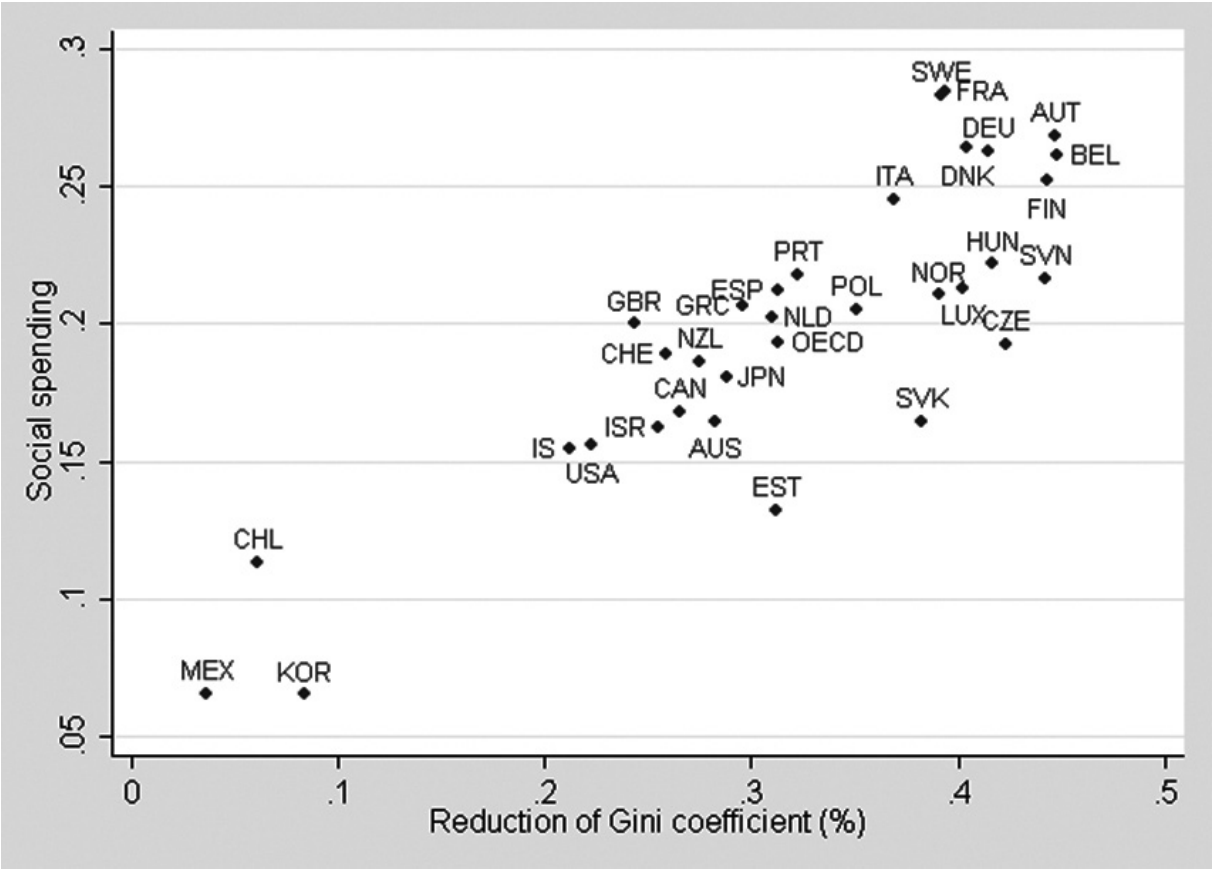
Progressive taxation

Another measure is to asminister export gains to where there are market inequalities, through more progressive taxation. But the question is whether countries can do it in isolation. However, there is certainly a debate about whether it's possible for countries to go alone on this or whether these efforts should be internationally coordinated. Certainly, what we saw before the crisis is that, for the majority of countries, there was a decline in top income taxes.

Social transfers

Finally, the last measure is to administer the social policy through social transfers to the poor and so on. Although that certainly helps, there is a double limit to this. The first limit is that countries need to spend 2.4 per cent

Figure 4: Social spending and income inequality



Source: IILS estimates (2011).

of GDP in social programmes in order to reduce Gini by just one point. Indeed, reducing inequalities to 1980's levels would require additional spending by 5.4 per cent of GDP – in the case of the United States, additional spending would reach 8.5 per cent of GDP.

Furthermore, a much deeper phenomenon is whether this kind of distribution is conceived as a way to compensate for something that happens in the market and, therefore, the need of distribution will be more and more, given that market inequalities grow more and more. For example, France spends 1.4 per cent of GDP just to support low-paid work. And if low-paid market incomes continue to fall, France will need to spend more and more. Therefore, that would contribute to increased spending and debt accumulation, so there is a connection between inequalities and debt accumulation if countries focus only on social spending as a way to correct for inequality. So, another limit has to do with the fiscal consolidation mantra which happens now. It seems difficult in some countries to redistribute only through social spending in the present circumstances.

A model developed in ILO (2010) analysed the employment effects of a set of policy measures and highlighted the importance of the right distribution of market incomes. While the effects of a 20 per cent nominal appreciation of the Chinese yuan vis-à-vis the US dollar are weak (the unemployment rate in China rises by more than 1.8 percentage points, and it remains broadly unchanged in the United States and other advanced economies), improved social security and higher wages in Asia would have important effects on global rebalancing and recovery (Table 1). A decrease in the net tax rate by 10 per cent, joined with a decrease in the propensity of wage earning households to save by 10 per cent and an increase in nominal wages by 10 per cent, would have a positive impact on employment in all regions. At the same time, the model suggests that fiscal austerity mea-

sures tend to depress world growth. For instance, a cut in the US deficit as a share of GDP by 2 percentage points would increase the US unemployment rate by over 3 percentage points and would lead to a downturn in all the regions (the unemployment rate in China would increase by 0.7 percentage points).

Table 1: Changes in unemployment rates as a result of three policy options for rebalancing the world economy (in percentage points)

	United States	China
Yuan appreciation	–0.1	1.8
Asia rebalancing	–0.1	–1.4
Aggressive cut in US deficit	3.1	0.7

Source: IILS estimates (ILO, 2010).

Income Inequality, Debt Leverage, and Economic Crises

Michael Kumhof

The United States experienced two major economic crises over the past 100 years – the Great Depression of 1929 and the Great Recession of 2007. Income inequality may have played a role in the origins of both. We say this because there are two remarkable similarities between the eras preceding these crises: a sharp increase in income inequality and a sharp increase in household debt-to-income ratios. Are these two facts connected? Empirical evidence and a consistent theoretical model (Kumhof and Ranciere, 2010, IMF Working Paper 10/268) suggest that they are. When – as appears to have happened in the long run-up to both crises – income inequality grows for several decades and the rich lend a large part of their added income to the poor and middle class rather than consuming it or investing it in the physical capital stock, debt-to-income ratios increase sufficiently to raise the risk of a major crisis.

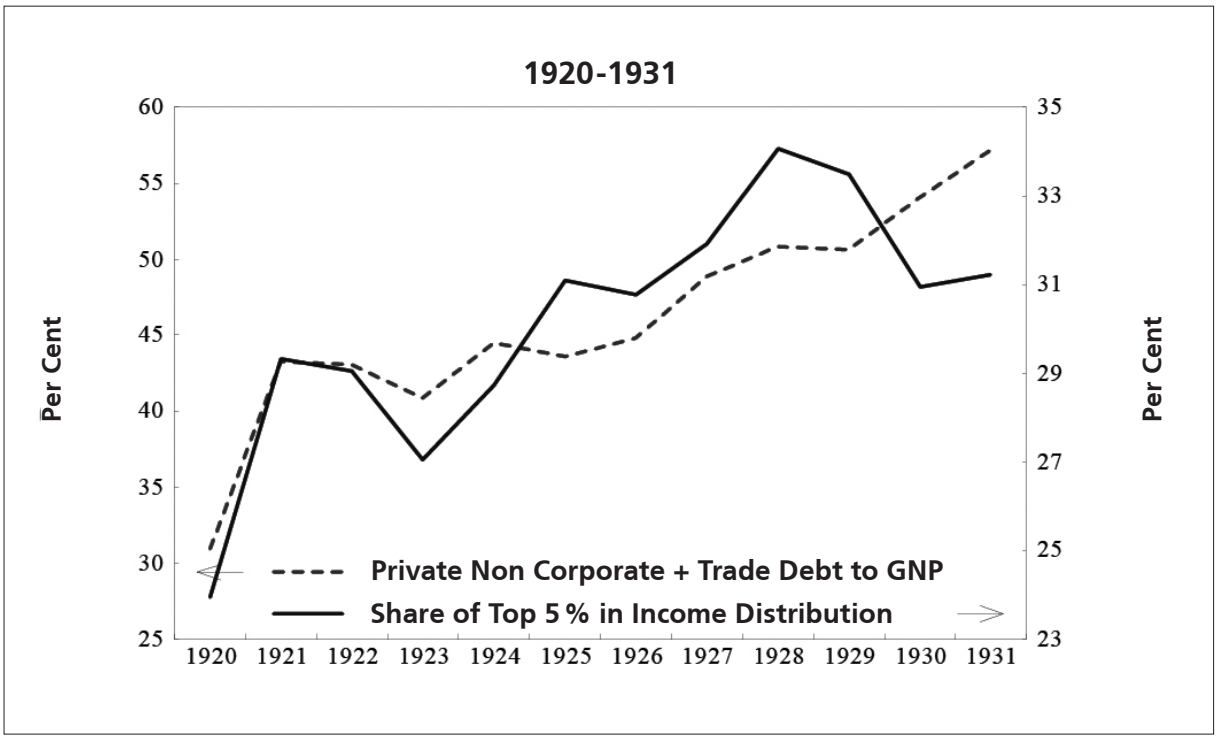
Empirical Evidence

We examined the joint evolution of the share of total income received by the top 5 per cent of U. S. households (ranked by income) and the ratio of household debt to income in the periods preceding 1929 and 2007 (see Chart 1). The income share of the top 5 per cent increased from 24 per cent in 1920 to 34 per cent in 1928 and from 22 per cent in 1983 to 34 per cent in 2007 (we focused on a shorter time period before 1929 than before 2007, because the earlier data were highly distorted by World War I). During the same two periods, the ratio of household debt to income increased dramatically. It almost doubled between 1920 and 1932, and also between 1983 and 2007, reaching much higher levels (139 per cent) in the second period.

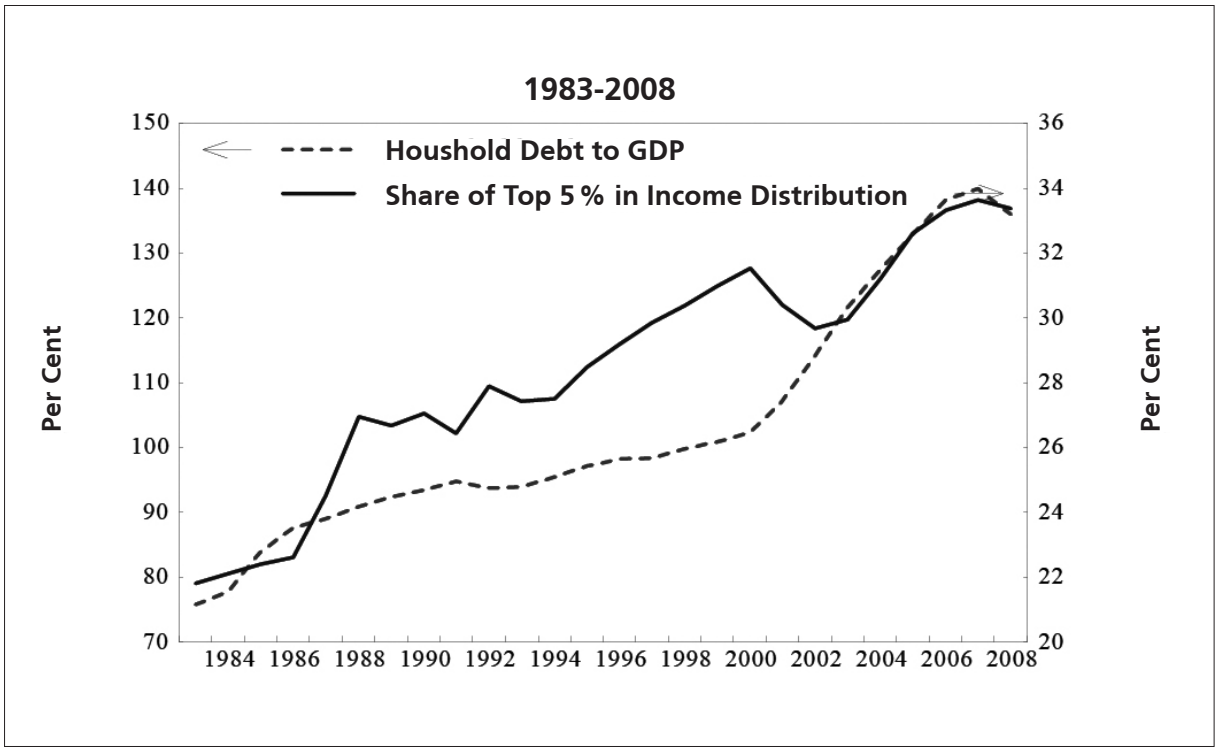
In the more recent period (1983–2007), the difference between the consumption of the rich and that of the poor and middle class did not widen as much as the difference in income between these two groups. The only way to sustain such high levels of consumption in the face of stagnant incomes was for poor and middle-class households to borrow (see Chart 2). In other words, the increase in the ratios of debt to income shown in Chart 1 was concentrated among poor and middleclass households. In 1983, the debt-to-income ratio of the top 5 per cent of households was around 80 per cent; for the bottom 95 per cent the ratio was around 60 per cent. Twenty-five years later, in a striking reversal, the ratio was 65 per cent for the top 5 per cent and 140 per cent for the bottom 95 per cent. The poor and the middle class seem to have resisted the erosion of their relative income position by borrowing to maintain a higher standard of living; meanwhile, the rich accumulated more and more assets, including financial assets backed by loans to the poor and the middle class. The fact that consumption inequality increased by less than income inequality has led to much higher wealth inequality. The higher indebtedness of the bottom income group has implications both for the size of the U. S. financial industry and its vulnerability to financial crises. The bottom group's greater reliance on debt – and the top group's increase in financial wealth – generated a higher demand for financial intermediation. Between 1981 and 2007, the U. S. financial sector grew rapidly – the ratio of private credit to gross domestic product (GDP) more than doubled, from 90 to 210 per cent. The financial industry's share in GDP doubled, from 4 to 8 per cent. With increased debt levels, the economy became more vulnerable to financial crisis. When a crisis eventually hit in 2007–08, it brought with it a generalized wave of defaults; 10 per cent of mortgage loans became delinquent, and output contracted sharply.

There are of course other possible explanations for the origins of the 2007 crisis, and many have stressed the roles of overly loose monetary policy, excessive financial liberalization, and asset price bubbles. Typically these factors are found to have been important in the years just preceding the crisis, when debt-to-income ratios increased more steeply than before. But it can also be argued, as in Raghuram Rajan's 2010 book »Fault Lines: How Hidden Fractures Still Threaten the World Economy«, that much of this was simply a manifestation of an underlying and longer-term dynamic driven by income inequality. Rajan's argument is that growing income inequality created political pressure – not to reverse that inequality, but instead to encourage easy credit to keep demand and job creation robust despite stagnating incomes.

Chart 1: Inequality and Leverage before the Major Crises

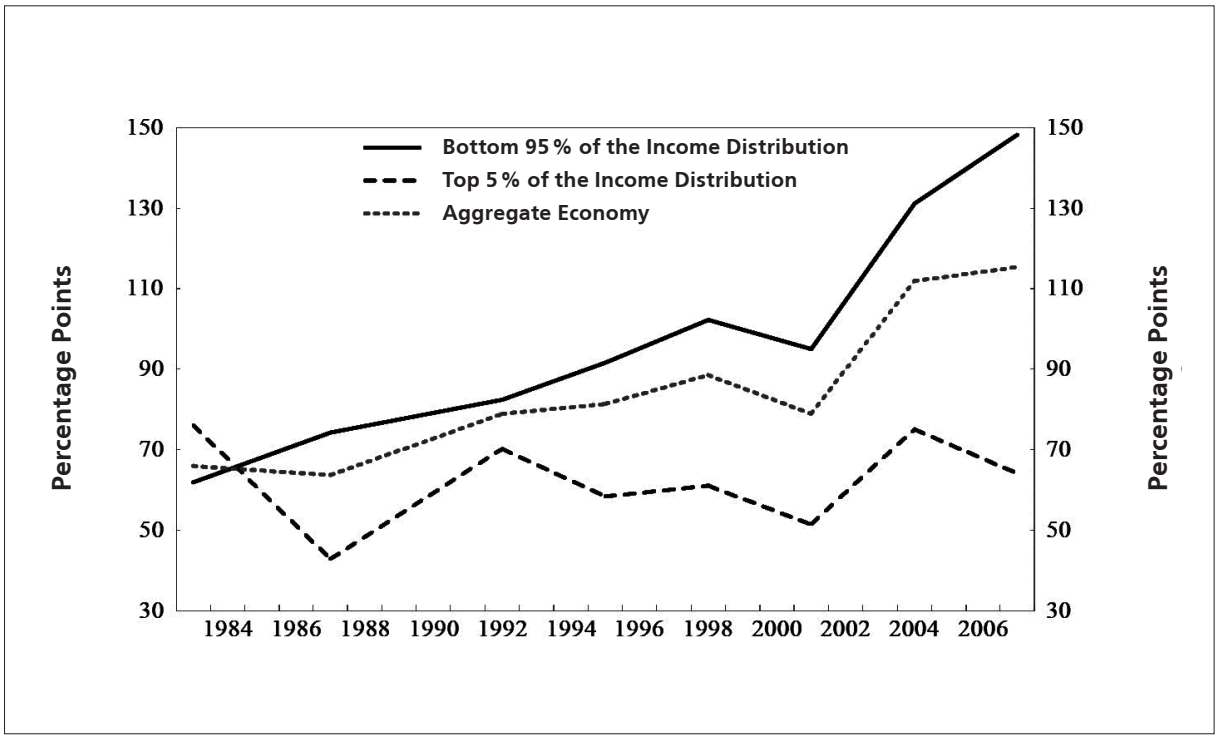


Source: Statistical Abstract of the United States, U.S. Department of Commerce.



Sources: Income shares from Piketty and Saez (2003, updated). Income excludes capital gains. Debt-to-income ratios from Flows of Funds database, Federal Reserve Board. Income excludes capital gains.

Chart 2: Increase in Debt-to-Income Ratios is Concentrated in Lower Part of Income Distribution

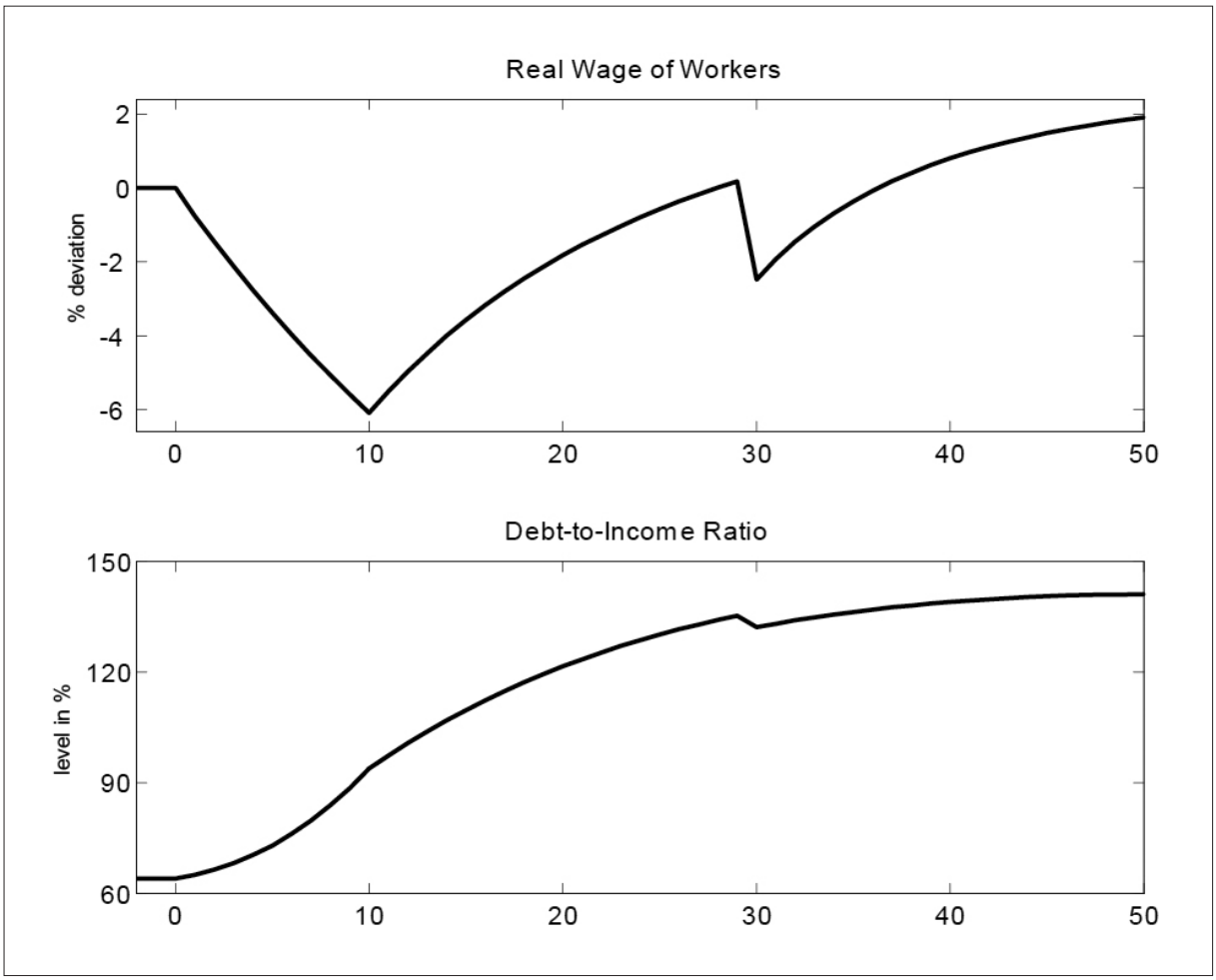


Source: Survey of Consumer Finance (triennal), 19832007. Debt corresponds to the stock of all outstanding household debt liabilities. Income corresponds to annual income before taxes, including capital gains and transfers, in the year preceding the survey.

Modeling the Facts

An economic model can clearly illustrate these links among income inequality, leverage, and crises. Our model has several novel features that reflect the empirical facts described above. First, households are divided into one income group at the top 5 per cent of the income distribution (call them »investors«) that derives all its income from returns on the economy's capital stock and from interest on loans and a second group composed of the remaining 95 per cent (»workers«), who earn income in the form of wages. Second, wages are determined by a bargaining process between investors and workers. Third, all households care how much they consume, but investors also care about how much capital – physical capital and financial assets – they own. This implies that when investors' income increases at the expense of workers, they will allocate it to a combination of higher consumption, higher physical investment, and higher financial investment. The latter consists of increased loans to workers – whose consumption originally accounts for a very high 71 per cent of GDP – giving them the means to consume enough to support the economy's production. Our model can be used to show what happens after the economy experiences a lengthy shock to the distribution of incomes in favor of investors. Workers adjust through a combination of lowering their consumption, and borrowing to limit the drop in their consumption (see Chart 3). This gradually raises workers' debt-to-income ratio, which follows the pattern and magnitude documented in Chart 2. Workers' higher debt is made possible by the lending of investors' increased disposable income. More saving at the top and more borrowing at the bottom mean consumption inequality increases significantly less than income inequality. Saving and borrowing patterns of both groups spur a need for financial services and intermediation. As a result, the size of the financial sector roughly doubles. The rise of poor and middle-class household indebtedness begets financial fragility and a higher probability of financial crises. With workers' bargaining power, and therefore their ability to service and repay loans, recovering only very gradually, loans continue to increase and the risk of a crisis persists. When the crisis does occur – assumed here to materialize after 30 years – there are large-scale

Chart 3: Baseline Scenario: Workers Borrow to Compensate for a Lower Real Wage

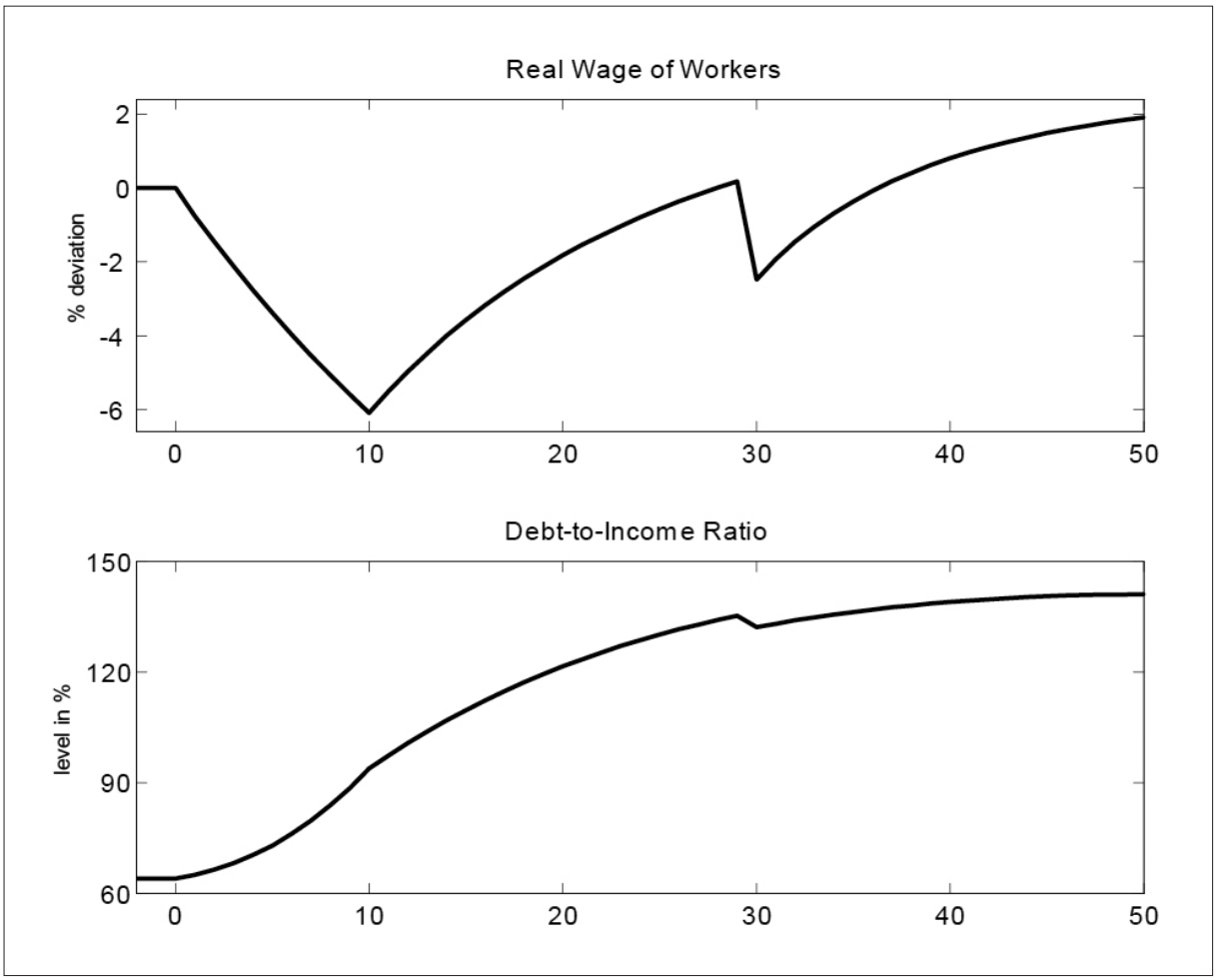


household debt defaults on 10 per cent of the existing loan stock, accompanied by an abrupt output contraction, as occurred during the 2007–08 U.S. financial crisis. The model points to a number of ways the increase in debt-to-income ratios in the precrisis period could be more pronounced than shown in Chart 3. First, if investors allocate most of their additional income to consumption and financial investment rather than to productive investment, debt-to-income ratios increase much more. The reason is that investors are willing to lend at lower interest rates, thereby increasing debt, and the capital stock is lower, thereby reducing output and workers' incomes. Second, if the rate at which workers' bargaining power recovers over time is close to zero, even a financial crisis with substantial defaults provides little relief: debt-to-income ratios continue to increase for decades after the crisis, and a series of financial crises becomes very likely.

Policy Options

There are two ways to reduce ratios of household debt to income.The first is orderly debt reduction. What we have in mind here is a situation in which a crisis and large-scale defaults have become unavoidable, but policy is used to limit the collateral damage to the real economy, thereby leading to a smaller contraction in real economic activity. Because this implies a much smaller reduction in incomes for any given default on loans, it reduces debt-to-income ratios much more powerfully than a disorderly default. Still, a long-lasting trend toward higher debt-to-income ratios resumes immediately after the debt reduction, because workers continue to have a reduced share of the economy's income. The second possibility, illustrated in Chart 4, is a restoration of workers' earnings – for example, by strengthening collective bargaining rights – which allows them to work

Chart 4: Alternative Scenario: Restoration of Bargaining Power Reduces Debt and Crisis Probability



their way out of debt over time. This is assumed to head off a crisis event. In this case, debt-to-income ratios drop immediately because of higher incomes rather than less debt. More importantly, the risk of leverage and ensuing crisis immediately starts to decrease. Any success in reducing income inequality could therefore be very useful in reducing the likelihood of future crises. But prospective policies to achieve this are fraught with difficulties. For example, downward pressure on wages is driven by powerful international forces such as competition from China, and a switch from labor to capital income taxes might drive investment to other jurisdictions. But a switch from labor income taxes to taxes on economic rents, including on land, natural resources, and financial sector rents, is not subject to the same problem. As for strengthening the bargaining power of workers, the difficulties of doing so must be weighed against the potentially disastrous consequences of further deep financial and real crises if current trends continue. Restoring equality by redistributing income from the rich to the poor would not only please the Robin Hoods of the world, but could also help save the global economy from another major crisis.

The World Needs Truly Multilateral Institutions

Rogério Studart

In this more integrated, interconnected, and interdependent world, a crisis that began in 2008 in a relatively small part of the United States' financial system quickly spread to become a world financial disaster, which dragged with it the world trade and production in major countries, and finally turned into an employment crisis and a major source of political instability in several parts of the globe.

Few would nowadays disagree that the world is in desperate need of global, *truly multilateral* institutions – not only to overcome the current crisis, but also to promote a more sustained (and sustainable) world development in the future. I emphasize *truly multilateral*, because we have global institutions – such as the World Bank and the IMF – but, as I see it, these are not truly multilateral.

Here I will also make the case that, considering the enormous and increasing challenges faced by the international community – from poverty and inequality to climate change – which can be dealt with only by significant coordination and partnership from stakeholders in the international community, it is both scary and a puzzle that genuinely global, multilateral institutions still remain to be built. Furthermore, what is interesting to ask is, What will it take to build truly multilateral, global institutions that can help us address these challenges?

It is a difficult task to write about these issues completely in the abstract. So I will try to address them by using the example of the World Bank Group – whose future and role are being fiercely discussed by the media, blogs, and governments as we engage in the first-ever competitive election of its leadership.

The World Bank: Global but not Multilateral

The International Bank for Reconstruction and Development (IBRD) was founded in 1944, amidst World War II and a severe global economic recession. Its founding reflected the prevailing attitude that the best way to avoid history repeating itself would be to promote a speedy reconstruction and the balanced development of all nations. As the large industrialized economies attained full recovery, this initial perception faded. Development support for all nations began to be seen less as a common interest and more as a question of charity from donors.

Actually, in the documents and debates of the World Bank, developed economies are called »donors«, and developing countries are referred to as »beneficiaries«.

To depict the Bank as a conduit of aid is mysteriously misleading: only one of the four financial institutions that comprise the World Bank Group – the International Development Association (IDA) – is a conduit for donations. The Group can be better compared to a financial development cooperative composed of four financial institutions – the IBRD, the IDA, the International Finance Corporation (IFC), and the Multilateral Investment Guarantee Agency (MIGA) – as well as the International Centre for Settlement of Investments Disputes (ICSID). The IBRD and IFC use their AAA bond status to obtain preferred market rates and to lend, respectively, to middle-income developing countries' governments and developing-country private projects with significant development impacts.

Indeed, as a financial cooperative, the Group has been a success. Both IBRD and IFC have historically been so profitable that their entire recapitalisation after the Asian crisis in 1998 has occurred with no additional capital injection from shareholders; and part of their net income has been used to replenish another part of the Group, the IDA. Despite being a successful cooperative, and having become a global institution, it has not evolved from its founding as a set of truly multilateral institutions, where members are seen as equal partners under a common vision and goals. Actually, its »clients« – borrowing members from IBRD and recipients of IDA funds alike – are seen as recipients of assistance by non-borrowing members. This culture is also perceived in the attitude of management, which often engages with »clients« as if the Bank represented an entity independent of its own governance structure, almost as another donor. (Interestingly, several official internal documents refer to the Bank as donors,

where even IDA is simply a conduit of funds coming directly from developed and developing donors, or indirectly from net income, which belongs to its members.)

This attitude is the final result of the evolution of the Bank, and was reflected and reinforced throughout its history and by the changing focus of its operation. Indeed, according to its official website, until the 1980s it was the bank of reconstruction (1940s), infrastructure and industry (1950s), and agriculture (1960s). Already in the 1970s it had become the bank of »basic needs and education«. Finally, it evolved into the bank of structural adjustment (1980s) and economies in transition (1990s). That is, the Bank evolved from an institution of a group of nations dedicated to promoting partnerships in building physical development towards a more balanced development of its members, to a global institution dedicated to »defining« best practices to its »clients«. As it evolved, the multilateral aspects underneath its visionary foundation seemed to have been left behind. In turn, and accordingly, its business model became overpopulated with conditionalities strongly geared by donors' views on the best development paths.

In the 2000s, the issue of climate change revived the view of common destiny among developed nations. In turn, the international community seemingly awakened again to the dangers of fast globalisation without global common purposes, and interconnectedness without global multilateral institutions. So, even though it maintains poverty alleviation as its main mandate, the Bank has mainstreamed climate issues as part of its operations and technical assistance. Other themes have also emerged with time: governance and corruption, needs of post-conflict countries, gender equality, and so on.

However, although the Bank entered a new phase (that of a bank of »global partnerships«), it continued to function as a donor-recipient institution – which offered best practices in terms of addressing global issues to its clients. Notwithstanding how crucial these issues are, in practice the way they have been introduced resulted in *de facto* cross conditionalities which have substantially increased the transaction costs of doing business with the institution.

As developed countries began to see the Bank as an instrument to push specific – albeit important – agendas, the view that the Bank is a preacher, rather than a partner, grew with developing nations. Particularly because the Bank deals with policies only towards developing nations, one cannot avoid having a sense of asymmetry in any conditionality or advice given by the Bank to its clients – notwithstanding the merits it may have in some cases. In addition, for some developing countries, the way the Bank behaved during the crises of the 1980s and 1990s only enhanced the view that it used its strength in times of difficulties to impose reforms – some of which led more to hardship than development. Indeed, as is now a well-known fact, the Bank responded to those crises as part of a larger crisis management tool, by significantly increasing its lending to crisis-stricken countries. This assistance came loaded with conditionalities that required substantial sacrifices from their citizens.

In addition, the assistance came with significantly higher financial costs to the »client members«, justified by the need to maintain the financial sustainability of the institution. That is: as the Bank expanded its lending and had to assist countries in difficulties, the capital base became too small to shelter the higher risk profile of its expanding exposure. The response from large shareholders to this challenge was not a significant capital injection – which would be a sign of solidarity expected from a multilateral agency membership – but a change in the pricing, which led to higher costs to clients and created net incomes sufficiently large to promote the recapitalisation, and even to make transfers to IDA. To put it succinctly, loans to middle-income countries came with ever more conditionalities (usually associated with the donors' priorities). This substantially increased the transaction costs of operations, on top of the higher financial cost.

In sum, as the Bank evolved, maintaining political support from developed and developing members alike became a challenge. Developing nations increasingly saw it skeptically as a donor-driven institution imposing rigid conditionalities which were less related to development effectiveness and more to the agendas defined by developed economies. In turn, more significant access to capital markets became available to developing countries, and it became hard to convince developed-nations' taxpayers of the need for what was perceived as a global »conduit of aid«. The *raison d'être* for the creation of a global development institution, which was so clear in the 1940s, was simply forgotten, although globalisation was again making our destinies too interconnected to allow any of us to fail alone.

History Repeats Itself

The 2008 crisis was a tragic reminder of our need for truly global, multilateral institutions. Again the World Bank played a role in responding to the financial crisis by increasing its lending, by providing extra support to private sectors, and by channeling concessional finance to low-income countries. The Bank's role, however, was severely limited by its size, by its business model as a »donor-recipient« institution, and by the fact that it was overwhelmed by cumbersome conditionalities and operational inflexibilities. Now the situation grows worse: the World Bank's financial capacity to respond further is crippled even as we are far from overcoming the current crisis and its consequences.

In my view, as I indicated already, this situation reflects faltering political support – indicated by the slow implementation of fundamental governance and operational reforms and lack of substantial capital injection. Some justify this disdain on the grounds that any additional capital injection would be a misuse of taxpayers' money, and by claiming that, now that some clients have become larger economies and have access to capital markets, the World Bank is less needed. This vision is wrong on at least two counts:

- First, contrary to conventional perception, the dependence of the World Bank Group on taxpayers' money has been overstated. As mentioned above, it is a successful financial cooperative which has depended very little on taxpayers' contribution. The significant transfers of net income from IBRD and IFC to IDA have reduced the burdens of traditional donors in complying with their international commitments of aid transfer. The last IDA replenishment is evident proof of this.

- Second, if the World Bank's costs to taxpayers are relatively small, its benefits are enormous. The Group is not simply a provider of cheap finance and aid. In fact, it is not even just a »bank«. It has become an important platform to promote dialogue and cooperation among nations, to gather and share experiences in policy making, to foster private sector development, and to debate and help address challenges faced by almost all its members – such as climate change, food insecurity, unemployment, lack of appropriate social safety nets, social and economic exclusion, and gender inequality.

In a moment when most of us (developing and developed nations) need to reinvent our development paths, when our authorities are faced with extraordinary challenges and scarce resources, certainly a platform such as this can be a remarkable global instrument at the service of both developing and developed nations alike. But this potential can be fulfilled only if it can gather support from all its members – that is, if it is perceived and functions as a truly multilateral institution. Its strategies and policies must be the fruit of a consensus-building process that can be owned by all members. This requires changes in the World Bank's governance and its business model. Currently, it is still perceived as a »donor-dominated« institution, in which developing countries' voice and influence is incompatible with their relative size and responsibility in addressing our enormous global challenges.

Whence From Here?

Truly multilateral institutions should have at least three characteristics: resources, a multilateral governance structure, and a client-driven corporate culture.

Resources are required to anticipate needed policies and to help implement them in a coordinated way. Also, financial resources are needed to support such policies, as well as to respond in crisis moments. Interestingly, members of the IMF fully understood and responded to that institution's need for substantial increases of resources to address the surges of balance of payment problems, for precautionary reasons, and even for analytical capabilities – to entertain multilateral surveillance exercises, increase technical assistance in areas of financial regulation, develop crisis early-warning tools, and so on.

The World Bank, as mentioned, is still lacking that kind of support: the 2010 recapitalisation was too timid, leading to a crippled capital base and a need to reduce its lending by almost two-thirds. Despite the increasing demands to act counter-cyclically and respond rapidly to clients' needs, large shareholders still impose very restrictive real zero-growth balance discipline. The Bank's capacity to act is now crippled both by its limited capital base and by the corresponding budget constraints.

Clearly, this is not the way that members of a truly multilateral development institution should respond to an increasing demand for support from its member-clients.

This is where the issue of governance structure comes in. Those who followed closely the discussion on the recapitalisation of the World Bank in 2010 know that one of the main considerations of large shareholders in limiting capital injection, in addition to the resistance created by their own budget constraints, was their refusal to give away significant voting power. Again, this was because most shareholders – and particularly the largest ones – see the Bank more as an aid agency than as a potential multilateral development bank.

The first step to addressing the issue of legitimacy of the Bank should be an immediate restart of the negotiations of another capital injection. A multilateral development institution without lending capacity cannot be a serious player in addressing some challenges – which can only be solved, for instance, by helping build (and sometimes reconstruct) basic infrastructure of developing countries, promoting changes in energy matrixes, expanding social protection substantially in developing countries, and fostering expansion of food production and productivity.

This capital injection should be associated with a discussion of burden sharing and voting power – an important part of the governance reforms. In the past, we strongly defended the fact that our goal should be parity of voting power between developing and developed countries. This would be a strong message indicating the willingness to change the perception that the Bank is a donor-dominated institution. In addition, this could be a first step towards evolving into a truly multilateral institution.

But other steps have to be taken: a discussion of strategic vision and priorities, a rethinking of cross conditionalities, mainstreaming South-South cooperation as part of the Bank's business model, and so on. The Bank currently does not seem to have any strategic direction. As mentioned already, even though its core mandate continues to be intact, new »themes« are introduced almost every year. Because of the budget limitations, the role of trust funds in shaping the »dialogue« around one or another of them with countries should not be underestimated. Even though each new theme has important merits, and the intentions of donors are the best, this creates a segmentation of management and very little incentive for coordinated action towards common goals.

Finally, the Bank has to mainstream an engagement role that is already a common case in large client members: one where strategies and operations are client-driven. That means that its management should put its resources, its knowledge, and its instruments at the service of the needs as defined by the government programmes, as much as capabilities are available. And in countries that lack such capabilities, the Bank should be a platform to accelerate capacity building, preferably by using resources and knowledge from practitioners in developing countries with a history of successful experiences.

In sum, the world badly needs true global, multilateral institutions. The institutions that we have at the moment, such as the World Bank, are still far from being truly multilateral. The World Bank is even in danger of disappearing as a global institution, because of the increasing perception that it is becoming too small, too cumbersome, and too heavy to be relevant. But the Bank has enormous potential, plenty of resources, and accumulated knowledge. The reforms needed can only come from a better understanding and support from shareholders, particularly from those that have dominated these institutions for so long. The opportunity has been unfortunately presented to us by this tragic crisis that is still unfolding. Let us at least not waste it.

Inequality and the Global Financial Crisis – Can the IMF Ever Be Reformed?

Pablo Pereira

Preamble

Inequality is at the heart of this financial crisis. Although mainstream economics had never thought of it, the link between inequality and financial instability was unmasked by the burst of the ›super-bubble‹ in mid-2008. This link has run through debt. As Raghuram Ranjan[1] has rightly explained, the political response to rising inequality (driven by stagnant paychecks and growing job insecurity since the early 1970s) has been to expand lending to households, especially low-income ones. The rise of finance and free-market policies in advanced economies then gave leeway to a debt parade and Ponzi schemes (particularly after the burst of the tech boom in 2000), which for years delivered a pattern of consumption that appeared ›broadly‹ egalitarian and consistent with the standards of modern capitalism. »What cannot be earned, must be borrowed« came to dance to the tune of the credit cycle.

Rising inequality has therefore been an important factor affecting the increase of both demand and supply of credit. Easy money vis-à-vis an amoral financial sector and deregulated markets then created this crisis. The downside of expansionary monetary policies was increasing private-sector debt and unrealistic expectations about future earnings. It was only a matter of time, as bubbles always go bust. The subsequent downturn has not only made inequality even worse, but it has proven that the redistribution of income towards the top one per cent has led to weak aggregate demand and a jobless recovery in the absence of a new bubble. Indeed, income inequality has created a deep ›fault line‹ that will impede a quick recovery in those countries at the centre of the crisis.

The unprecedented liquidity injections prompted by the Federal Reserve and the European Central Banks are attempts to resuscitate the old economic paradigm (and a new asset price bubble), but it could backfire. Central Banks cannot create wealth out of thin air. The notion that the resolution of the crisis can be put off for years is also delusional. Meanwhile, the Europeans are the first victims of the fallacy of austerity-based fiscal consolidation, exacerbating their own debt problems. One hopes the United States will not follow this course. In any case, the crisis is here to stay. Advanced economies face a decade of debt. Dealing with the crisis is now all the more difficult, as the path to recovery will be slower and much more complex than need be. The risks of greater financial instability, social and economic fragmentation, and trade and financial protectionism are mounting. As such, the international monetary system might not survive in its present form.

The International Monetary Fund (IMF) and the Crisis

Few can question that the International Monetary Fund (IMF) has been part of the problem. For decades, the IMF has lectured countries about the benefit of free-market policies, imposing deregulatory policies (including capital and financial market liberalisation) wherever and whenever it could. As such, the only international institution in charge of maintaining the stability of the global economic system failed to prevent the crisis. As Joseph Stiglitz rightly pointed out[2], the IMF has been an instrument of ›post-colonial control‹. Tellingly, the free-market ideology turned out to be an excuse for new forms of exploitation to the benefit of those who run the institution (creditors' countries). Money has been provided by the IMF in exchange for harsh policy conditionality, aimed at helping Western creditors recoup more of their money. Changes have been introduced in its lending function (i. e., precautionary lending facilities), but severe procyclical conditionality coupled with overstretched prior actions are still the norm. Again and again, the IMF has

1. Raghuram G. Ranjan (2010): *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press.

2. Joseph Stiplitz: *Free Fall: America, Free Markets, and the Sinking of the World Economy*, Chapter Eight: »From Global Recovery to Global Prosperity«, 2010.

tried to force the socialisation of the losses in debt crises. Their costs then have fallen almost entirely on countries' taxpayers to pay for foreign banks back. The IMF has failed to take into account the implications of belt-tightening policies for bankruptcy and the implication of bankruptcy for both aggregate demand and supply. No attention has been given to the distributional impact of its policies. Greece, now accused as the parable of the risk of fiscal profligacy, can give vivid testimony of all this.

As the global financial crisis is about to enter a perilous new phase, three fundamental mistakes further impair the IMF's ability to be an effective crisis-resolution and crisis-prevention institution. First, the IMF has failed to unveil the root causes of this crisis. It is time to bring to the fore that the configuration of the current international monetary system (based on the dollar as the main reserve currency) and rising inequality have been key contributing factors to this global crisis. Without even warning that these fault lines lie behind this financial crisis, the IMF will continue to be ill-equipped to facilitate remedies and the multilateral cooperation needed to tackle the challenges ahead in this multipolar world economy. The danger is that authorities of systemically important countries will continue to ignore these problems. The IMF is failing to take prompt actions and limits itself to chasing after China to request faster exchange rate appreciation in line with the needs of the US political battles.

Second, the ›predatory lending‹ of the IMF is exacerbating the negative impact of this crisis. Policy conditionality is wrong if it is destructive of national or international prosperity, particularly if there is a risk of systemic contagion. In this sense, the vast majority of the IMF programs have failed. They are of flawed design even from a purely fiscal point of view, as falling revenues because of the depressed economy and worsened long-term prospects have only depressed domestic demand and swept away market confidence, digging an even bigger debt hole. The promised big gains in return for the pain will never materialise. The economic recession is the key driver of debt explosions. The lending function of the IMF has been designed for another era and needs to be fundamentally reformed. The idea of simply increasing the IMF's firepower is misleading.

Third, IMF effectiveness is critically hampered by concerns about governance and stigma. There have been opportunities for fundamental governance reforms, but they have been squandered. The Fund is still functioning as an ›old boys' club of the rich industrial countries‹. If it fails to adapt its governance structure to the demands of a multipolar world economy, it will be unable to put forward the global solutions needed, anchored in cooperative actions (no unilateral decisions). Let me explain these three flaws in more detail before delineating some key areas of reform.

Why is this crisis rooted in the configuration of the international monetary system? Before this crisis erupted, the global economy had large and widening imbalances across regions. These chronic imbalances are closely related to the nature of the current international monetary system, characterised by the use of the US dollar as the major reserve currency and instrument for international payment.

The current account deficit of the United States has been the norm since the collapse of the Bretton Woods system (BWS) in the early 1970s and has risen to unprecedented levels since 2000. As a result, the United States is the world's largest debtor. The absence of an external constraint has allowed the United States to adopt policies that are more stimulatory than those of other countries. It has been able to finance persistent external deficits with its own currency while also profiting from its role as the world's banker. In contrast, most countries – particularly developing countries – have not been able to use their own national currencies in international transactions and need to accumulate international reserves given their limited access to global credit markets, the unprecedented volatility of capital flows, and the fear of losing their economic sovereignty to the IMF in the event of external crisis. Thus, global imbalances have ballooned.

It is fair to say that the United States has played an important role in keeping the global economy growing. Without the American profligacy, there would have been insufficient global aggregate demand (money put into reserves is income not spent at a global scale). In other words, the flood of liquidity during recent years was the flip side of insufficient global aggregate demand. Yet, the external US deficit has also reflected a shortfall of the country's savings in relation to its investments. As such, the United States has absorbed the vast majority of the savings that other countries do not invest domestically, despite its position as a net international debtor.

This crisis has now brought to the fore a fundamental flaw: the surpluses of savings of the rest of the world have been misspent. Indeed, in the absence of an investment boom (as in the 1990s), the United States must run an aggressive consumption and fiscal deficit to keep full employment. However, this time the deficit financed domestic consumption and military expenditures (rather than investment), and it was increasingly funded by short-term flows rather than direct investment. Along the way, increasing inequality was a warning sign that something was going wrong. The upward movement of inequality has followed a common global pattern, but the problem was neglected (technological changes and lack of flexibility in labour markets were to be blamed), and no linkage was established between economic and social differences and the risks of financial crisis. Then the story is well known: financial exuberance, financial deregulation, and pro-corporate policies engineered the worst asset price bubble in advanced economies ever witnessed in recent history.

The problem going forward is that the configuration of the international monetary system is precluding the global economic recovery and needs rebalancing. In the United States, large government expenditure programs are no longer feasible to offset the depressing effects on demand derived from private sector deleveraging. Yet, the deleveraging process in the country is far from over. The housing bubble has left a legacy of excess capacity and over-indebtedness. By easing monetary policy, the United States is trying to create the illusion that the recovery is self-sustained, as the equity market boomed and has taken advantage of free money. This could be short-lived, or it could backfire. The economy will almost certainly need more stimulus to bring unemployment down. A weak dollar has been instrumental to jumpstart the economy through exports, but this policy faces several limits.

First, the European debt crisis is running counter to a weak dollar, exacerbating the role of the dollar as a safe heaven. Dragged by the lack of domestic demand, most advanced economies have embarked on ›weak currency‹ policies, but they cannot have both at the same time. This will mark the beginning of a true ›currency war‹, this time involving advanced economies. Second, the depreciation of the dollar faces limits in and of itself. The US debt fiasco had a significant impact on equity markets. The bond market could be next, as a depreciation of the dollar could impose loses to those lending to the United States. The Federal Reserve Bank's (Fed) intervention is preventing this from happening, but that cannot last forever. Eventually, bondholders could request higher interest rates, killing the incipient economic recovery. Europe faces even bigger challenges given its private and public debt crisis. The European Central Bank (ECB) is following the Fed: it has printed one trillion euros to prevent systemic banking-sector failures from happening. It worked, but it can hardly be the whole solution. Time has been bought, but more problems are around the corner in the absence of a sovereign debt restructuring process. If trade protectionism and buy-national policies were to prevail given the jobless, slow recovery, several Asian economies could be dragged into a debt crisis, too. Third, it is important to understand that the appreciation of the euro or the Asian currencies could also place new brakes on global growth and run counter to the rebalancing process needed to correct the global imbalances. Currencies' appreciation will reduce investment demand and growth, increasing (rather than reducing) the saving surplus of these regions.

All in all, instabilities are built into the current international monetary system. Its configuration is precluding the global economic recovery. If it is not fixed, a bigger crisis is waiting to happen. The IMF has a key fiduciary responsibility in ensuring the stability of the international monetary system, but has failed to alert policymakers of systemically important advanced economies of the immense risks that are taken. To be fair, the IMF has made clear that large and widening global imbalances have critical implications for global growth and financial stability, but it has fallen short on calling for fundamental reforms of the international monetary system. The IMF needs to blow the whistle before it is too late.

The lending function of the IMF has always been a source of huge controversy, but this crisis has now proven that its lending facilities need to be reformed from scratch. The IMF is clearly ill-equipped to deal with debt crisis in systemically important countries. Why? Above all, because the IMF has failed to timely understand that a huge tectonic shift has occurred: yesterday's creditors are today's potential debtors. Indeed, the identity of potential international borrowers and creditors has changed, and with it the whole political economy that sustains the institution. Being that advanced economies are now at the very centre of this crisis, the whole

financial architecture of the post-Bretton Woods era is exacerbating the single most important collective problem: the lack of global aggregate demand. The model of exchanging money for harsh policy conditionality is neither effective nor feasible, and is only creating bigger risks of systemic contagion. It is ineffective because growth-killing austerity is hardly the way to debt sustainability. It is unfeasible because advanced economies are simply too big to be saved. It would require a continuous increase of the IMF permanent resources and it would probably end up being ›too little, too late‹, as private capital flows have exploded relative to official flows. We all have witnessed how fast a liquidity crisis can become a solvency one, creating worldwide financial instability. So, those who advocate that the solution to this crisis is now to increase the IMF's firewalls are misled. In a world of free and unregulated capital flows, there is a need for fundamental changes in the lending function of the IMF. Its whole funding model has to be reinvented under a new global ethic.

Finally, as a former IMF Board member, I am convinced that the current governance structure is a key impediment to adapting the institution to the needs of the 21st century. There is a huge democratic deficit in its decision-making process that is hampering its legitimacy and effectiveness. This crisis has showed us that global problems require global solutions. It has also brought forward a multipolar world economy, where developing countries play a key role as the drivers of global growth. Thus, the IMF can no longer be the ›old boys' club of the rich industrial states‹ who can impose their decisions on the rest. In order to avoid measures that will be destructive to national or international prosperity, cooperation needs to be brought at the core of the Fund decision-making process. The governance structure of the IMF is still designed for the post-war years and cold war era. From now on, solutions must come from collective and cooperative actions to escape an even bigger crisis.

Can the IMF Ever Be Reformed?

Four broad multilateral challenges lie ahead. First, contain the impact of the current crisis without resorting to measures destructive of national or international prosperity. Second, ensure an adequate functioning of the international monetary system, integrating highly dissimilar economies into its core while managing the declining role of the dollar. Third, facilitate an orderly sovereign debt restructuring process setting international rules and procedures to force holdout creditors to accept the terms of a debt restructuring. Fourth, take a more prominent role as a crisis prevention institution, sharpening its surveillance function and setting an agenda to reduce capital mobility to minimise future financial crises.

In principle, the IMF should be prepared to tackle these intertwined problems. It would require, however, fundamental governance reforms, a change in its funding model, and a complete overhaul of its surveillance and lending functions. To be sure, these reforms must conform to a new mandate that must be anchored in an amendment of its Articles of Agreement, where countries agree to a new delegation of responsibilities over sovereign policy options in order to facilitate global balance growth, higher levels of employment, and real income for all members (a new global compact). It would give the IMF a new foundation and the needed legitimate basis to address the challenges of this new global and multipolar era. Without a doubt, I stress that simply changing modalities in the way its lending and surveillance function are conducted or solely increasing its firepower is a mistaken approach. It will not suffice. The Fund must adapt itself to a new global economic order.

To contain the impact of the crisis, the IMF must introduce fundamental changes in its lending and funding model. First, it should stop ignoring the vital question of growth. Emphasis must be put on sustaining global aggregate demand. The Fund has a vital role to play. Instead of one-side austerity programs that only throw economies into deeper recession, the IMF must adopt »growth conditionality«. That is to say, growth initiatives must be part of its financing programs, with specific targets and deadlines. Even beyond the moral imperative behind the unfair distribution of the cost of the crisis onto the working classes, economic growth is a key precondition for debt sustainability. The oncoming bailout programs for those countries derailed by this crisis must emphasize economic growth. Second, the IMF must begin backstopping regional reserve pooling arrangements in developing countries, key drivers of global growth. Third, further steps must be taken toward the creation of a global reserve currency. In a world where self-insurance and the accumulation of foreign reserves is the only mechanism that countries have at hand to protect against short-term volatile capital flows, the insufficiency

of aggregate demand is exacerbated. Under the current international arrangements, countries need to set aside their current income to protect against global volatility. This crisis vividly reminds us that only countries on their deathbeds knock at the IMF's doors. Thus, large and periodic allocations of Special Drawing Rights (SDRs) will critically strengthen the global reserve system and the global economy. With it, the IMF would be in a unique position to provide unconditional counter-cyclical financing without fixed maturities to its membership in times of crisis and sub-normal economic growth, making access to international liquidity more systematic, credible, and organic. Let me stress that SDR allocations will not contribute to the money parade that is now creating new financial excesses and compromising the limited absorption capacity of developing countries. SDRs are allocated among governments (not thrown to amoral markets), and it will be up to them to determine how to best use those reserve assets to sustain growth. SDR allocations are aimed to supplement countries' reserve positions and potentially facilitate reserve diversification.

The funding model of the IMF would also need to be completely overhauled. Up to now, the Fund has been a quota-based institution, where a country's quota contributions make a pool of permanent resources available to correct maladjustments among its membership. This model is anachronistic now that the crisis is of a systemic nature and centred in advanced economies. Since those quota resources are part of countries' reserve positions, moral hazard problems have paved the way for amoral austerity. The IMF needs to start financing country programs through the issuance of SDR-denominated notes, allowing countries in crisis room of maneuver to implement pro-growth policies. Countries could actually mobilise non-utilised, newly allocated SDR resources to help others, making stronger multilateral cooperation a reality.

Revamping the role of SDRs will critically ease the tensions inherent in the current international monetary system explained above, facilitating a global growth strategy and the rebalancing of the world economy. In addition, the IMF should facilitate the internationalisation of key emerging market economies' currencies, adding the renminbi into the SDR currency basket and ensuring that sound financial and regulatory frameworks are in place before becoming freely convertible currencies.

To strengthen its crisis-prevention role, the IMF needs to apply better and stronger surveillance over issuer countries (advanced economies), sharpen its focus on systemic and multilateral risks to deploy an effective early warning system, and fundamentally enhance financial surveillance. However, none of this will be effective without an agenda to reduce global capital mobility and regulate capital flights to curb financial excesses. The IMF must step up its work in this area and come up with proposals, while countries extend the perimeter of financial regulation and supervision in a coordinated manner.

An orderly multilateral debt restructuring mechanism is of the essence to complete the global financial architecture. Recent debt exchange processes clearly show that a mechanism to force holdouts to accept the terms of a restructuring is missing. This fundamental gaping hole in the governance of international finance needs to be filled. Many advanced economies face a decade of debt. It is time to recognise that one hand cannot clap. Embracing further fiscal austerity will predictably produce a wider crisis. Remember that these countries are not only challenged to deliver growth, but ›inclusive growth‹ given the unprecedented concentration of income amassed in last decades. Without a fair contribution from creditors and bondholders, countries will lack the room to growth. The IMF put forward in 2001 the Sovereign Debt Restructuring Mechanism (SDRM). If capable of furthering growth, it could be resurrected under the co-auspices of a highly reputed institution that does not lend to sovereigns (i. e., the United Nations).

Last but not least, the governance of the IMF needs to be reshuffled. After two flawed attempts to truly rebalance their quota-share to have a greater say in the Fund's decision-making process, developing countries continue to be impaired in shaping the IMF's policies to their needs. I doubt that fundamental changes in the quota formula could be agreed to in the near future. The current ad-hoc system where the redistribution of power basically comes at the expense of middle-income countries (while the meager voting power of the poorest countries are merely protected, not enhanced) will continue to be the norm. So, it is time to de-centralise the IMF decision-making process. The first step could be to reinvigorate the link between the IMF and the United Nations (UN) System. The activation of a Global Economic Coordination Council set in the framework of the UN could provide strategic guidance to the IMF in key economic and

financial issues such as the functioning of the international monetary system, global financial safety nets, inequality and financial instability, etc. This should be kept at the level of Leaders. Second, a Ministerial Council could also be created as part of the IMF governance structure, provided that broad representation is granted and decisions are made under a double-majority system. This Ministerial Council would offer oversight of both management and the Executive Board, supported by an Independent Evaluation Office that oversees the work of the Institution (i.e., programs' performance). Finally, the composition and size of the Executive Board should be revisited to keep the current representation of developing countries and to ensure that this group as a whole can have more voice and representation in the decision-making process. A formal voting process and double-majority system for key selected decisions is also recommended at the Executive Board level, with stronger oversight over management and the staff.

Concluding Remarks

Strange though it may now seem for mainstream economics, there is a broad consensus that inequality and financial instability are linked and that rising inequality has followed a common global pattern. Economic and social differences are at the root of this financial crisis. The configuration of the current international monetary system has also been a key contributor factor of the crisis, precluding the recovery and needed rebalancing. To tackle these problems, the IMF will require fundamental reforms, prompting a new global ethic and true cooperation among its membership as the basis to work from.

Rising Inequality and the Sharing of Macroeconomic Risk

Jonathan Coppel

This article surveys some of the recent work that the Organisation for Economic Cooperation and Development (OECD) has been doing on income inequality and poverty, and the groups that have been particularly affected by the global economic, financial, and social crisis.

There are four questions I would like to address:

- How has inequality and poverty evolved?
- What are the driving forces explaining changes in inequality?
- How is macroeconomic risk shared?
- What are some of the implications for policy?

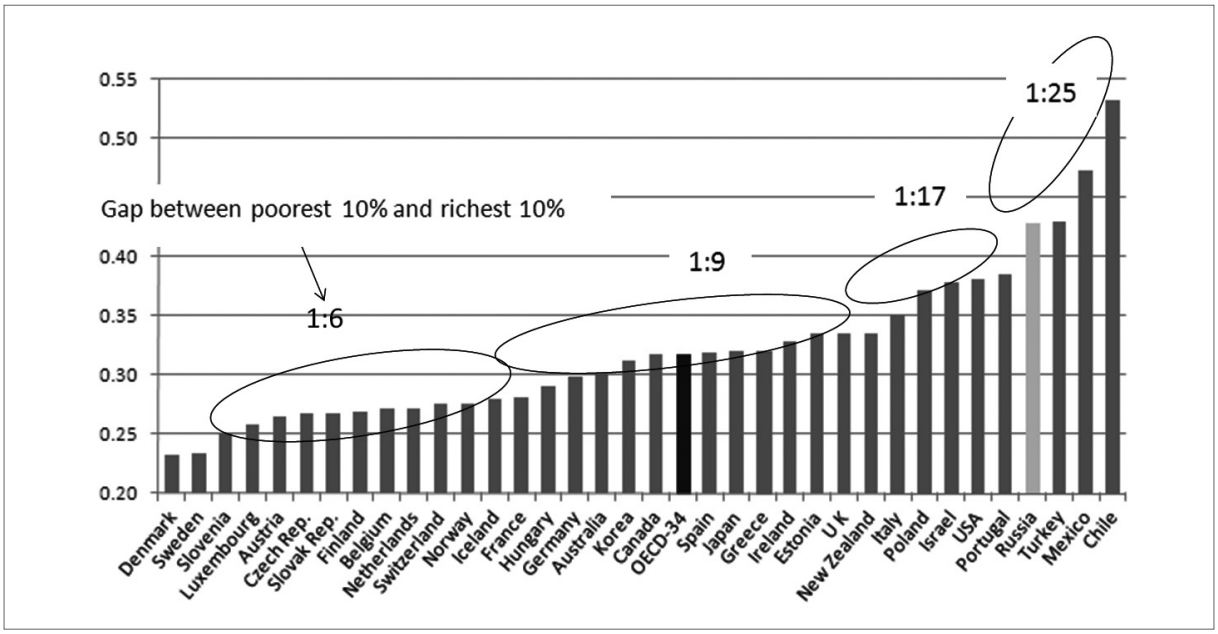
How Has Inequality and Poverty Evolved?

There are many concepts and measures of income inequality, and although different metrics will show different results, the general pattern across countries holds. There is also a close association between measures of income inequality and poverty at a given point in time. However, if you look at movements in income inequality and poverty across time, you can have situations where an increase in inequality can be associated with a decline in poverty.

The levels of income inequality across the major OECD countries differ a lot (Graph 1). The data in this graph, which is based on household income, predates the crisis, and shows that around 2005 to 2007, on average, in the OECD group of countries the gap between the richest and the poorest 10 per cent of the population was about one to nine. Typically, it is in the emerging market economy members of the OECD where the level of income inequality is higher, and in the smaller-sized and industrialised economies of northern Europe where it is lower.

In the emerging market economies outside the OECD area very rapid economic growth over the past decade has been associated with some reduction in extreme

Graph 1: Gini coefficient, disposable household income



Source: *Growing Unequal?*, OECD 2008; OECD 2010.

poverty. However, income inequality, despite the rapid growth, has increased over time, with the exception of Brazil (Graph 2).

There has also been an upward trend in income inequality in about three-quarters of OECD countries, as measured by the Gini coefficient, between the mid-1980s and the mid-2000s (Graph 3). Much of the change in income inequality is attributed to an increase in the level of income among the highest quintile or decile of the income distribution and a reduction in the lower and the middle quintiles.

The economic crisis has put additional pressure on the distribution of incomes. While this is not captured in the graph (Graph 3), because the data pre-dates the crisis, it is noteworthy that the few countries where income inequality fell include Ireland, Spain, and Greece. These are all countries that have been most deeply hit by the crisis, especially among the youth and among migrant and unskilled workers, and where fiscal consolidation measures risk widening income distribution. Certainly, in past financial crises, both high income and poor households have been hit more severely than the middle class.

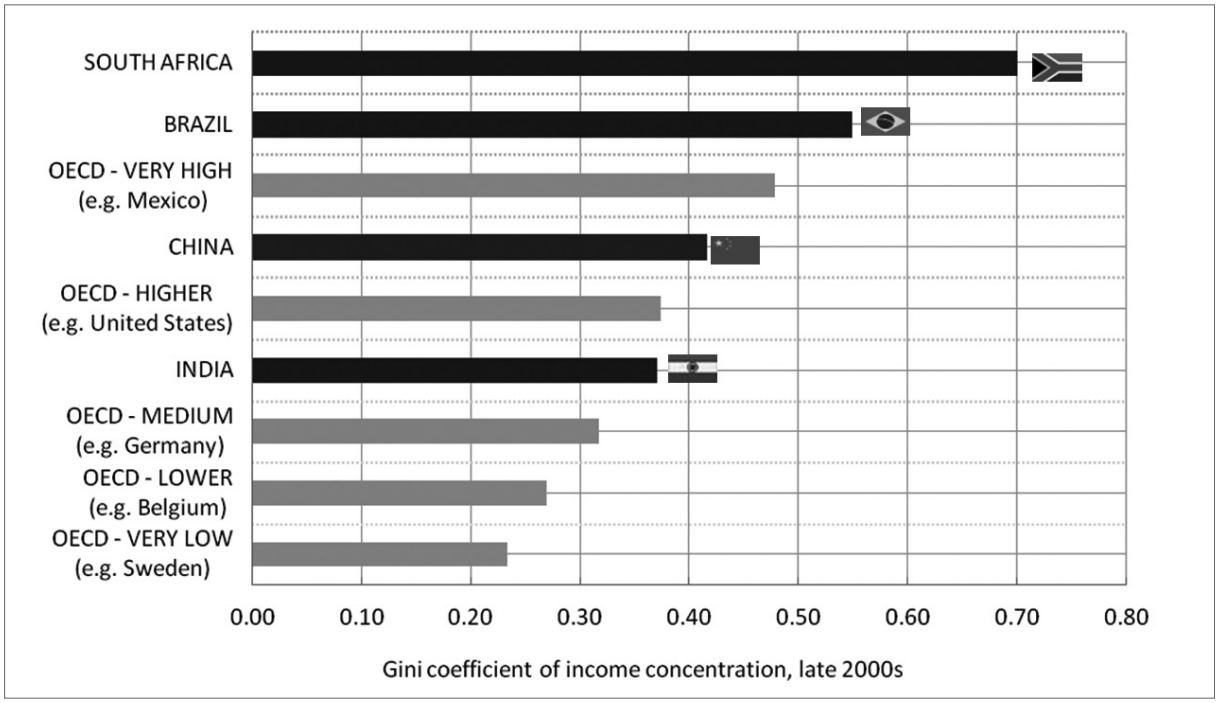
The Driving Forces Explaining Changes in Inequality

The OECD has done extensive work on the forces underlying the changes in income distribution and poverty. It is not possible in this article to survey all of the evidence collected, but I would like to report on some of the findings.

The first point to note is that the breadth of the potential factors depends on the metric that one uses to measure income distribution. One can focus on individual labour earnings, which is a narrower measure, or a broader concept of income that also includes public goods such as education and health (Graph 4). The choice of metric that you use will also influence the sorts of policy instruments that are important in influencing developments in income distribution.

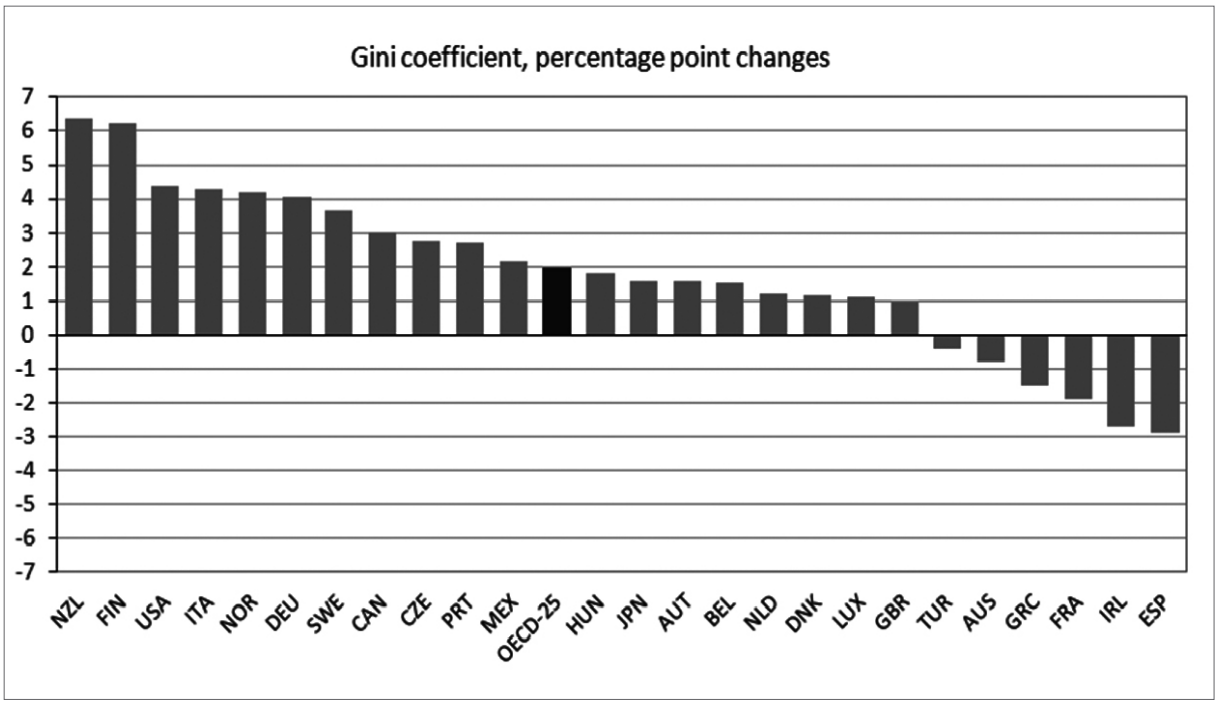
Tax policies, for instance, are very important to household market income, and with high public debt there is a lot of pressure for governments to consolidate their fiscal position. Consolidation through higher taxes would have an impact on household disposable income But fiscal consolidation through cuts in social, health,

Graph 2: International levels of income inequality



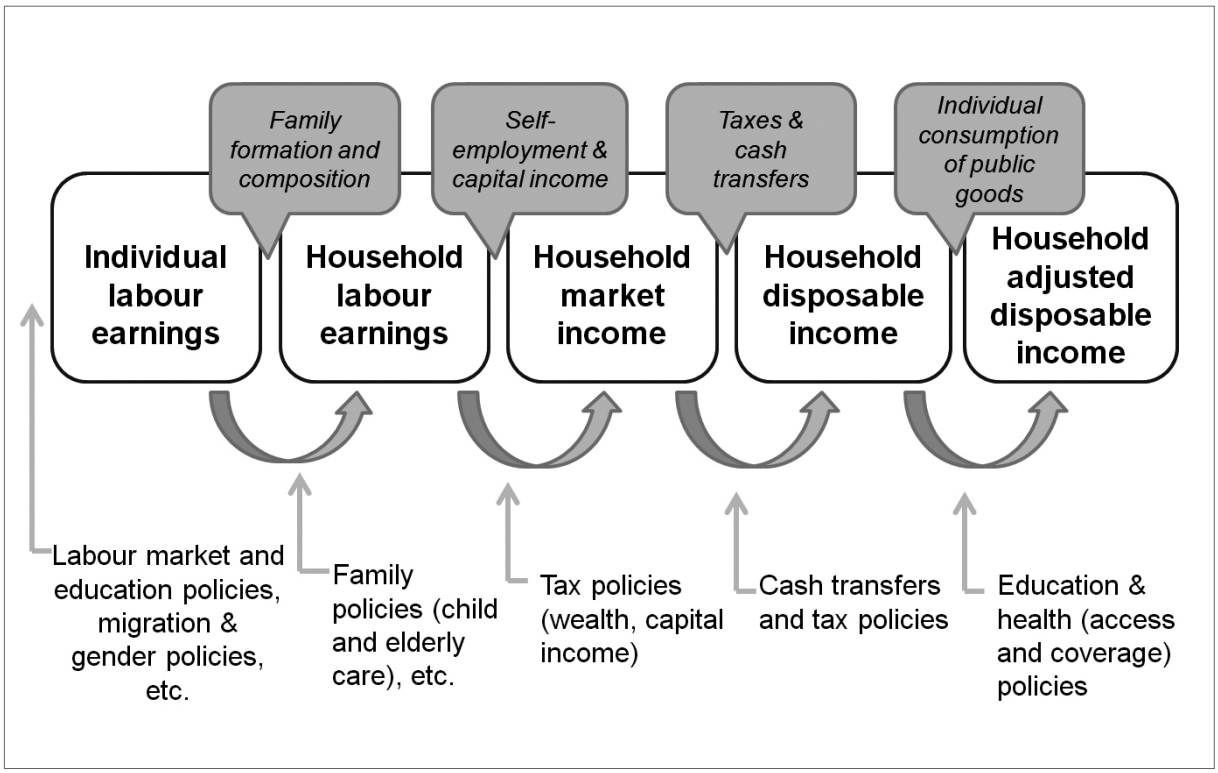
Source: OECD, *Inequalities in emerging economies*, 2010.

Graph 3: Gini coefficient, between the mid-1980s and the mid-2000s



Source: *Growing Unequal?*, OECD 2008

Graph 4: Concept of income that includes public goods



and education expenditures would not be captured by this measure. Clearly, to assess the distributional impacts of the financial crisis and policy responses to it is necessary to focus on broader measures of income, such as household adjusted disposable income.

A number of forces have been at play in shaping trends in income distribution; there is no single factor. Changes in household structure – for instance, towards smaller households, more single parents, and more elderly – have been among these forces. Labour market developments are another, with weaker wage bargaining and weaker unions having an effect on the distribution of income. Policies to address social protection policies and social transfer policies have also become less effective over time.

Sharing Macroeconomic Risk

The distribution of income is not only shaped by long-term trends such as technological change, globalisation, or economic and social policies, but is also affected by macroeconomic shocks like the recent financial crisis where the effects can be concentrated among different groups in society.

For example, Graph 5 shows that the increase in youth unemployment has been about double the rate among the overall population. Taken together with the fact that the incidence of poverty, or the risk of falling into poverty, has moved over time from the elderly population towards the younger population, it is evident that youth unemployment has been one of the driving forces of an increase in income inequality among that group.

Recent OECD empirical work has systematically examined the distributive effects of macroeconomic shocks and the role of policies and institutions in shaping them. Of course, the impact of macroeconomic shocks on different groups in society depends on the kind of economic shock. Table 1 provides a taxonomy of the distributional impact of macroeconomic shocks.

Some of the results are very intuitive. The left-hand panel in Graph 6, for instance, shows the impact on poverty rates following a financial crisis peaks over a period of five years. To the extent that this holds for this current crisis, the impact that we have seen to date is about only half of the likely full impact.

Some Implications for Policy

The main point that I would like to draw from this short exposé is that inequality and poverty have increased over the past two decades and the financial crisis has exacerbated these trends. Accordingly, a well-functioning international monetary system and macroeconomic stabilisation policies that are more effective in the preven-tion of instability and in better distributing the burden of shocks across a wider group of the society will go some way toward addressing income inequality.

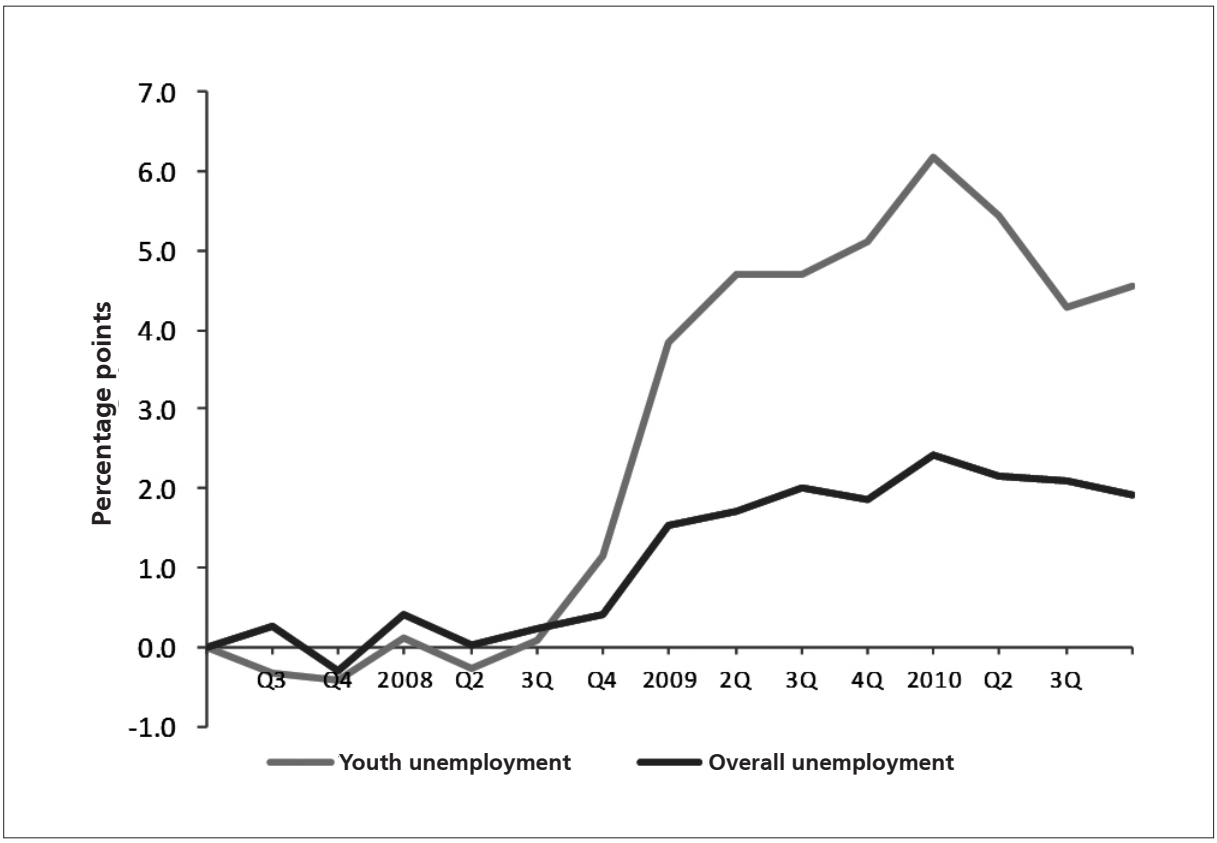
The main drivers of rising inequality are not macroeconomic, however. To tackle inequality in a significant way also requires direct policy measures that focus on redistribution and inclusive employment policies.

Table 1: Distributional impact of macroeconomic shocks

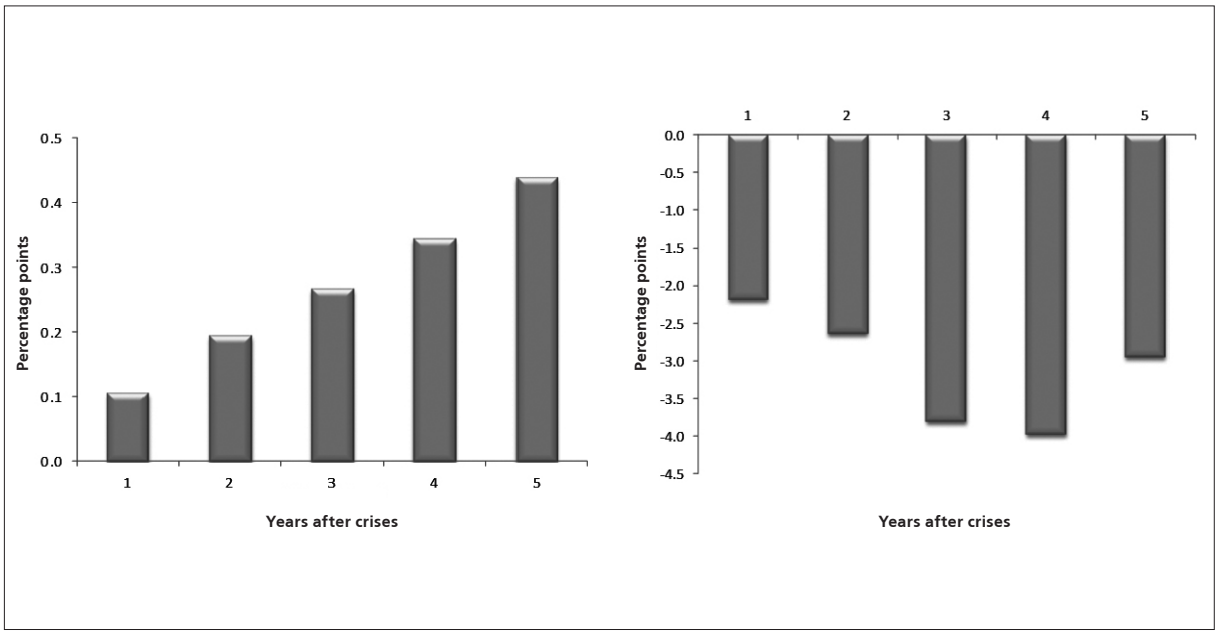
	Income Inequality	Poverty	Relative labour market prospects of »marginal groups«
Financial crises	N	N	N (young, seniors, women)
Fiscal consolidations	N	N	N (young, seniors)
Fiscal expansions	P	P	P (young, seniors)
Exchange-rate devaluations	N		N (young, seniors)
Exchange-rate appreciations	P		
Commodity-price increases		N	N (young)
Commodity-price declines	N		

N = negative impact, P = positive impact

Graph 5: Increase in unemployment with respect to 2nd Quarter 2007



Graph 6: A. Average increase in poverty rates following financial crises
B. Decline in youth employment following financial crises (gap with overall change in employment)



In an Era of Systemic Shocks

Rishi Goyal

My first point is that global macroeconomic and financial stability – which the IMF seeks to promote – is a necessary, but not a sufficient, condition for the correction of social inequalities. When there is instability, the vulnerable segments of society are most at risk. For example, at least 20 to 30 million people have become unemployed as a result of the global financial crisis. Many of these are young people. Many of them are low-skilled people. Much of this is long-term unemployment. The adverse impact of instability is likely to persist for quite a long time. Another example is inflation. But, here too, instability – as in high and volatile inflation – adversely affects the vulnerable. Inflation is a regressive tax. So the mandate of the Fund to promote economic and financial stability is a pre-condition for durably redressing some of the social and inequality issues that we all face.

My second point is that the world in which we lived before the crisis was a rather different one from the one in which we live today and are likely to live through for the next few years. Prior to the crisis, the core of the global economic and financial system was stable. Shocks that hit the system were largely idiosyncratic. That is, shocks remained localised at the country level and did not become systemic. How does one deal with idiosyncratic shocks? By pooling resources and focusing on adjustment at the country level, where the shock or instability is localised.

When shocks hit the core of the system, however, they can quickly become aggregate or systemic. Dealing with large shocks and aggregate volatility is a much more difficult problem than dealing with idiosyncratic or country-level ones. The mechanisms that we have in place are inadequate to deal with such shocks.

To better understand the impact of such shocks, we calculated the impact of a one per cent GDP shock to the United States on other systemically large economies in the world. If such a shock operates primarily through trade channels, the impact is estimated to be small – a one per cent shock in the US roughly translates to 0.2 per cent of the GDP to others. The impact is larger when financial channels are taken into account. Proxied by asset price co-movements in »normal« times, the transmission of shocks through financial channels implies that a one per cent shock in the US translates to a roughly 0.5 per cent of GDP impact on others. In stressful times, the impact is even larger. For advanced economies in Europe, as well as Japan, the impact is around 0.8 to 0.9 per cent. For emerging markets, the impact is more than one per cent. So a one per cent shock in the US has a much bigger impact on others during financially stressed times. As the crisis has shown, shocks that transmit through financial channels have particularly large, rapid, and widespread impacts. Yet, we do not have effective, collective mechanisms to cope with the volatility and the adverse impacts on society that can result.

My third point is that the recovery from the current crisis is likely to be a long one. We are in a balance sheet recession. At the present time, there is an adverse feedback loop between sovereign balance sheets, financial sector balance sheets, and weak growth. How can this adverse loop be broken? How can stability be restored quickly? Historical experience points to several years to repair balance sheets, and even this repair is generally underpinned by strong export growth. But when the shock is global, the opportunities to export are limited.

The problems that we face are difficult and complex. They are likely to be with us for some time. Against this background, how can social inequality issues be addressed? How can the vulnerable segments be protected? How can the Fund help to safeguard global economic and financial stability, and thus help to provide the enabling environment for benefiting especially the weaker segments of society?

The Fund can help first through its advice on macroeconomic and financial policies that is pointed and ahead of the curve. What does this mean in practice? It means taking into account the interconnections through which shocks transmit, trying to see not just the view at the ground level of how policies in the US impact the US, or how policies in the euro area impact the euro area, but

also how they spill over and impact others. What are the specific channels through which they operate? How big can these be?

This has implications for early warnings. As others have mentioned, we have an early warning exercise – vulnerability exercises for advance markets and emerging markets, and a new exercise that we are introducing for low-income countries – to try and understand ahead of time where key vulnerabilities are and how one should act to get ahead of them. We have launched the spillover reports. This is a new exercise launched this year that, hopefully, will continue in some form. Our Executive Board needs to decide on the precise modalities. These reports focus on how policies in the systemic-5 economies – in the US, in the euro area, in China, Japan, and the UK – impact their partners. The intention is to be granular and specific, to the extent possible, on how economic policies and developments in these systemically important economies affect not just themselves, but others as well.

So one way that the Fund can help is through policy advice that is precise, that is ahead of the curve, and that tries to speak the truth to power. You have to give credit to the managing director for coming out and saying that the world is at a dangerous new phase. How much stronger a statement does one want about the risks that the global economy faces right now and the narrowing window of opportunity to act, as many have said?

A second way that the Fund can help to ensure stability is through the lending mechanism. Here, I would point out that »bystanders« are going to be adversely impacted in systemic crises. Crisis bystanders are economies that have strong fundamentals and strong policy frameworks, and yet are adversely affected. It is of course not unusual that, when a shock hits – say, the 1980s debt crisis, the Asian crisis, the Russian crisis, etc. – countries with weak fundamentals have financing difficulties and enter into a period of economic adjustment. There is no surprise that countries with weak fundamentals face the need to adjust.

But what we see now is that countries with strong fundamentals and strong policy frameworks may also face difficulty. What kind of financing instruments can be provided to assist them? The Flexible Credit Line and its subsequent reform and the Precautionary and Liquidity Line are insurance mechanisms, so to speak, to try to address this gap in the global financial safety net.

There is also the issue of systemic liquidity provision. This is a very complicated subject, and central banks are uncomfortable with introducing yet another source of liquidity provision in the global economy. That said, it is important to bear in mind that when Lehman Brothers collapsed, the central bank swap lines that were established were ad hoc, several in number, very large, and reactive. One question to keep on the table: are such mechanisms the most useful, and proactive, forms of protection and safety net to deal with the recurrence of the financial problems of the past few years? Or do we need a predictable, multilateral cooperation mechanism?

A third way that the Fund can help relates to strengthening the architecture of global finance, in particular to cope with volatile capital flows. Many have spoken to this issue today. Capital flows are very large, and inflows and outflows can change from year to year quite substantially for a lot of countries. This raises the issue of domestic financial and macroeconomic stability. Inflows tend to be asynchronised, starting at different times in different countries. But they are often synchronised when they stop. In the most recent crisis, 80 per cent of inflow episodes stopped at the same time.

So we have asynchronised starts but synchronised stops. And, again, one must ask the question: are the instruments that a country has at the country level adequate to cope with the kinds of capital outflows or sudden stops that might result? This issue has recently generated significant discussion on the costs and benefits of various ways to manage capital flows, and of developing a coherent, comprehensive, flexible, and balanced approach.

Strengthening the architecture calls attention to the need for cooperation – a call that our managing director has been making. There is a danger that we move away from multilateralism into a more regional or national approach to issues, given the increased scope for external volatility now and in the period ahead. Yet, it is precisely a commitment to multilateralism that has underscored the significant improvement in living standards globally over the last 50 or 60 years.

The significant expansion of cross-border trade has been a tremendous engine of growth across many countries in the last several decades. In the post-war European economies and in East Asia, the expansion in trade underpinned a rapid recovery, improvement in per capita incomes, and reduction in poverty and social inequities. A reversal of this commitment can have very deleterious impacts. That is why the Fund and other international organisations that foster cooperative solutions to common problems must be seen as legitimate and representative.

At the Fund, there has been a historic reform of its governance structure – envisaging, among other things, a large shift in voting share to dynamic emerging markets and under-represented economies, a reduction by two of advanced European chairs in the Executive Board in favour of emerging markets, and preservation of the voice of low-income countries. For these reforms to go into effect, we need 113 member countries representing not less than 85 per cent of total voting power to consent to these reforms. Currently, we have only 21 who have consented, with 19 per cent of the voting power. With the membership having committed to undertake best efforts to put these reforms into effect by October 2012, a significant effort is needed for success. I would encourage you through your network to go out and make the case for multilateralism. We need to push this through.

Allow me to conclude with one final thought. The approach prior to the crisis was that stability at the level of the system equates to stability in each of its component parts. If things are going well at the country level, then it will all add up at the systemic level, and things at the systemic level will be fine. But the crisis showed us that just looking at institutional levels of stability (for financial stability) or country-level stability (for macroeconomic stability) is not enough. For example, following export-oriented growth strategies may be beneficial for some countries, but if all countries follow export-oriented growth strategies then the world will have a serious adding-up problem of deficient demand.

We need to be looking at systemic stability in its own right, and not just at stability at the country level. We need to be looking at the adding-up problem globally. One manifestation of this problem is the needed rebalancing of demand. Even as the advanced economy core today needs to break the vicious cycle between weak balance sheets in the public sector and the financial sector and weak growth, it is also the case that emerging markets or surplus economies need to step up and provide the necessary demand to be able to support growth.

3 Embedding social policy in financial and monetary policies

Inequalities, Shared Societies, and the International Monetary and Financial System

Y. Venugopal Reddy

It is gratifying to note that the IMF is taking an interest in the issues relating to inequalities and social cohesion. On first reading, the connection between the international monetary and financial system and social cohesion appears vague, but after some contemplation, reference to the literature, and the more recent socio-political developments consequent upon the global crisis, the links between international systems and social cohesion, and the significance of the subject, become evident.

On the Links

I was a Member of the Palais Royal Initiative Group that submitted the report titled, »Reform of the International Monetary System: A Cooperative Approach for the Twenty First Century«. The terms of reference did not cover aspects relating to inequalities, equity, or social cohesion. Hence, the deliberations did not take into account such broader aspects, and restricted themselves essentially to what may be termed as issues related to money and finance in the context of overall economic policies. The composition of the members reflected the heavy orientation towards money and finance since it consisted of former Managing Directors of the IMF, Former Governors or Heads of Central Banks, and a few Academics. However, the Committee was looking at unequal and iniquitous treatment of nations in the international financial and monetary system, and its consequences for growth and stability. The objective of the Initiative was to explore the feasibility of a better system, which can be reached in a non-disruptive manner from the current non-system whereby the currency of one country, vis., US dollar, operates as the predominant reserve currency. Incidental to this focus on the system was consideration of the global financial architecture, and in particular the role of the IMF. In brief, the link between social cohesion and the international financial and monetary system remains somewhat unexplored by this Initiative.

I was also a Member of the Stiglitz Commission (Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System). The report of the Commission gives extensive treatment to the issues of inequalities, the global financial crisis, and the links between the two. The report explains how the financial and monetary systems at the national level were under pressure due to the volatility in aggregate demand brought about by increasing inequalities. It also referred to the interaction between financial and real sectors in the context of increased inequalities. The implications of deregulation of the financial sector on increasing inequalities was also brought out clearly in the report. The report explains how the process of globalisation and the associated global systems often demanded policies at the national level that perpetuated and increased inequalities among the nations and within the nations. A comprehensive view of the links between inequalities and monetary and financial systems in the UN Commission was enabled by the fact that its terms of reference were wider than that of the Palais Royal Initiative, and its membership was representative of a cross-section of nations, policy makers, and academics.

In my view, it is appropriate that the IMF should bring out a paper and analyse the recommendations of the Stiglitz Commission since they happen to be comprehensive, pragmatic, and sensitive to issues that are as-

sociated with social cohesion. Such a response from the IMF should ideally be made available to G20, and to the wider public in due course.

I would like to make two introductory comments on the subject. Firstly, it is necessary to view inequalities in the broader context of social cohesion, which is an important source of human happiness and human welfare. Such an approach should complement the mainstream analysis that addresses the importance of reducing inequalities on economic grounds, and also on moral and ethical grounds. Economic policy and social cohesion do interact, and that can be either in a vicious cycle or in a virtuous cycle, but their inter-relationships and interactions may be evident over the longer run than over the shorter run. It may also be difficult to make a quantitative analysis of the relationship between economic factors and social cohesion. Secondly, issues relating to inequality or social cohesion should not be considered just as an add-on to mainstream economic policy, but such considerations should be embedded in all aspects of economic policy. In other words, the objectives of public policy include not only growth in output, maintaining employment, and price stability and financial stability, but also social cohesion. No doubt, the relative importance of social and economic factors in public policy do depend on the social, cultural, and institutional circumstances in individual countries and globally.

In the following text, I will draw from my experience in financial and monetary policy to explain how the issue of social cohesion and inequality can be embedded in public policy. In the second part of the text, I will mention some new challenges for public policy consequent upon the experience with the global financial crisis. In the third part, I will make a brief mention of what the IMF and other multi-lateral bodies could do on this subject.

Embedding Social Cohesion in Public Policy

As an Executive Director in the IMF, I gave a farewell speech in September 2003 since I was moving to India to take over as Governor of the Reserve Bank of India (RBI). I referred to the comments of some of the Executive Directors that I would be facing severe monetary challenges in managing a large economy like India, inhabited by one billion people. I explained that, in my view, the biggest challenge for me would be making central banking relevant to the millions of poor people. That remained a guiding principle for me in my work and interactions with the Board of the RBI, the professionals of RBI, and the Government of India. This approach was, in some ways, consistent with the long tradition of the RBI, which has an enviable record of maintaining excellent inflation record since independence, as evinced by the fact that inflation seldom exceeded 10 per cent. There has been virtually no banking crisis in the country. There was no serious currency crisis, though several stresses on balance of payment had to be managed. Most of the pressures on balance payments were due to the shocks on account of food, fuel, or geo-political developments, rather than monetary management.

Next, I will give specific illustrations of how broader issues of social cohesion – or, more specifically, equity considerations – were embedded in the policies of RBI, and have been articulated as such in the policies especially during the period 2003–2008.

Monetary Policy

Firstly, inflation targeting as an objective of monetary policy was not accepted in India despite global intellectual support for it on economic grounds, which have been well known and articulated. The RBI held that inflation is difficult to measure, and in any case, in India there are several measures of inflation, vis., one wholesale price index and three consumer price indices. Further, even if a particular index is chosen for purposes of targeting, inflation targeting requires targeting core inflation, which generally excludes food and fuel. However, for most poor people, food and fuel account for about half of their budgets. How could a central bank target a measure of inflation that excludes close to half the budget of the poor? Hence, RBI preferred to continue with whole price index as headline inflation while assessing inflation by considering the other indices of inflation and other relevant factors. Further, RBI took the view that inflation expectations cannot be considered only in terms of the behaviour of the bond markets, or even simple surveys, though surveys are important. The inflation perceptions were also taken into account. For example, when the prices of some essential commodities which are purchased by poor people frequently in-

creases, the impact on inflation perceptions would be more severe than when the price of infrequent purchases like air conditioners or electricity increases.

Analysts often pointed out that the Central Banks should communicate their commitment to price stability, and in the absence of inflation targeting, such a commitment is not demonstrable. The position of the RBI has been that the commitment to price stability in India must be derived from three sources, vis., policy statements, policy actions, and, above all, the policy outcomes.

Another source of difference between mainstream thinking and the approach of the RBI was in its response in monetary policy to what is described as shocks or temporary phenomenon. We accept the view that it is not possible to know in advance what is temporary, and how temporary it was in many cases. For example, an increase in the price of vegetables due to a strike by truckers or floods in some area may be temporary, but not necessarily so in the case of, say, fuel prices. The issue in regard to treating an increase in prices as a shock relates to the level of confidence that the prices will revert to the normal level or pre-event level. Hence, it is necessary to communicate effectively and, if considered necessary, take appropriate actions in regard to all cases of stress on prices, rather than simply ignoring what appear to be shocks, particularly in commodity prices due to global developments. Further, the government might make efforts to smooth the impact of such shocks, and in such circumstances, the central bank should be assessing the capacity of the government to absorb such shocks on a prolonged basis and the possible fiscal implications. It is true that these multiple considerations could virtually lessen the policy direction, but it is equally true that in many circumstances it is better to be approximately right than precisely wrong.

In regard to the use of interest rates as an instrument of monetary policy, considerations were not restricted to the trade-off between output and stability, but also the limit to longer-term growth and the distribution of burdens among different sections. In many advanced economies, a large segment of the population contributes to household savings, and they also borrow for variety of purposes, including consumption and housing, et cetera. In India, a large section of the savers continue to be savers, while there is a small section of borrowers. Most of the borrowing is by government and businesses, rather than households. As a result, the impact of changes on the balance sheets of savers and borrowers was taken into account. It is noteworthy that banks generally draw savings from the rural areas and lend in the urban areas.

Financial stability as a goal was explicitly articulated in addition to growth and price stability, since financial sector became more important than before, and also because of the global developments. The philosophy that it is ideal to leave it to the markets to adjust was moderated by a continuous assessment of who gains and who takes pains in different phases of the business cycle and steep movements in prices of assets. It was assumed that poor people gain to some extent, but rich people gain significantly more in the boom phase of a business cycle, while the poor persons suffer severely in the down turn. Hence, it was considered essential to moderate such cycles by continuously assessing distributional implications of different phases of the business cycle. In fact, concern for distributional implications of asset prices was the foundation for countercyclical monetary policy that was undertaken in India. RBI assumed for itself the responsibility for financial stability, and took measures to ensure it, keeping in view its responsibility for not only maintaining growth and price stability, but the distributional implications of volatilities or instability.

A countercyclical monetary policy within the country during the period of ample global liquidity and low interest rates globally also meant higher interest rates domestically, which could attract large capital inflows from other countries due to the global liquidity that was prevalent, driving the economic cycle upwards. The RBI concluded that, to some extent, the capital account has to be managed in such a situation to moderate the impact of volatility in capital flows. There has been an admission that the traditional trilemma could not be resolved easily, and hence with all the imperfections, a choice had to be made to somehow manage the trilemma, which necessitated managing the capital flows. This approach also meant that the issues of volatility and flexibility in exchange rate had to be considered in a dynamic fashion. Progressively, what was considered volatile could become flexibility. What is flexible would depend on the development of institutions and markets to manage the volatility in their respective balance sheets. In this regard, the interest of the poor and the under-privileged could not be ignored in making assessment of what was a flexible exchange rate and what was a volatile exchange rate.

Regulations

The countercyclical monetary policy was complemented by a countercyclical policy in regulation of the financial sector on the grounds that have already been described. Accordingly, countercyclical weights and provisioning requirements were prescribed. In doing so, it was necessary to identify sectors where credit expansion was more of a speculative nature, and treat them as sensitive sectors. Simultaneously, it was necessary to ensure credit flow to productive sectors, in particular to agriculture, small and medium industries, and, to the extent feasible, vulnerable sections. Finance for housing is a priority in India since there is a huge unmet demand. Rising incomes and demographic profile add to the demand, though housing markets remain illiquid and characterised by several imperfections. Taking account of the prevailing asset bubble and the priority to housing, the regulatory burden was increased in respect of real estate and a segment of housing, but loans for houses below a specified value were exempt from such countercyclical measures. The effort was to ensure continued flow of credit to the needy, and equally to protect the banks from possible excessive exposures to sensitive sectors. Further, the element of regulation was extended to non-banking financial companies, or what has been described as shadow banking, but this was done in a way that the flow of credit to productive sectors is maintained to the extent possible. The advantage of this approach was that it was possible to reverse many of the stipulations when the global crisis occurred, and it impacted India.

When monetary policy undertook tightening in response to the asset bubble, there was serious criticism that it was unjustified, and that it would seriously affect growth, and, in any case, increase in prices of food and fuel was on account of global commodity shock. We, the Reserve Bank, argued that it would be logical to increase the cost or price of money when the price of rice, vegetables, and fuel increases for some reason or the other. The price of money cannot be kept artificially low when the prices of many other commodities are going up.

Financial Inclusion and Micro Credit

The objective of financial inclusion, which was formally announced in 2006, is to provide access for all to financial services. These include (a) a safe place for keeping their savings in terms of deposits, particularly for women; (b) a facility to send and receive money through family sources or migration, or for education, etc.; (c) consumption smoothening or accepting deposits, and, as needed, provision of loans to overcome issues relating to seasonal employment or irregular incomes; and (d) micro credit link to, or with, an assurance of productive investments which are likely to generate incomes to service the loans with interest.

The concept of financial inclusion is slightly different from micro credit, which essentially concentrates on provision of credit. It was observed that in some countries, micro credit and micro financial institutions were encouraged often as a supplement for the highly commercialised banking that was promoted through the programmes of liberalisation and deregulation. The policy of encouraging micro-credit in many countries involved for-profit institutional mechanisms to lend to the poor. Often this meant some penetration of debt to poor sections, and expansion in credit to them, but often at high interest rates. This approach also led to the fear of emergence of one set of financial services for the poor and another for non-poor. In India, the approach to micro-credit was slightly different.

The services of non-profit micro finance institutions, as in the case of Grameen Bank of Bangaladesh, were encouraged by the RBI. In the process, some profit-making Micro-Finance Institutions (MFIs) also gained prominence, which subsequently led to some complications. The longer-term objective of financial inclusion policy is to avoid one set of banking services for the non-poor and another set for the poor. The approach has been to extend banking services to as many as possible through expansion of a branch network of banks, and have extended arms of such branches through self-help groups, MFIs, and business correspondents. Technology was a key element in strategy.

The instruments used by the RBI for advancing the cause of financial inclusion were several. The RBI exercised its powers to grant licenses for the opening of branches by banks to ensure that they move to under-banked or unbanked areas in conjunction with their expansion in well-banked areas. The RBI invested in improvements to technology and financed pilot projects for use of technology for mass banking, in particular banking through mobile phones. A business correspondent model was developed

whereby the bank branches employed business correspondents with the sole purpose of operating as extended arms of the bank branches to reach the remote areas and the poorer sections at their doorstep. The business correspondents were agents of banks, and hence were subject to the overall regulatory discipline imposed on banking system by the RBI. The RBI also invested in technologies for access in remote areas so that the viability of branch banking is enabled. The state governments were also interested in making welfare payments, including old age pensions, under an employment guarantee scheme through use of bank accounts. With active cooperation from RBI, some of the state governments subsidised commercial banks to enable them to incur the processing cost for opening of accounts, etc.

Payment System

Payments to bank customers through automated teller machines (ATMs) were mandated by the RBI to be free for the customers irrespective of the ownership of the ATM (all ATMs were owned by banks only). In regard to inter-bank transactions in this regard, the banks concerned were free to fix any charges, but they could not be passed on to the customers. Switch facilities for use of ATMs of one bank by the customers of another bank were provided free of cost by the Institute of Development Research in Banking Technology (IDRBT), an institution promoted by RBI. ATM was also considered to be a great leveliser in the sense that all customers have to stand in the same queue at the ATM, unlike in the banks where the privileged customers could get faster service.

Regulatory Philosophy

The underlying philosophy in regard to regulation of banks is that the license for banking is a privilege granted. There is a sort of monopoly over payment services granted to them. They are also permitted to accept non-collateralised deposits. Hence, there is legitimacy in the regulator demanding some services in public interest. Further, financial services are considered to be in the nature of a public utility, and approval of tariff should not be ruled out, provided it does not undermine competition or efficiency. This underlying philosophy enabled social cohesion to be embedded in the policies relating to money and finance in India.

Crisis and New Challenges for Public Policy

The global financial crisis is unraveling the significance of social cohesion in maintaining stability in financial and economic systems. There is a recognition of the need to consider equity aspects and emergence of inequalities in conduct of policies relating to money and finance. Some of the emerging challenges to public policy are presented here to enable further debate.

First, public policy in regard to social cohesion has to take into account both the fears and the hopes of different sections of the people. As a result of the global crisis, people in advanced economies, particularly young people, are fearing whether they can maintain their current levels of employment and current standards of living that they are accustomed to, in the post-crisis period. Many of the elderly people are also fearful about the continuation of the benefits that they expect for old age, and the benefits around which they have built their lives. Many of the younger people are also fearful about the possibility of maintaining their standard of living for their children that the current generation has become accustomed to.

On the other hand, in developing economies and emerging market economies, the dominant mood is one of hope of better standards of living for the young people and even better standards of living for their children. The debates essentially center around how much better they would be in the future, and how equitable the benefits would be in future.

In a global scenario, social cohesion has to take into consideration the divergent fears and hopes in different societies in the global community. Public policy, particularly in regard to coordination at the global level, cannot ignore this divergence, since these divergences pose divergent challenges to public policy in different nations.

Second, inequality and social cohesion have different challenges depending on the country context. In some advanced economies, such as the United States, inequality has been a dominant theme. In some of the countries in the Middle East, the issue is not necessarily poverty but inequity, and issues are not centered around generation of wealth. In many emerging market economies, there is a serious perception of unfairness in governance.

In some other countries, like Chile, the dissonance comes from the middle class. In China, there seems to be serious structural issues in the rural-urban inequities. In other words, social cohesion, inequity, inequality, and fairness are interlinked, but may not have similar characteristics across the countries. Hence, while all factors relevant to social cohesion should be integral to public policy, at a global level, the causes of and cures for social cohesion are significantly country-specific. Hence, many social issues need to be considered at the national level, while spillover of national policies to global issues ought to be an important agenda of global cooperation. At the same time, all matters involving global cooperation should display sensitivity to impact on social cohesion in different countries.

Third, it has been observed that countries with greater social cohesion experience less resistance to higher taxes and compliance with taxation. Perhaps the fiscal dimension to social cohesion has been somewhat neglected in the debate.

Fourth, the impact of the digital and skill divide that is emanating through technological progress and their transmission globally on issues relating to inequality should be recognised. Technological progress gives a premium to well-qualified persons. At the same time, in many countries, higher education is being privatised, which closes the doors for many of the poor to the acquisition of high skills. This impacts the poor adversely, and injects inequality in opportunities. Admittedly, technological progress enables greater growth and prosperity across the board, but a divide in opportunities has adverse impact on social cohesion, and thus can be a drag on longer-term growth and stability.

Fifth, it is useful to recognise the two contrasting characteristics of finance capital and of labour. Finance capital can be mobile, and is very mobile. It can be withdrawn from circulation and stored with no or marginal loss of value. Labour is less mobile for several intrinsic reasons, apart from restrictions imposed by governments. Labour cannot be stored, since as a person ages her capacity to work for the rest of her life is reduced correspondingly. Labour cannot withdraw its supply or hold back its supply for a prolonged period since the worker may die of starvation. Because of these reasons, the bargaining power of labour relative to capital is inherently unequal and loaded against the labour.

Finally, the relative bargaining power of labour is not uniform across the countries. For instance, in India, 90 per cent of the workforce works in the informal sector with virtually no bargaining power. The balance 10 per cent have been often unionised and till recently tended to take advantage of their bargaining position to corner disproportionate benefits for themselves. In India, until recently, it was a tyranny of 10 per cent which was prevailing, but that has now been reduced. On the other hand, in some of the advanced economies such as those of the United States and the United Kingdom, the counterveiling power of unions over management has diminished. Hence, public policy should consider continual balancing between finance capital and labour, in the light of circumstances in each country.

The Role of the IMF

There are several ways in which the IMF can contribute to social cohesion in its surveillance and also advice. First, the IMF could emphasize the importance of diversity in financial systems as a source of stability in all matters relating to global coordination. Diversity in financial systems would provide possibilities of managing divergence in national challenges, keeping in view social cohesion, whereas a coordinated approach essentially based on market principles would find it difficult to capture issues of largely national-specific social cohesion in public policy. Further, it would be useful to visualize what would have happened if the regulation of financial sector in the past followed a globally fashionable Anglo-Saxon model. Even China and India would not have been spared from the serious adverse impact of the crisis.

Second, the IMF should recognise the merits of coordination in public policy and the dangers of conflicts of interests in the private sector in their assessment of relationship between state and market.

Third, it is recognised that one of the main reasons for the global financial crisis has been the race to the bottom in regulation of the financial sector, in order to attract financial sector activity. The IMF would do well to monitor such practices. It should also consider empirical data before concluding that capital will necessarily shy away from jurisdictions that impose regulatory burdens or taxes.

Finally, the perception that there is a sensitivity deficit in the IMF, which is to say a deficit in being sensitive to inequalities, equality, and fairness, etc., should be removed. For example, the global community guided by the IMF responded to the global financial crisis with several unconventional measures to avoid collapse of the financial market. These measures involved huge fiscal support to the financial sectors in matters of days and hours. It will be useful to look in retrospect at the unconventional measures that have been considered, analysed, and proposed by the IMF to tackle the unemployment and insecurity that have been generated by the global crisis. In fact, some of the super-rich in the world seem to have become more sensitive to the impact of inequality on social cohesion in the United States than, perhaps, others have been. It could be that the super-rich are afraid that the frustration of the unemployed may affect them. The main issue at this juncture for the international monetary and financial system, as well as for the global financial architecture which includes the IMF, is: how innovative and how sensitive should they be to the real lives of real people in all countries and societies?

Rising Inequality is Bad for Growth

José Antonio Ocampo

I would like to emphasize the growing evidence that income inequality is rising, and that it is bad for growth. Income inequality contributes to the duration of the current crisis, even according to the former chief economist of the International Monetary Fund (IMF), Raghuram Rajan. It was also one of the basic diagnostic elements in the Stiglitz Commission, the Commission of Experts on the International Monetary and Financial System that was organised by the president of the General Assembly in 2008–09.[1]

What are the instruments that should be taken into account? The composition of fiscal policy is essential – how the budget is distributed – and also the tax and spending sides are a major issue. There are many questions there. For example, the structure of taxation is critical, but so is the structure of spending policies. There is tremendous evidence that the more universal social policies are, the more redistributive they are, which is what some have called the »paradox of redistribution«[2]. With a greater number of narrowly targeted social policies, the effect is actually less redistributive than a universal policy, although, of course, universal policies are more expensive. In the end, you need a larger state to be able to undertake those more redistributive policies.

I would also like to underscore the importance of employment. For example, it is a mix of employment and education that is largely responsible for the improvement in income distribution that has taken place in many countries in Latin America over the past 10 years. But it is important to underscore that, when we are talking about sharing macroeconomic risk, the critical issue is counter-cyclical macroeconomic policies. There may not be much incentive to undertake counter-cyclical macroeconomic policies, but it is essential to be able to do them during a crisis. If you do not do counter-cyclical macroeconomic policies, the policy space you have in a crisis is very limited. That is what many countries are learning again, and what Latin America has learned several times in its history – even in its recent history.

A major advance in the beginning of the crisis was the consensus that built up around counter-cyclical macroeconomic policies, which had a bad name just five or six years ago. The policy came into fashion again during the »Keynesian moment« in the beginning of the crisis. Since then, we have seen a movement away from that Keynesian consensus towards very widespread pro-cyclical policies again.

We have seen this outlook in particular in Europe, but it is much broader than that. One of the reasons is that many developing countries do not have the margins for counter-cyclical macroeconomic policy. It is different with the middle-income countries. They have built up accumulations of reserves, but small countries in particular do not have much policy space. They always have a bit of policy space on the fiscal side, but because most countries did not undertake counter-cyclical macroeconomic policies during the boom, they do not have the room today for counter-cyclical macroeconomic policies during a crisis.

This leads me to the discussion we are seeing now among the developing countries: do we not have room to maneuver for counter-cyclical macroeconomic policies? I think there is a growth of the estimation of maneuvering room in the name of good fiscal balance in the long term, against the possibility of more active counter-cyclical macroeconomic policies. For several countries, even in Europe, I would say there is much more room for more fiscal stimulus in the short term.

Some of the larger emerging market economies now have maneuvering room that they should utilise. The IMF sends the wrong message when it says that most emerging markets should still be cautious. The worldwide situation, including the growth estimates for emerging market economies, indicates that we are already slowing down significantly and that there is room

1. »Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System«.

2. Since narrowly targeted policies are typically ungenerous and potentially stigmatising because of a lack of broad electoral support, the paradox of redistribution argues that universal benefits attract broad support and therefore result in more generous benefits that will also reach the most needs with greater certainty.

to maneuver that should be taken into account. So, for instance, the Central Bank of Brazil made the right decision in lowering the interest rate.

In industrial countries that have fiscal sustainability issues, in many cases – not in all cases – there is also room to maneuver through the composition of the fiscal packages. In my opinion, the US administration came out with the correct point – that you can get a balanced expansion based on taxing the rich and at the same time giving some employment benefits through the lowering of taxes on employment creation.

You can think of the same thing for Europe. There are many possibilities of doing this, including, for instance, for some of the weakest members. So what has been totally missing today in Europe is an expansionary package for Greece. We have learned in the past in emerging markets that just *demanding* contraction is a sure recipe for *continuous* contraction if you never meet the fiscal targets – because of the contraction and the effect that it has on wages. So you could think, for example, of using the structural funds of the European Union to target them on the countries experiencing strong recessions rather than on the lower-income regions, as one particular policy package. But, as I said, in several European countries, starting with Germany, there is probably more maneuvering room for expansion than is recognised.

The third thing that I wanted to mention as a countercyclical policy, which is generally totally ignored in the debates, is wage policy. I do not see even the recognition that wage policies can be macroeconomic policies, except the acknowledgment that in some cases they do have significant effects. China's greatest contribution to rebalancing is its increased wages, a factor which is sometimes ignored, both in its own domestic imbalances and also because increased wages in China are a real appreciation on the renminbi, which is not estimated anywhere. I saw a little piece in *The Economist* a few months ago exactly about how much China has appreciated real exchange rates through its unit labour costs. They have gone through a huge appreciation on the renminbi since the crisis.

Brazil is another example: for several years it has undertaken explicit policies to increase minimum wages as part of the domestic macroeconomic policy package. This could be applied to other countries as well. So if someone asked me, »What is the best recipe for the Euro area?« I would say, »An increase of wages in Germany«. I think it would be, first of all, expansionary in Germany itself, and in the European Union. It would allow a better rebalancing of relative wages in the European Union than the way the euro is doing it now, by forcing countries in a weaker situation to reduce nominal wages. The use of wage policies is very important.

Two final points in conclusion. One point that comes from this analysis is that mainstreaming the principles of employment and income distribution effects in macroeconomic policy is essential. All the international organisations will play a significant role in doing that, and there are basically two ways to go.

The first is what I call »visibility«, using the terminology of the gender leadership. This means making visible the effects of macroeconomic policies – macroeconomic events – on poverty and income distribution. For example, it means forcing central banks to explicitly analyse effects on employment, even if they do have employment as a policy mandate, forcing them to present regular reports. They do regular reports on inflation, so they should do regular reports on the effects of monetary policy on employment and income distribution, which I think should also go one step further, to incorporate employment in particular as one explicit objective of central banks.

The final point is that the current turmoil in the world economy is calling for a much larger IMF. I think it is time to reconsider the role of an issuance of Special Drawing Rights (SDRs) together with reforms that would allow a better use of SDRs – in particular to fund the lending programs of the IMF. This was the original idea of one of the intellectual fathers of this institution, Jacques Pollack, who wanted to fund all IMF programs with SDRs.

How Can the IMF Contribute to the Correction of Social Inequalities and a Sustainable International Monetary and Financial System?

Ulrich Volz

Introduction

In the decade following the Asian financial crisis of the late 1990s, the International Monetary Fund (IMF) suffered its own severe crisis, which may be described as a »crisis of irrelevance«. Alienated by the IMF's policy prescriptions and its governance dominated by advanced countries, many developing and emerging countries turned away from the Fund and tried to self-insure through reserve accumulation and reduce the likelihood of needing to apply for IMF assistance ever again. Moreover, as a result of the overall benign world economic environment during the era of »great moderation« that lasted until the outbreak of the global financial crisis in 2008, there were few crises where the IMF was called for rescue. In the perception of many, the IMF had lost its relevance, and some even called for its closure. In early 2007, *The Economist* called the IMF the »Turkish Monetary Fund«, since at the time a loan to Ankara accounted for two-thirds of its credit outstanding. With its interest earnings drying up and no new takers for its facilities, the Fund experienced severe funding pressure, forcing the IMF management to announce the layoff of 15 per cent of its staff and implement other cost-cutting measures at the end of 2007.

Tables turned in September 2008 with the outbreak of the global financial crisis. Since then, the Fund has been back in business as a firefighter on several fronts. Backed by the G20, it has also seen a tripling of its lending resources from about 250 billion US dollars to 750 billion US dollars. The IMF is now assuming an important role in all major economic discussions, from global economic imbalances over capital account management to enhancing financial stability. It is also confronted with numerous demands from various sides, including the G20, academia, and civil society. While the Fund should clearly assume a central role in global economic governance, and especially in safeguarding global monetary and financial stability, there is also a danger of the Fund becoming a Johnny do-it-all.

Against this backdrop, the remainder of this note will discuss the roles that the IMF could and should assume, and areas which will be better looked after by other international organisations. The next section will discuss whether the IMF should take on a role in the correction of social inequalities. Section 3 will outline major challenges for making the international monetary and financial system more resilient and sustainable, and discuss the contributions that the IMF can make in this respect. The final section concludes.

What is the IMF's Role in the Correction of Social Inequalities?

Widening social inequalities over the last decades have become a major concern in developing and advanced countries alike. This is not only a moral issue or a problem that could cause social and political instability (as recently witnessed in the countries of the »Arab spring«); social inequality can also have serious repercussions for macroeconomic and financial stability.

Recent research has highlighted the adverse effects that social equality can have for economic and financial stability, and hence sustainable growth. In his 2010 book *Fault Lines*, former IMF chief economist Raghuram Rajan argues that rising social inequality in the US was a major factor that led to a debt-financed investment boom in property by poor households – supported by publicly subsidised housing finance – who were clearly not able to afford their own property. The development of an unregulated »sub-prime« mortgage market that collapsed once over-indebted households were unable to make the required payment of principal and interest on their mortgages triggered a chain of events that eventually led to the meltdown of the US financial system.

Recent research by IMF economists Michael Kumhof and Romain Rancière describes the linkages between inequality, credit, and crises in a formal model in which

financial crises are preceded by increases in income and wealth inequality. Because of rising inequality and stagnant incomes, lower- and middle-income households finance a growing share of their consumption through debt. The resulting increases in their debt-to-income ratios become unsustainable and eventually trigger a financial crisis.

In a new paper, Marina Azzimonti, Eva de Francisco, and Vincenzo Quadrini highlight another way in which inequality can increase the likelihood of crisis. In their model, government borrowing responds positively to a less equitable distribution of wealth, which increases uninsurable risks that government will assume. They are able to provide empirical support for their theory using a sample of 22 OECD countries for the period 1973–2005.

Given these linkages between social inequality and macroeconomic and financial stability, there is no question that the IMF also must be concerned with this topic and let its policies and policy prescriptions be guided by the greater aim of cushioning social inequalities. However, when discussing the Fund's potential role in mitigating social inequality, we have to be clear about its mandate in distinction to that of other multilateral institutions. As Ted Truman from the Peterson Institute has pointed out, Article 1 of the IMF's Articles of Agreement does not contain a clear statement of the IMF's purposes relevant to the international financial system of the 21st century, which leaves room for interpretation. In my view, the Fund's major duties should concentrate on five areas.

- The first one is to support member governments in pursuing economic policies that will help sustainable economic development (which in my understanding includes equitable, or pro-poor, growth), with a focus on macroeconomic and financial policies. IMF activities to this end include regular Article IV consultations and general policy advice based on its insights gained through research and previous policy experience. For some countries, especially least developed countries, the IMF may also provide technical assistance.

- Secondly, an important area for the IMF is monitoring and surveillance to detect macroeconomic and financial vulnerabilities early on. Besides Article IV consultations, the Fund carries out Financial Sector Assessment Programmes together with the World Bank for comprehensive and in-depth analysis of an individual country's financial sector. At the global level, the IMF provides analysis through the publication of the World Economic Outlook and the Global Financial Stability Report. Since recently, the Fund is also engaged in the G20's Mutual Assessment Process and collaborating with the Financial Stability Board on regular Early Warning Exercises.

- A third area, and one in which the Fund has made important advances recently, is crisis prevention through the provision of crisis prevention facilities and strengthening of the global financial safety net. An important move was the launch of the Flexible Credit Line with *ex ante* conditionality for member countries with very strong economic fundamentals and institutional policy frameworks in 2009, followed by the introduction of the Precautionary Credit Line in 2010 for countries with moderate vulnerabilities yet sound fundamentals and policy track records (now replaced by the Precautionary and Liquidity Line).

- The fourth area for the IMF is to support crisis resolution when a crisis hits. This includes crisis lending and support of structural adjustment, but may in the future also include a role in an internationally recognised sovereign debt restructuring mechanism, a proposal that was made by Anne Krueger, then First Deputy Managing Director, in the early 2000s.

- Lastly, the IMF has a role to play in facilitating international economic cooperation and discussion by providing a forum for exchange between member countries. The IMF should also act as a knowledge platform for sharing policy experiences.

These five areas are of course all primarily directed at maintaining or restoring macroeconomic and financial stability – correcting social inequality is not among them. Nonetheless, through its actions and policy prescriptions in these areas, the Fund can have a profound impact not only on the economic development of its member countries in general, but also on their social developments in particular. Hence, in its policy advice and prescriptions, the Fund should take account of the social consequences of these policies. This is par-

ticularly necessary when the Fund is closely involved in formulating a country's economic policies, i. e., when it is attaching conditionality to its lending and requiring borrowing countries to adopt structural adjustment programmes. An obvious example of where the Fund must recognise its responsibility and the effects of its policy prescriptions on social development is fiscal adjustment, where cuts in social welfare, healthcare, or education budgets could have grave consequences for the poor and widen social inequalities. This does not mean that the Fund should not demand fiscal consolidation where it is needed, but it should advise governments to do so in a socially acceptable way.

The Fund should hence streamline its policies and procedures to take account of their short-term, medium-term, and long-term consequences on social development and equality in member countries in order to prevent adverse effects. It should also take a strong stand in trying to protect the poor and vulnerable wherever they are affected by fiscal or other adjustment policies which it can influence.

Beyond this, however, I see a limited role for the Fund in correcting social inequalities, which in my view is a challenge that lies within the mandate of multilateral development banks, including the IMF's sister organisation, the World Bank. Indeed, the Fund has been long criticised, from the left and the right, for extending its activities beyond its core mandate and trying to micromanage the economies of its member states. A study undertaken by the IMF's Independent Evaluation Office in 2007 also came to the conclusion that a significant number of structural conditions imposed by the IMF were very detailed, not obviously critical, and often felt to be intrusive and to undermine domestic ownership of programmes.

Against this background, I think it would be a mistake to demand the Fund to actively get involved in its member countries' social policies, especially since different societies have diverse preferences regarding the state's role in providing social security and the IMF is lacking expertise in this field. Other international organisations which have a mandate to work on these issues, including the World Bank, regional development banks, and various UN agencies, are much better positioned than the IMF to work on poverty eradication and lessening social inequalities.

But one thing the Fund could do is to use its central position in the international financial community to advance discussion among its membership – which in most cases is represented through central bank and finance ministry officials – on the way financial and monetary authorities can impact economic development beyond their traditional »stabilising role«, which is focused on ensuring macroeconomic and financial stability. As pointed out by my German Development Institute[1] colleague Florence Dafe, monetary and financial authorities in developing and emerging countries can also successfully assume a »transformative role« for promoting financial system development, and so encourage financial deepening and inclusion.

How Can the IMF Contribute to a Sustainable International Monetary and Financial System?

As argued above, guarding macroeconomic and financial stability within countries and on an international level should be the Fund's core mandate. Over the past couple of years, the Fund has demonstrated its ability to adjust to new challenges. The Fund responded very quickly to the global financial crisis and made very important and positive contributions to stabilising the world economy. Its governance reform has advanced, albeit slowly, with the 2008 quota and voice reform. The IMF has also overhauled its lending tool kit and revamped its conditionality policy.

The IMF's various activities in the five areas outlined above are all crucial for contributing to a stable international monetary and financing system. Yet important challenges remain for making the global monetary and financial system more resilient and sustainable. In my view, there are three major challenges at the moment.

The first one is to further advance work on regional and global financial safety nets in order to reduce the need for individual countries to hoard excessive amounts of foreign exchange reserves (which is costly) and reduce the danger that fundamentally sound economies experience crises due to financial contagion and short-term liquidity shortages. Here the Fund can play a leading role. The creation of the IMF's precautionary lending

1. Deutsches Institut für Entwicklungspolitik (DIE).

facilities should be welcome, and further measures should be taken to promote the use of such facilities. The Fund should also seek to engage with regional financing arrangements (RFAs), which are becoming increasingly important elements of the global financial architecture. Guidelines are needed for organising inter-institutional relations between the IMF and RFAs, as well as for a clear division of labour in crisis lending, and co-operation in surveillance and analysis activities.

Secondly, the IMF should support member countries in dealing with global liquidity and volatile international capital flows that pose a challenge to financial and macroeconomic stability. The rapid increase in global liquidity over the past decade, and especially since the expansionary monetary policy responses of advanced countries to the global financial crisis, have raised serious concerns about adverse effects on emerging countries that are facing large-scale net capital inflows. These include the danger of overheating, exchange rate appreciation pressures, inflationary pressure on consumer and asset prices, and risks to financial stability. Furthermore, the historical experience of many emerging countries, not least during the global financial crisis, highlights the risk of a rapid reversal of capital flows, followed by a possible financial and currency crisis. The IMF should try to advance our knowledge on the efficacy of different types of capital controls and macro-prudential regulation, and share this knowledge with member countries.

Thirdly, international monetary stability would be helped by a reform of the international reserve system that should no longer be centred on a single sovereign currency. This, however, is a field of reform where the IMF can make rather little contribution by itself, given the diverging interests among its membership on this issue. While a greater role for Special Drawing Rights would be desirable, it is unlikely that it will assume the role of a major reserve currency. Instead, we will most likely see the emergence of a multipolar currency world, where currencies such as the dollar, euro, yen, and yuan will each have their roles as invoicing, reserve, and investment currency. The speed of transformation toward this multipolar system will depend on the policies of individual countries, not least the United States and China. The IMF can at best assume a mediating role to help prevent disruptions during this period of transition.

Conclusion

Given important linkages between social inequality and macroeconomic and financial stability, the IMF cannot turn a blind eye to social challenges. In all its policy advice to member countries it should therefore consider potential effects on equitable development. Yet the Fund should be careful to stay within its mandate, and acknowledge that other international organisations, including the multilateral development banks and various UN agencies, are much better positioned to work on poverty eradication and lessening social inequalities. The IMF has important roles to play in making the global monetary and financial system more resilient. It can make important contributions, particularly to the development of a global financial safety net and in assisting its member countries in dealing with volatile international capital flows to reduce the risk of future crisis.

4 The challenge for development

Why Bother to Create a Stable and Functioning System?

Jomo Kwame Sundaram

The first question we should ask is: Why bother with a stable and functioning international monetary and financial system? The major reform in this regard was in 1944 with the Bretton Woods Conference. The Bretton Woods Conference was not something which would have happened naturally, but rather was the outcome of a number of developments. Most importantly, of course, there was the Great Crash, the Depression of the 1930s, and, very importantly, the rise of fascism and militarism, the outbreak of the Second World War, and President Roosevelt's leadership.

These were not unimportant considerations, and the earlier attempt by Roosevelt to try to stimulate the economy during his first term was basically reversed when he tried to balance the budget in his second term. To be fair to President Hoover, who is often much maligned, he did try to adopt some major infrastructure projects – most importantly, the Hoover Dam. If you look at his report after the Second World War on how to treat Europe, particularly Germany, Hoover actually took a view against Morgenthau, who wanted to de-industrialise Germany because he considered the Germans almost congenitally likely to be militaristic, looking back to both the First and Second World Wars. It was necessary to de-industrialise Germany to be able to deal with the German problem as he saw it.

When Roosevelt called the conference in mid-1944, before the end of the war, it was a major achievement. UK Prime Minister Churchill did not want the conference. Churchill's view was that a bilateral deal, between the ascendant United States and the declining United Kingdom, would be more than enough. Why bother organising a potentially messy, inclusive multilateral conference? At the conference, 44 countries were represented, including a couple of colonies at that time – India and the Philippines – and 19 countries from Latin America. Altogether, there were 28 developing countries. Thus, a majority of the countries which met for almost a month at Bretton Woods were developing countries. They did not have a strong impact on the conference, but it is important to recognise that they helped shape the establishment of the Bretton Woods institutions. The purpose of the Bretton Woods conference was not simply monetary and financial stability. Sustained growth and employment creation were also major priorities, and as reflected by the name of the World Bank, post-war reconstruction and post-colonial development were also crucial priorities for the Bretton Woods institutions.

With that background, let me turn to some trends in inequality. It is important to recognise that, in most countries, household income inequality has been increasing over the past three decades, with some important exceptions – notably northeast Asia and northern Europe. In recent years, South America has also become an exception, because of the reductions in inequalities in some countries. There is also a very important project under the previous director of the World Institute for Development Economic Research (WIDER), in Helsinki, where they have done a couple of estimates of global wealth inequality. The picture which emerges is that wealth inequality is much higher than income inequality, and has been growing faster than income inequality in the past decade. Yet, it is the primary distribution of wealth which is the major determinant of income and of human welfare levels. Far greater attention than is usually the case should be given to the ›functional distribution of income‹ because it is important to look at the share of labour as opposed to the share of capital, and at how this has changed over time. Within the share of capital, it is especially important to examine the sectoral distribution. For example, in the United States, although the share of assets in the financial, or FIRE (finance, insurance, and real estate), sector is in the teens, before the crisis it accounted for 40 per cent of profits.

This is not insignificant because it reflects the relative rise of finance and its success in capturing the greatest share of income streams. In this endeavour, the Washington Consensus was very helpful: it liberalised markets, but labour markets much more than product markets, as, for example, the anti-trust legislation in most countries of the world. But for decades now, we have had a systematic push towards labour market liberalisation. The push towards globalisation, both in terms of trade liberalisation and financial liberalisation (or what some people refer to as financial globalisation) has also played a very important role in allowing capital to use cross-border arbitrage as a means of more effectively making claims on income.

Another big issue in the past two decades has been improving governance in developing countries. A lot of it has centered on property rights (especially after the Douglass North Nobel laureate[1]), such that now hardly anyone pays attention, for example, to Elinor Ostrom's arguments[2], and what she had to say about alternative ways of organising society along the lines of a »well-governed commons« and some of the advantages that would provide.

We should also recognise that until the middle of the last decade, global income inequality also increased – but, primarily because of the rise of East Asia, and China in particular, it began to decrease in the mid-1990s. However, there was a significant shift in the terms of trade beginning around the same time. Two other things that contributed to the reduction of inequality are the uneven impact of the crisis on different types of income and the two-speed recovery in the past two years: faster in developing countries and slower in developed countries.

We should also consider what has happened to gross productivity increases. As Singer and Prebisch[3] pointed out 60 years ago, and as José Antonio Ocampo and others have pointed out more recently, there has been a secular decline in the terms of trade for primary commodities. And as W. Arthur Lewis[4] noted, the prices of agricultural commodities from the tropics have declined more compared with agricultural commodities from the temperate zone. Higher incomes and consumer demand contributed to higher commodity prices, but it is very unlikely that the trend of declining commodity prices in the past few decades will be reversed by un-sustained short-term price increases. Finally, there has been a decline in the past three or four decades in the prices of manufacturers' terms of trade for manufacturers from developing countries compared with those from developed countries. This trend has probably been reinforced by the strengthening of intellectual property rights.

So productivity increases do not necessarily mean higher wages. They can mean *lower* prices, for example. Food prices trended downwards in the past two decades before they shot up beginning in 2006. The earlier decline in food prices was largely because of increased productivity in food production and contributed to the global decline in poverty in the 1990s until the middle of the last decade, when the last international income and prices comparison was done. In conclusion, we also need to have a more policy-relevant discussion on taxation, because taxation is now seen as the main redistributive tool, besides being crucial to improving fiscal imbalances.

1. Douglass Cecil North is an American economist known for his work in economic history. He is the co-recipient (with Robert William Fogel) of the 1993 Nobel Memorial Prize in Economic Sciences. In the words of the Nobel Committee, North and Fogel were awarded the prize »for having renewed research in economic history by applying economic theory and quantitative methods in order to explain economic and institutional change«.

2. Elinor Ostrom is an American political economist who received the Nobel Prize for Economics. She is the co-recipient (with Oliver E. Williamson) for her analysis of economic governance, especially the commons. She is the first, and to date only, woman to win the prize in this category. Her work is associated with the new institutional economics and the resurgence of political economy.

3. In 1950, economists Raúl Prebisch and Hans Singer independently developed the thesis that countries which export commodities (developing countries) would in time import fewer manufactured goods relative to a given level of exports. The Singer-Prebisch thesis postulates that terms of trade between primary products and manufactured goods deteriorate over time.

4. Sir William Arthur Lewis was a Saint Lucian development economist. In 1979 he won the Nobel Prize in Economics, becoming the first black person to win a Nobel Prize in a category other than peace.

Global Inequalities and the Crisis – The Need to Bring Equity to the Development Agenda

Isabel Ortiz

At the beginning of the 21st century, inequalities are staggering. We live in a world in which, by the most conservative calculations, the richest 20 per cent of the population enjoys more than 70 per cent of global income, while the poorest 20 per cent of people at the bottom only has two paltry percentage points. Further, the richest one per cent (61 million individuals) had the same amount of income as the poorest 3.5 billion (or 56 per cent of the whole world population) as of 2007. More than 2.5 billion people, or around forty per cent of the world's population, live below the international poverty line of 2 US dollar a day; of those, one billion people live in extreme poverty, surviving on less than 1.25 US dollar a day. Most of them are children and youth, given high fertility rates among the poor.

But inequality is not only about income. Inequality also has non-economic dimensions, like lack of access to services, discrimination, exploitation or fear, vulnerability to shocks, lack of voice in decision-making, and being helpless to violence and corruption. As we take a wider view of inequality, the numbers of people affected by it increase. Note that about 20,000 children die daily from preventable diseases – and 20,000 more children will die tomorrow, and the day after, if we don't act. Nearly a billion people entered the 21st century unable to read a book or sign their names. One thousand women die every day because of complications related to pregnancy and childbirth, and more than six million people die of infectious diseases every year – far more than the number killed in the natural catastrophes that make headlines. All this suffering could be avoided if there were effective equitable policies in place.

The extreme inequalities in our world raise serious questions about the adequacy of current development models (development for whom?), in which gains have accrued mostly to the wealthiest. This fact should make us consider the need to place equity at the centre of a new development agenda.

There are strong arguments for equity. Social justice is the first one. But there are also strong economic and political arguments. Inequality is economically dysfunctional. Poverty and inequality inhibit growth, depress domestic demand and hinder national economic development. Francois Bourguignon, former Chief Economist of the World Bank, and Nancy Birdsall, President of the Center for Global Development, among others, have shown that developing countries with high inequality tend to grow more slowly. Expanding Birdsall's analysis using more recent data and a larger sample of 94 countries, we in UNICEF found that, on the aggregate, those developing countries that increased levels of inequality experienced slower annual per capita GDP growth over the same time period.

Unequal societies are not only unjust and a barrier to economic growth; additionally, they cannot guarantee social and political stability in the long term. Examining crime rates and Gini inequality indices across a sample of 141 countries, our analysis in UNICEF finds that countries characterised by high levels of inequality tend to be much more violent and prone to political instability.

Historically, income inequality has been growing over the last centuries. Branco Milanovic at the World Bank finds that global income inequality rose steadily from 1820 to 2002, with a significant increase from 1980 onwards. To further inform the more recent trajectory, Andrea Cornia concludes that inequality increased globally between the early 1980s and 1990s in different studies for the United Nations.

There is a strong likelihood that income inequality is being exacerbated in the on-going global economic crisis. Earlier analyses show that financial crises often deepen poverty and worsen income inequalities. There is a lot of opinion about current events. UNICEF's recent analysis of 128 developing countries shows the need to understand the timing of the two different policy responses to the crisis:

- *Phase I – Fiscal Expansion (2008–09):* After the first »triple F« shocks – food, fuel and financial – in the first stage of the crisis, the vast majority of governments

boosted public expenditures in an attempt to sustain economic growth and buffer the impact of the different global shocks on their populations. While the size of fiscal stimuli varied by country, in general, the most massive Keynesian macroeconomic packages in history were put in place, including in developing countries. According to United Nations Development Programme (UNDP) calculations, the total fiscal stimulus size amounted to 2.4 trillion US dollars in a sample of 48 countries, which equaled nearly four per cent of global GDP in 2008, and about 25 per cent of this was spent on social protection.

- *Phase II – Fiscal Contraction (2010–):* In 2010, a fourth »F« wave of the global economic crisis began to sweep across developing countries: Fiscal austerity – despite vulnerable populations' urgent and significant need of public assistance. UNICEF analysis, based on IMF fiscal data, confirms that the scope of austerity is severe and widening quickly, with 91 developing countries (or more than 70 per cent of the sample) expected to reduce annual expenditures in 2012. Moreover, comparing the 2010–12 and 2005–07 periods suggests that nearly one-quarter of developing countries appear to be undergoing excessive contraction, defined as cutting expenditures below pre-crisis levels in terms of GDP. A UNICEF review of the latest IMF country reports shows that governments are considering various cost-saving policies, including: (i) wage bill cuts/caps, including salaries of education, health, and other public sector workers; (ii) elimination or reduction of subsidies, including for basic food items; and (iii) rationalising social protection schemes by reforming pensions or further targeting or scaling down social safety nets – at a time when scaling up is most needed. Also widely discussed is the introduction or broadening of taxes, such as VATs, on basic products consumed by vulnerable populations.

There are three important messages to take away: First, billions of children and poor families were left behind before the crisis. Second, despite being temporarily supported by fiscal stimulus plans during the first phase of the crisis (2008–09), vulnerable populations have been affected by the multitude of global shocks since 2008. Third, when most governments aggressively moved to implement fiscal austerity in a second phase of the crisis (2010–), children and poor households were again left behind.

UNICEF's, as well as ILO's, Oxfam's, United Nations', World Bank's, and other analyses show that current trends in unemployment, food, and fuel prices, as well as austerity measures, are having severe negative impacts on poor households and likely increasing inequalities, summarised below:

- *Hunger and malnutrition:* After two major international food price spikes in 2007–08 and 2010–11, populations are paying much more for basic foodstuffs when compared to price levels prior to the 2007–08 crisis. Higher food prices, fewer and lower-paying jobs, and reduced social support, including the scaling back of food subsidies, have limited household spending on food. As families purchase smaller quantities and cheaper food items and subsequently consume fewer meals – sometimes reducing food intake to just once a day instead of three times – and smaller, less nutritious portions, hunger and malnutrition risks have been widely reported across the globe.

- *Fewer and lower quality jobs:* The jobs crisis is deteriorating amidst the low economic growth that continues to besiege much of the globe. Of the 102 countries with available estimates for 2012, 35 have unemployment rates in excess of nine per cent. Importantly, this estimate understates the magnitude of the jobs crisis. The employment-to-population ratio, which indicates the employment-generating capacity of a country, shows that economies are simply not generating sufficient employment opportunities to absorb growth in working-age populations, with two out of every five potential workers in the world unable to find a job. Additionally, labour markets worldwide are characterised by lower-paying jobs that are increasingly vulnerable and proliferating the incidence of working poverty that had already trapped nearly one billion workers and their families through 2011. Recent trends in fiscal contraction in both high income and developing countries are further dragging down economic growth prospects and casting increasing doubts on the ability of markets to generate new and decent jobs. Even more alarming, more than 120 million potential new young workers are entering the global labour market each year, nearly 90 per cent of which are from developing countries. Millions of jobs need to be created over the next 10 years just to meet this growing supply of young job seekers – nearly 1.1 billion are expected between 2012 and 2020 – and to evade further unemployment woes.

- *Poor health:* Another common coping mechanism related to the income shocks from the global economic crisis is reduced healthcare expenditures and service utilisation. There is also ample evidence that the crisis is inflicting serious physical and mental damage, including illness, stress, loss of self-esteem among the unemployed, alcohol and substance abuse, and even suicide. Additionally, since 2010, austerity measures are cutting/capping the wage bill of health and other social workers, as well as promoting cost-saving measures scaling down health and social protection in both developing and higher-income countries, precisely at a time when a social protection floor should be scaled up to protect populations in need.

- *Lower school attendance and higher rates of child labour:* The increasing need to supplement household income, coupled with the inability to cover the costs of school attendance, has forced many families to pull their children out of school and put them to work. Evidence in rural areas shows that children as young as five years old are increasingly involved in supporting family farms, selling produce in markets, and working as apprentices in different trades, especially among boys. It has also been widely documented that many girls in urban centres have stopped going to school in order to help their mothers earn additional income in urban areas.

- *Increased vulnerability to future shocks:* Household incomes are being reduced due to the worsened jobs crisis and austerity measures (e.g., smaller pensions and more targeted social protection). In order to pay for basic goods and services such as food, rent, electricity, healthcare, and education, many households have subsequently resorted to selling assets and borrowing money. Since 2008, families have been widely observed drawing down savings, selling household possessions such as livestock, and turning to relatives, community groups, and banks (where possible) for financial help, in a context of reduced remittances. However, these informal safety nets for the poor are easily exhaustible. And given that many vulnerable households have been forced to confront an unabated wave of shocks since 2007, the poor increasingly find themselves in situations of extreme vulnerability to any prolonged or renewed shock.

- *Social instability:* The global economic crisis has led to an outbreak of protests and civil unrest worldwide and further threatened household well-being. While food riots were widespread during the earlier 2007–08 food price spike, 2011 was blanketed with strident reminders of the dangers of unaffordable food, with violent protests erupting in Algeria, Bangladesh, Burkina Faso, Egypt, India, Iraq, Jordan, Morocco, Mozambique, Nigeria, Senegal, Syria, Tunisia, Uganda, and Yemen. The world was also shaken by renewed unrest in 2011 due to the combined effects of high unemployment, worsening living standards, eroding confidence in governments, and perceptions that the burden of the crisis is being unequally shared. This was clearly visible in the Arab Spring, the Occupy Wall Street movement in the United States, and the *»indignados«* (outraged) in Spain, and in other European countries. The ILO's index of social unrest empirically documents the rising levels of worldwide discontent, with the *World of Work Report 2011* warning that social unrest is being aggravated in 45 of the 118 countries surveyed.

In short, children and poor families are bearing the costs of a »recovery« that has largely excluded them. This need not be the case. It is often argued that social and economic investments that benefit poor households are not affordable, or that government expenditure cuts are inevitable during adjustment periods. But there are alternatives, even in the poorest countries – six broad areas that governments can explore to expand fiscal space today, which are supported by policy statements of the UN and international financial institutions. These include: (i) re-allocating public expenditures; (ii) increasing tax revenues; (iii) lobbying for increased aid and transfers, as well as fighting illicit financial flows; (iv) tapping into fiscal and foreign exchange reserves; (v) borrowing and restructuring existing debt; and/or (vi) adopting a more accommodative macroeconomic framework.

Crises oblige policymakers to rethink development models. The 1929 financial crash led to a New Deal that radically altered the development model of the day. As a response, Henry Ford paid his workers a wage that would allow them to buy the cars that they built, and this was only the beginning of a major policy shift. At the end of World War II, politicians from advanced economies were determined that unemployment and economic crisis, which had provoked political crisis and fueled the rise of fascism, should never be repeated. They accepted that full employ-

ment, political stability, and social cohesion should be primary national policy objectives, and, as a result, governments became more involved in education, medical care, and social and housing assistance, as well as in employment policies, which included introducing minimum retirement benefits and enforcing different labour laws and regulations. Such programmes were not new; they were an essential part of modernisation programmes in these societies during the early stages of their development. Historically, these governments progressively formalised their labour forces as a way to expand the tax base, build social protection systems, raise social standards, and develop domestic markets. This approach was highly successful: postwar policies achieved high productivity gains in the workforce, expanded internal markets, and increased economic growth, with the populations of Europe, North America, Japan, Australia, and New Zealand experiencing unprecedented prosperity.

A comparable policy push is needed today. The current global economic crisis presents an opportunity to rethink socio-economic policies for all persons. This requires shedding the myopic scope of macroeconomic, trade, and sector policy decisions of recent decades and, instead, basing them on their potential to achieve food security, employment, human development, and inclusive and sustainable growth for all. Economic policy choices at both international and national levels have often been taken without adequate consideration of their distributional impacts; if there are negative social impacts, these may be mitigated, but equity and social progress cannot be achieved by this approach alone.

As an alternative, the United Nations development agenda has been proposing the combination of social and economic policies in a complementary and mutually reinforcing manner. An indicative summary of selected sector interventions that typically have equitable or regressive outcomes is presented below in Table 1.

The crisis has already triggered a shift in the way that the international community sees the relationship between growth and public support for the poor. In the Asia-Pacific region, for example, policymakers are increasingly shifting away from unsustainable export-led growth models toward more inclusive employment-intensive recovery strategies that are based on developing internal markets and improving social protection systems. Latin America, another region much affected by financial crises in the 1990s, has pursued regional integration to expand internal markets, and invested significantly in social protection systems to improve living standards; much of the region's relative resilience to the contagion effects of the current crisis is due to these recent policy stances. At the global level, there is also increased awareness of the need to eradicate poverty and the extremes of inequality, and to strike the right balance between growth and inclusive development progress.

The policies to achieve an inclusive recovery for all are well-known by governments worldwide; indeed, all nations have endorsed them in the UN General Assembly: decent jobs, a social protection floor, and many others. However, whether this remains simply an ideal or results in actual policies depends on global leadership.

For billions of people, the persistence of the food, unemployment, and austerity shocks can only be expected to further the depth and scope of coping mechanisms that households have adopted since 2008. Above all, it is important that decision-makers understand that children cannot wait. While an adult may fall into poverty temporarily, falling into poverty in childhood can last a lifetime – few children get a second chance at an education or a healthy start in life. Even short periods of food deprivation can impact children's long-term development. If children do not receive adequate nutrition, they grow smaller in size and intellectual capacity, are more vulnerable to life-threatening diseases, perform worse in school – if they can attend at all – and, ultimately, are less likely to be productive adults, reducing their income prospects, and therefore domestic demand. Not only does child poverty threaten the individual child, but it is also likely to be passed on to future generations, entrenching and even exacerbating poverty and inequality across society; this is an extraordinary price for countries to pay.

It is time for global leaders to think about the longer term, to turn the current vicious cycle into a virtuous cycle that effectively links economic and human development, promoting inclusive and employment-generating sustainable growth, social progress, political stability, and long-term global prosperity for the majority: a recovery for all.

Table 1: Mainstreaming Equity in the Development Agenda

	Typical Interventions with Equitable Outcomes	**Typical Interventions with Inequitable / Regressive Outcomes**
Agriculture	Food security; land redistribution; access to water, markets; livestock, credit for smallholders, rural extension services	Large investments that may benefit major land-owners (e. g. irrigation systems)
Education	Universal free education; scholarships and programmes to retain students	User fees; commercialisation of education; cost-saving in teacher's salaries
Energy and Mining	Rural electrification; life-line tariffs; contract laws ensuring local benefits from natural resource extraction	Untaxed or poorly taxed oil / mineral extraction
Finance	Regional rural banks; branching out to local areas; managing finance (regulating financial and commodity markets, capital controls); fighting illicit financial flows	Financial liberalisation; rescue of banking system (transfers to large banks); subsidies to large private enterprises
Health	Universal primary and secondary health services; nutrition programmes; free reproductive health services	User fees; commercialisation of health; tertiary highly specialised clinics that benefit a few
Housing	Subsidised housing for lower income groups; upgrading of sub-standard housing	Public housing finance for upper income groups
Industry	Technology policy to support competitive, employment-generating domestic industries, large and SMEs	Deregulation; general trade liberalisation
Labour	A jobs pact, active and passive labour programmes; adequate minimum wages; employment-generating policies across sectors	Labour flexibilisation
Macroeconomic Policies	Employment-sensitive monetary and fiscal policies; countercyclical policies; corporate, personal income, inheritance, financial sector taxes	An excessive focus on macroeconomic stability; cyclical policies; indirect taxation (VAT)
Public Expenditures	Pro-poor expenditures; fiscal decentralisation	Military spending; subsidies to activities benefiting upper income groups
Social Protection	A social protection floor, comprising cash transfers and social services	Private funded pension systems
Tourism	Small-scale local companies; financing basic infrastructure; international marketing campaigns	Poorly taxed luxury hotel chains
Trade	Linking employment-generating local companies with export markets; adequate protection of national industry; taxing exporting sectors for domestic development	Most bilateral free trade agreements; current intellectual property agreements
Transport and Infrastructure	Rural roads; social infrastructure; affordable public transport; non-motorized transport for households (bicycles, buffalos, horses)	Large (and costly) infrastructure investments that the poor / excluded do not use or do not benefit by taxation
Urban Development	Slum upgrading; accessible universal design	Large urban infrastructure projects in wealthy areas
Water and Sanitation	Rural water supply and sanitation	Poorly negotiated privatisations

Source: Ortiz, I. and M. Cummins (2011): Global Inequality: Beyond the Bottom Billion – A review of Income Inequality in 141 Countries, New York: UNICEF; based on (in alphabetical order) DFID, FAO, IDS, ILO, ODI, UN, UNCTAD, UNDP, UN HABITAT, UNICEF, UNRISD, World Bank's PRSP Sourcebook, WFP.

Towards Equitable, Inclusive, and Sustainable Human Development

Sigrid A. M. Kaag

Introduction

Social and economic inequality has emerged as a core development concern. The second half of the 20th century was characterised by unprecedented economic growth and prosperity in aggregate terms. During this period, several countries – the Republic of Korea, Singapore, Malaysia, and Chile to name just a few – made the leap from developing to developed country status, and others – including China, Turkey, and Mexico – are well on their way in making the transition. Almost simultaneously, both the developing and developed world witnessed a steady rise in economic and social inequality, creating divisions within societies – most notably between those who benefited from economic growth and those that were left behind. More recently, disparities and divisions have widened, and the call for a more equitable, inclusive, and sustainable form of human development couldn't be more urgent. In many respects, while issues leading to inequality are not new, they have become increasingly critical to address.

The Secretary-General's 2011 Millennium Development Goals (MDGs) Report[1] indicates that many countries are making impressive strides, including towards the MDGs. But despite numerous gains, aggregate progress on MDGs disguises a picture of uneven development marked by deep disparities across and within societies.

The world has made repeated commitments to human rights and values that underpin equitable and inclusive development. Again in 2000, world leaders came together and renewed their commitment by unanimously adopting the Millennium Declaration[2], which emphasised fundamental values of freedom, equity, solidarity, tolerance, and shared responsibility. Unfortunately, political commitment has not yielded sufficient results on the ground; inequality across social groups, between rural and urban areas, and also within urban areas is on the rise. Economic growth has not led to a commensurate increase in employment. In fact, as the International Labour Organization's (ILO) *Global Employment Trends 2012* report picks up on the enormous challenge the world faces of creating decent jobs for the estimated 900 million workers who live below the 2 US dollars per day poverty threshold. Moreover, the report states that 400 million new jobs are needed over the next decade to absorb the estimated 40 million-person growth of the labour force each year.

Social Disparities

Looking beyond the income dimension, significant disparities also exist in access to basic goods and services, including health, education, transportation, and enabling infrastructure. UNDP-ESCAP-ADB's[3] 2011/2012 Regional MDG Report[4], *Accelerating Equitable Achievement of the MDGs: Closing Gaps in Health and Nutrition Outcomes*, points to the trend of increasing disparities across and within countries in terms of non-income based MDGs.

Evidence demonstrates that, across the board, people are being systematically left out of or left behind by development progress on the basis of race, ethnicity, creed, gender, and geographical location. As stated in the 2011 Institute of Development Studies-Sussex University and the MDG Achievement Fund publication[5], social exclusion is the result of intersecting inequalities, which can be categorised as:

a) *Cultural inequality:* expressed through the devaluation of certain groups based on their ascribed identity;

b) *Political inequality:* seen through the denial of voice and influence over decisions that affect the lives of marginalised groups;

1. The report can be found at http://www.un.org/millenniumgoals/pdf/(2011_E)%20MDG%20Report%202011_Book%20LR.pdf.

2. The text of the Millennium Declaration can be found at http://www.un.org/millennium/declaration/ares552e.htm.

3. United Nations Development Programme, Economic and Social Commission for Asia and the Pacific and Asian Development Bank.

4. The publication can be found at http://www.snap-undp.org/elibrary/Publication.aspx?id=632.

5. The publication can be found at http://mdgfund.org/sites/default/files/Inequality%20Roundtable%20report.pdf.

c) *Economic inequality:* experienced through a disadvantaged position in the distribution of assets and livelihood opportunities; and

d) *Spatial inequality:* since these groups frequently live in places that make them harder to reach or easier to ignore.

While each of these is a form of injustice, it's their mutually reinforcing interaction that explains the persistence of social exclusion over time and its resistance to *business as usual* approaches. Illustrative examples abound:

- Infant mortality rates among indigenous groups in Latin America are much higher than those for non-indigenous groups: 1.5 times higher in Brazil and Mexico, two times higher in Ecuador and over three times higher in Panama in the early 2000s.

- In Bolivia, Peru, Colombia, and Guatemala, a) being indigenous, b) being an indigenous woman, and c) being a poor indigenous woman places you significantly further away from the national average estimate for years of education.

- In Nigeria, the predominantly Hausa-Fulani northern states (which are also Muslim) have much higher levels of poverty and child and maternal mortality than the predominantly Yoruba/Igbo (Christian) southern states.

- In Nepal, incidence of poverty was highest among the Dalits (45.5 per cent), who live in Terai and hill region, and least among the Newar, Brahmin, and Chettri groups (18.4 per cent) in 2004.

- In Sri Lanka, development outcomes for the Tamil population has been much lower than those for the majority Sinhala population. The Tamils tend to earn less, on average, than the Sinhalese, partly because they are underpaid compared to the Sinhala population, and mainly because they are employed in professions that pay less.

- In India, the Sachar Committee found significant socio-economic differences in favour of the Hindu majority population vis-à-vis minority groups (Muslims, Christians, Sikhs, and Buddhists).

The historically silent but persistent issue of social exclusion seems to resonate in all corners of the world. It undermines progress on MDG and other development goals and slows down the rate at which a given level of economic growth translates into poverty reduction. And at the level of everyday life, it undermines one's sense of self-worth, dignity, and agency, and is associated with despair, depression, substance abuse, and often criminal activity. On a larger scale, neglecting grievances emerging from historical marginalisation and discrimination can spur conflict that can seriously hamper economic progress, regional peace, and stability, and lead to development reversals.

Making a Difference

Tackling inequality is more critical than ever, especially as the global economy is facing intensified downside risks and enormous uncertainty. It is widely recognised that growth by itself is a not sufficient condition for sustainable progress, and in fact development challenges including those related to growth, inequality, social exclusion, environmental sustainability, and governance are intertwined. The recent social upheavals not just in the developing world, but also in the developed world remind us of the importance of addressing these challenges together.

UNDP has a long tradition of working with governments, private sector, civil society, and development partners in promoting and advancing equitable, inclusive, and sustainable human development. The human development approach pioneered by UNDP more than twenty years ago put people at the very centre of development. People are the real assets of countries. Through building their capabilities and capacities they can realise their potential to spark change, and make meaningful contributions towards development.

It is an encouraging sign that the equity agenda is gaining prominence. Policymakers around the world are acutely aware of the need to address inequality, and cognizant of the negative implications if they let inequality fester. Equality is now perceived not only as an important ethical concern, but also as an important pathway to development and advancement of societies as a whole. However, it is important to move from international consensus to action in tackling persistent inequalities in a coordinated and sustained manner. Ideas and agendas on paper need

to be converted into development results on the ground. What can be done to advance towards a more equitable and inclusive world, a *shared society* so to speak? It is worth noting that exclusion does not happen by chance. It is the result of policies and practices – or the lack of them. So it is welcome news that inequality is not immutable, and that change is possible. While inequalities have risen in many developing and developed countries over the last two decades, some countries have actively pursed policies and programmes that encourage a more equal sharing of the benefits of growth. Lessons can be learnt from such cases, in particular on how to bring the social, political, and economic calculus to work in a coordinated way to overcome structural impediments to persistent and high inequality. With the clock rapidly ticking towards 2015 – the MDGs deadline – we should embrace the fact that equity is equally, if not more important than aggregate progress in achieving and realising the MDGs and other national development goals.

There is an immediate need to give priority to the reduction of inequalities as a component of more balanced economic recovery strategy. Promoting employment opportunities through a more flexible labour market in the short term, and a more skilled one in the longer term, would help the low income population secure decent work. A comprehensive social protection programme for the neglected and vulnerable segments of society should supplement broader development efforts. This would not only require resources, but also political will and commitment. At the macro policy level, countries can often find the necessary fiscal space to pursue the social agenda through switching priorities. For example, many countries have a military budget that is significantly greater than the one reserved for social initiatives. And countries that have succeeded in creating more balanced societies have given relative priority to the social side by investing a relatively higher proportion of their GDP in education, health, infrastructure, and provision of basic services.

In the medium- to longer-term time horizon, there is more to debate and act upon.

First, as social exclusion and inequality deny excluded groups full dignity and citizenship, all efforts to overcome it should be situated within the broader framework offered by the International Bill of Human Rights. Although this is an abstract and normative framework, it does remind us that social exclusion is not only rooted in the denial of people's social and economic rights, but is also inextricably linked to the lack of voice and participation of excluded groups, thereby placing civil and political rights on par with social and economic rights.

Second, we need to make the reduction of inequalities an integral part of the development agenda and establish it as an explicit public policy objective since inequalities are not only the outcome, but also drivers of vulnerability and poverty. Public policy lacking a social focus exacerbates inequality, but high inequalities create conditions that make it harder for countries to address poverty, reinforcing a negative cycle.

Rather than treat the reduction of inequality as a desirable by-product of, or an add-on to a successful poverty reduction programme, inequality itself should be addressed through specific public policy instruments. These instruments need to reflect the multidimensional nature of inequality and be designed to reach the poorest and most vulnerable people. There needs to be an explicit focus on developing the capabilities of the poor and vulnerable so that they become part of the formal productive sectors of the economy over the medium- to longer-term horizon.

Some policy instruments appear to have helped break the persistent cycle of inequality. For example, a recent UNDP study shows that a number of Latin American countries have experienced a decline in income inequality over the past decade. That decline and trend reversal owes much to policies aimed at addressing the issue head on, including higher social spending (through cash transfer programmes, for instance). Also, Malaysia provides a useful example in tackling social inequalities through affirmative action policies, including in the education sector, in favour of the *Bumiputras*. The policies helped diffuse inter-ethnic tensions between the *Bumiputras* and Chinese Malaysians. While these policies helped create an urban middle class, they were somewhat less successful in tackling rural-urban income inequality and rural poverty.

Third, enhancing the scope and effectiveness of policies to reduce inequality requires strengthening capacity to mobilise domestic resources. An effective and progressive tax system will be needed, as well as redistributive fiscal policies. It is true that tax reform would be politically difficult to push through in some countries, but

innovative tax practices have been introduced in developed and developing countries to boost revenue, which can be emulated by other countries. Better management of lucrative revenue streams such as from extraction of natural resources can provide a steady stream of funding. In the rural and agricultural hinterland, distribution of land is highly skewed in favour of large farmers. Mechanisms need to be developed that allow for titling for small land holders. Major social shifts such as those in the Arab Spring countries provide an opportunity to look at existing laws and practices afresh. Such contexts tend to be politically more favourable for passing land and tax reforms.

Fourth, the role of financial inclusion in reducing inequality should be strengthened. Financial constraints worsen access to the basic services essential to reducing poverty and inequality. Appropriate financial services can enable employment-generating businesses to grow and families to bridge tough times and strengthen livelihoods. Expanding access to financial products can also bring people and businesses into formal financial systems – making their assets available, in turn, for productive investments. In both ways, financial inclusion can enable inclusive growth – and thus help countries accelerate progress toward the MDGs. Multilateral organizations such as the UN, along with development partners, can multiply impact by twinning financial services with programmes designed to help people meet basic needs. For example, initiatives can be designed such that they forge a link between cash transfer programmes and opportunities for saving.

Fifth, a comprehensive approach to inequality should also aim at ensuring political inclusion for better social cohesion. Unequal access to political representation and participation can reinforce the persistence of inequality. Political voice can go a long way in empowering historically neglected groups and addressing issues particular to minorities.

Sixth, group-based exclusion would benefit from group-based solutions since policies targeting individuals and households can prove inadequate in tackling problems that are essentially group-based and collective.

Lastly, we need to go beyond ameliorative approaches that address the symptoms of the problem to transformative approaches that address its root causes. It is possible to meet the basic needs of the poor without strengthening their ability to do so themselves, thereby leaving their longer-term vulnerability intact. Toward this end, in the longer term it would be prudent to develop the public education system with a focus on quality and access so that in the foreseeable future the poor are able to escape poverty and develop skills that allow them to compete in the domestic, as well as the international labour market. The Republic of Korea provides an illustrative case, where a focus on quality of public education transformed the country from a developing country to a leading skill-based society.

Inclusive and Sustainable Human Development to Reduce Inequality

Bringing equity and social justice to the centre of international and national development policy agenda can be strongly supported by the collective action of various sectors. A broad coalition of partners comprising national and international NGOs, social movements, academics, UN agencies, governments, and others can advocate in various spaces and places to make this a reality. In an increasingly connected world, active coordination and collective effort would be necessary to achieve positive outcomes.

In looking at what it takes to achieve the MDGs, UNDP's International Assessment Report[6] launched during the 2010 MDG Summit identifies inclusive models of economic growth as key drivers of progress that can drive down poverty and create decent work and sustainable livelihoods.

UNDP's 2011 Human Development Report[7] argues that the urgent global challenges of sustainability and equity must be addressed together. Past reports have shown that living standards in most countries have been rising – and converging – for several decades now. Yet the report projects a disturbing reversal of this trend if environmental deterioration and social inequalities continue to intensify, with the least developed countries diverging away from global patterns of progress by 2050.

6. The report can be found at http://content.undp.org/go/cms-service/stream/asset/?asset_id=2620072.

7. The report can be found at http://hdr.undp.org/en/reports/global/hdr2011/download/.

Sustainable human development seeks to ensure people's right to enjoy a decent standard of living while also respecting the earth's natural limits. The 2012 Rio +20 conference provides a unique global platform to discuss and work towards a consensus on equitable economic growth that is environmentally and socially sustainable. Policy and regulatory frameworks should be designed to attract and use finance and new technologies in ways which generate sustainability, allowing for ›triple-win‹ solutions which can bring economic, environmental, and social benefits.

Conclusion

The role of the UN development system is to support developing countries in making sustainable transitions through mobilising knowledge, expertise, and resources. Clearly, achieving a more balanced and sustainable growth trajectory is a complex challenge. We still have a lot to learn and a long way to go. But we do know that reducing inequality will not only facilitate economic growth, but also promote fairness, peace, and security – foundational values of the UN. Enabling poor people to have equal education and employment opportunities, access to health services, and a voice in decision-making processes would boost human development.

Tackling inequality requires strong, broad-based partnerships. I hope we can work constructively towards a shared vision for equitable, inclusive, and sustainable development.

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