After the Istanbul Meetings:
Has the IMF changed? If so, how relevant is that change?*

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The 2009 annual meetings of the Bretton Woods Institutions – the IMF and World Bank -- were convened in Istanbul in early October on the heels of the G-20 gathering in Pittsburgh a week earlier. From the point of view of the IMF, in particular, these events as well as the London Summit in April 2009 were historically important. Just before the eruption of the 2007/2008 global crisis the IMF was largely irrelevant. The expansionary phase of the global economy was so strong and credit was so cheap and abundant that the ensuing financial glut almost rendered the IMF obsolete.

But now, having achieved a status as "*lender of the last resort*" for the much of the world, the IMF claims not only expertise but also a dominant role in the global economy. It is no coincidence that the theme of the Istanbul meetings was a self-acclaimed call to "*the Road to Recovery*", while the IMF had already obtained promises of $500 billion from the G20 to oversee this task.

After a series of *communiqués*, a summary statement of the so-called Istanbul decrees can now be made:

> *Governance reform*: Changes in the global geo-politics now clearly necessitate the need for recognition of new "players" in the global economy. It is clear to everyone that without due invitation of the Peoples' Republic of China to the world casino table and its debt ridden consumption boom, there can be no talk of any sustained recovery, or of any concept of equilibrium in the world markets. China, with its vast reserves and a humongous foreign trade surplus (originating in part from its enormous appetite for high savings and significantly low consumption), is regarded by many North American and European economists as the main source of the global imbalances we live in. Unless China is converted into a consumption-led, speculative-ridden economy, the rest of the capitalist world may not find another source for the global demand needed to drive a global recovery. In other words, China's foreign reserves and its pattern of under-consumption are depleting the world's potential effective demand from the global commodity markets, rendering much of the effective demand idle. In short, the perception is that China must be "brought into line". Such realities have been translated into a widely accepted recognition of the need of changing the existing quota structure within the IMF. The *International Monetary and Financial*

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Committee, for instance proposed "a shift in quota share to dynamic emerging market and developing countries of at least five percent from over-represented countries to under-represented countries using the current quota formula as the basis to work from". Yet, even though everyone seemed to have agreed to increase the quota share of the *under*-represented countries, it was not clear from which *over*-represented countries would relinquish their shares in order to make such a shift possible. Given the ambiguity of the language and failure to design a clear formula on how to shift the existing quota shares, the governance reform of the IMF remained, at best, as a display of good intentions, with more concrete steps being postponed to a future time.

- *Re-structuring of the IMF assistance*: as more and more evidence accumulates on the deflationary nature of the traditional stand-by packages of the IMF, there is now the official change in discourse of "IMF assistance". The recently created *flexible credit line* is now officially available to the countries in stress, although only Mexico, Colombia and Poland have availed themselves of it. This credit line is hailed as an innovation due to the fact that policy conditions are supplanted by requisites for eligibility for the FCL. Hence, the IMF has not hesitated a moment in breaching the iron laws of the market rationality by announcing that the FCL will only be open to "*countries that had embraced the market friendly reforms and maintained a good record of fiscal sustainability"*. Apart from the vagueness of these prerequisites, the IMF now seems to share the burden of responsibilities of its programs with a very few "sensible" governments.
- *Surveillance of the global financial economy*: The IMF is now deputized as the central surveillance agent of bilateral and multilateral policies "… *by developing a forward-looking analysis of whether policies are collectively consistent with more sustainable and balanced trajectories for the global economy*". Another display of good intentions, yet without substance. For one, this role is not a new one. Since the late 1990s, the IMF has been tasked with surveillance through bilateral and multilateral consultation with the "advanced economies," including with regard to the "spillover effects" of macroeconomic policies into the global economy.. There is no evidence that the IMF has changed its ideological approaches to its analyses on the root causes of the "global imbalances", nor any tangible evidence that it has improved its capacity to tackle such a task.

How relevant are the Istanbul Decrees to IMF reform?

How relevant are the above summarized announcements in the changes of the IMF's governance structure for the future of the global crisis and the future of global capitalism in general? The answer to this question depends very much on the roots of crisis and the ability of the *Istanbul decrees* to offer remedies to the existing structural imbalances in the global economy.

Let's be open and direct: the crisis, simply put, is the end result of globalized capital to postpone its inevitable crises by way of financialization. Gerald Epstein defines *financialization* in his *Financialization and the Global Economy* (2005, Edward Elgar Press) as: *the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of domestic and international economies*". As Duménil and Lévy (2004) underscore, "*what is at issue here, are not markets and states per se, but the stricter*

subjection of these institutions to capital: on the one hand, the freedom of capital to act along its own interests with little consideration for salaried workers and the large masses of the world population, and, on the other hand, a state dedicated to the enforcement of this new social order and the confrontation to other states."[†]

Concomitant with this development was a strong shift in the main ideology of economics as a profession. Prior to the current crisis, we saw the demise of interventionist Keynesianism and a rapid rise in the neoliberal ideology emphasizing private entrepreneurship and private choice over the collective; the market rationality over any other objectives whether social or economic; and an over-riding call for de-regulation, liberalization, and flexibilization. Brought under the motto of "*there is no alternative* (TINA)", the whole shift in ideology occurred simultaneously with an aggressive de-regulation of finance, blessed by mainstream economic thinking. The "rational expectations / business cycle theories" with their undisputed belief in *perfectly* competitive markets; firms producing with nice and smooth, convex technologies; all agents sharing the same sets of perfect foresight and full information,… provided the ideological foundation of the theater on show since about the early 1980s.

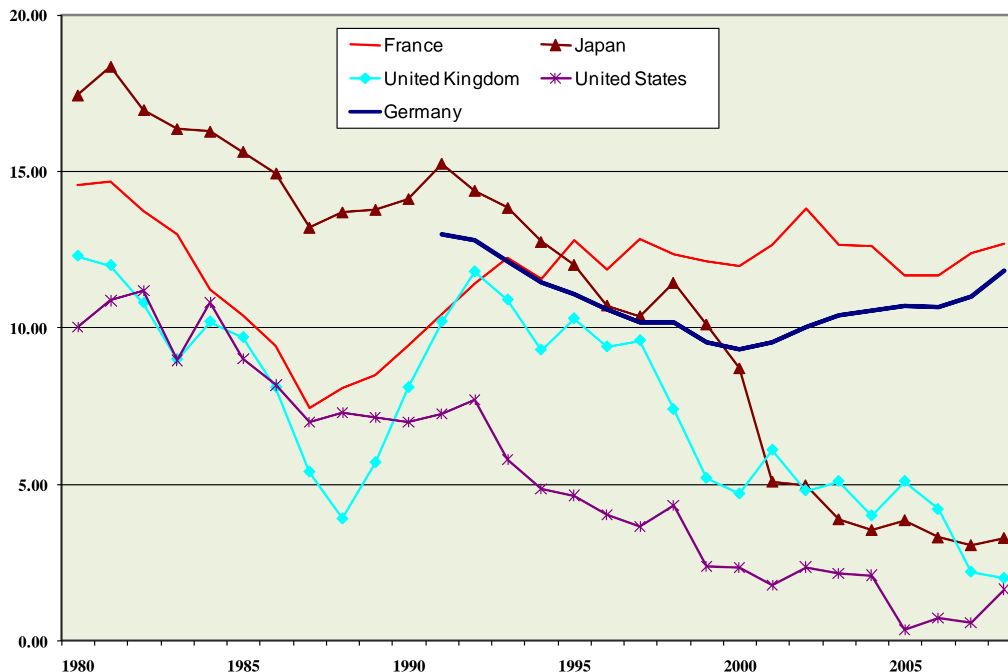
Thus, the burning question is whether the shareholders of the IMF and the World Bank will require that the institutions diagnose the underlying structural causes of the crisis in the context of a thorough overhaul of the existing dominant neoliberal paradigm, which engulfs economics in terms of education, research, and policy implementation. Or, will the Bretton Woods twins be content with a cosmetic make-over of the mainstream neoliberal paradigm and yet continue to subscribe to the fictitious models of capitalism? Let me be more specific on the nature of the issues that I believe merit attention:

- *Micro-foundations driven analysis of a representative agent economy:* where investment behavior is passive and savings-driven is far from reality. This theory, often disguised behind the elegance of *Hamiltonian* calculus, offers an unrealistic and wrong view of the global economy. Treating investment demand as a passive identity to household savings, it overemphasizes the role of *consumption smoothing*, carried by a perfectly competitive and perfectly knowledgeable representative person, responding smoothly and costlessly to every single arbitrage opportunity over an *infinite* life time horizon.

  Often dubbed as the Cass-Koopmans-Ramsey (CKR) framework, this vision is taken to far extremes to reach to self-acclaimed conclusions, often simply endorsing the current state of the global economy as "harmonious equilibrium" at the risk of neglecting many important threats of observed global imbalances. Note, for instance, the dramatic downfall of savings performance in the major economies over the last three decades (see Figure 1).

[†] Note for instance a widely cited comparison: In 2006, the U.S. GDP was $12.456 trillion. In contrast, the volume of derivatives trading in 2006 was one hundred times greater. That is, derivatives – mostly futures contracts on interest rates, foreign currencies, and Treasury bonds -- reached a level of $1,200 trillion, $1.2 quadrillion.

Figure 1. Household Savings, 1980-2009
(% of disposable household income)

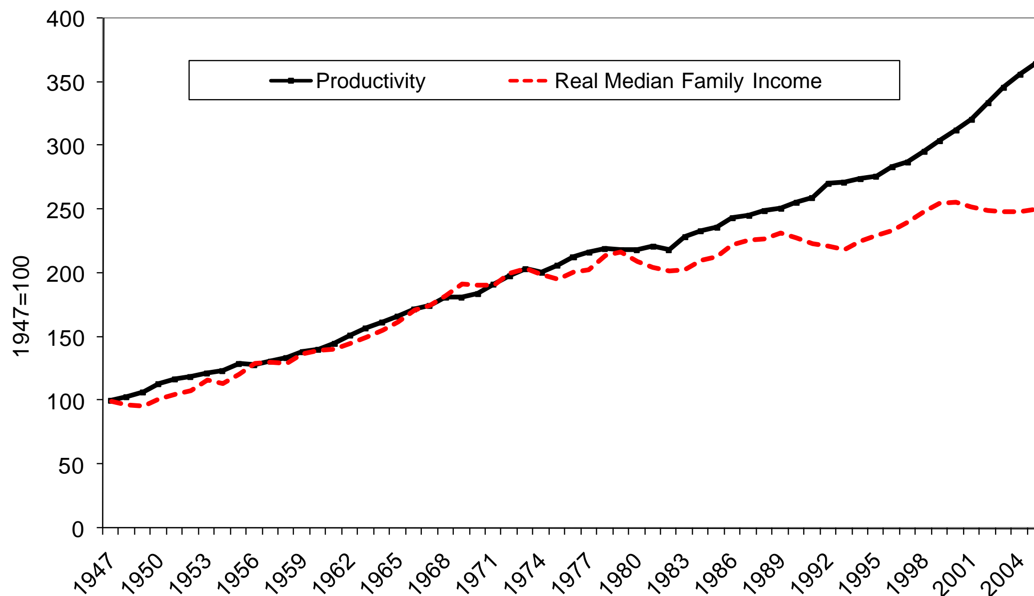


Source: OECD, 2008.

Disillusioned by the power of differential calculus, economists of the mainstream tradition have long neglected the consequences of the observed structural decline in savings performance in the center metropols of capitalism. The decline in the current savings rate, or by the same token, the rapid expansion of current consumption, had been interpreted as the optimal response of rational consumers, engaged in "arithmetics of pleasure" under an infinite planning horizon and within perfectly competitive, full information environments. The quest of risk hungry speculative agents, fuelling the placement of debt instruments into households' portfolios (often with "toxic" assets) had been justified by the un-contested conviction that markets are working efficiently in allocating funds across time and space.

In this fiction, the rather low consumption performance of the Chinese household was held as an "anomaly"; hence the invitation of China to the global consumption table, *aka* through granting a higher quota share in the name of "IMF governance reform". But a more important side of the observed fall of the savings rate had to do with the overall decline in real wage incomes and wage income shares of the middle income, working class households. Feenstra (1997) indicates, for instance that, since about early 1980's, real wages of unskilled labor (of persons with less than 12 years of schooling) in the USA had declined by 20%. Wolff and Resnick (2006) report that after 1970's the rate of growth of weekly real wage rates of American labor (calculated as decade averages) had turned negative for the first time ever since 1820s. Data compiled by the Economic Policy Institute (EPI) in Washington DC reveals that the gap between median household real income and labor productivity has started to widen out around mid-1980's (see Figure 2).

Figure 2. Productivity and Real Median Family Income Growth in USA



Source: EPI analysis of U.S. Census Bureau and U.S. Bureau of Labor Statistics data

Thus, expansion of the debt instruments (financialization) was as much a story for the working middle class households to maintain their status as "effective consumers", as it was also a re-newed round of profitability and opportunities of further accumulation for global capital. Yet, we have been reminded over and over again that finance is about bubbles; and that as the 1990's were driven by the dot.com bubble, the early 2000's had witnessed the rise of household debt instruments, consumer credit, mortgage credit, etc. All of these had been diverted into —what had been so cunningly named as, *toxic assets*; hence the eruption of the bubble.

Could economic theory have predicted this outcome? Not really, under the disguise of "micro-foundations" driven models of perfect competition with perfect substitutability of finance and other forms of capital, many of the realities of the world we live in had been harnessed behind the "smooth" functional forms and the idea of "intertemporal harmonious equilibrium", *ad infinitum*. Simply put, the mainstream paradigm is constructed so carefully behind a well-protected Byzantine wall of stability assumptions that it is virtually impossible, using this apparatus, to capture *bubbles* and *asset-mania* (Kindleberger) that the world markets had long been suffering.

- *Nature of international trade*: openness and trade reform had been seen as the miraculous panacea for all evils associated with waste, inefficiency and stagnation. Based again on models of perfectly competitive markets, neoliberal economics maintained the manta of *comparative advantage* for a quick-fix remedy to pick up the "hundred dollar bills laying on the side walk". Yet, the world trade is known to be

governed by principles of not comparative but *absolute* advantage with the trans-national companies (TNCs) accounting for 2/3 of the global merchandise trade. The static gains associated with revealed comparative advantage are often dwarfed with the dynamic gains that can be pursued from strategic trade policy, with a careful mix of both protectionist and export promotion policies. This is of course the crux of the Korean development strategy as documented in Amsden and more recently by Rodrik and Ha-Joon Chang. We have learned over once again that development warrants not doing more of the same thing more intensively, but diversification into producing *new* things up in the ladder of industrialization. The policy recommendations based on static comparative advantage, simply put, had been misleading advice.

- *Obsession with inflation phobia*. The last two decades had also witnessed a major shift in central banking policies destined only for targeting inflation, in almost cases at the expense of other possible macroeconomic objectives. Initially adopted by New Zealand in 1990, the norms surrounding the IT regime have been so powerful that the Central Banks (CBs) of both the industrialized and the developing economies alike have declared that maintaining price stability at the lowest possible rate of inflation is their *only* mandate. It was generally believed that price stability is a pre-condition for sustained growth and employment, and that 'high' inflation is damaging the economy in the long run. However, the common expectation of IT promoters that price stability would ultimately lead to higher employment and sustained growth failed to materialize. Generally, the world economy had been growing too slowly to generate sufficient capital investment and reduce unemployment. Cast in a deflationary environment where there has been a significant growth in the global labor supply, the IT central banks' almost exclusive focus on price stability fails to help address the root causes of the macroeconomic instability, including the globalization of unregulated finance in the past two decades.

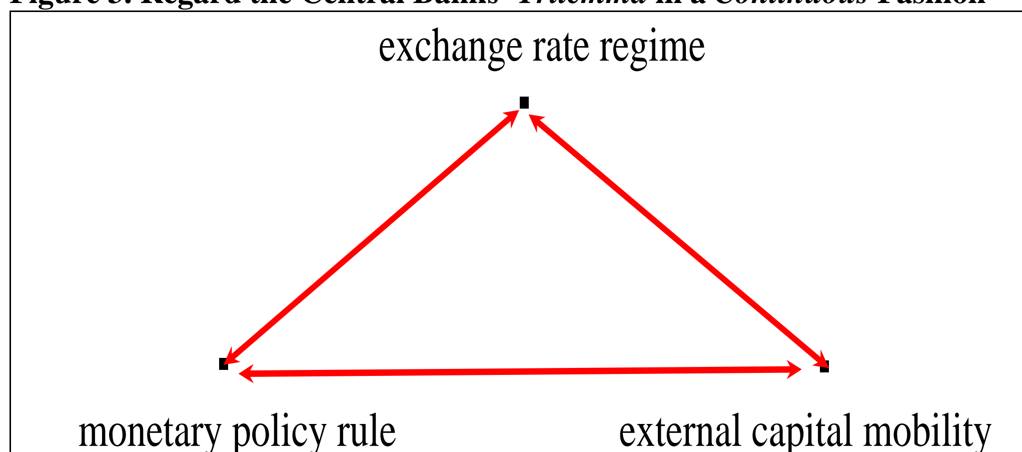
Part of the broader requirements surrounding the IT system was often argued to be the implementation of a "floating/flexible" exchange rate system in the context of free mobility of capital. Accordingly, the CBs should abandon their interventionist policies in the foreign exchange markets for all practical purposes other than pursuit for price stability. Thus, "*exchange rate flexibility and floating exchange rate administration*" became the new *motto*, and to many advocates, central bank "policy" has typically been reduced to mean merely "*setting the policy interest rate*". The exchange rate and macroeconomic prices such as the credit and consumer rates of interest were thereby left to the unfettered workings of the global financial markets.

The mainstream case for exchange rate determination rests on the well-celebrated Mundell (1963) and Fleming (1962) model where the model rests on an assumed duality between reserves (fixed exchange rate system) *versus* flexible exchange rate adjustments. Within the mainstream orthodoxy, the major policy implication of the Mundell-Fleming duality is the so-called "trilemma", which commands that central banks can only choose two out of three of the following: open capital markets, a fixed exchange rate system, and an autonomous monetary policy geared toward domestic goals. A "*fixed*" exchange rate regime along with "*open*" capital markets, for instance, necessitate reliance on international reserves and renders it impossible to have an autonomous monetary policy otherwise. By the same token, a central bank like that of China's can afford to pursue relatively *more autonomous* monetary

policies together with a *fixed/administered* exchange rate regime; yet it has to rely on "*controlled/regulated*" capital markets.

While this so-called "trilemma" is not strictly true as a theoretical matter, in practice it does raise serious issues of monetary management. From our perspective, the real crux of the problem turns out to be the very narrow interpretation of the constraints of the trilemma: CBs are often thought to be restricted to choose two "*points*" out of three. Yet, the constraints of the trilemma could as well be regarded as the boundaries of a *continuous* set of policies, as would emerge out of a bounded, yet continuous depiction of a "*policy triangle*". Thus, even within the boundaries of the trilemma a menu of choices does exist, ranging from administered exchange rate regimes to capital management/control techniques. I try to provide a visual portrayal of this statement via Figure 3.

Figure 3. Regard the Central Banks' *Trilemma* in a *Continuous* Fashion



The conundrum is that those interpreting the trilemma in a very orthodox fashion regard one of its corners, namely the free mobility of capital, as a pre-determined choice and take for granted that virtually complete financial liberalization in the external sector is the first-best, optimal policy environment. Yet recent evidence amply shows that open capital markets can create very costly problems for developing countries[‡] and that many successful developing countries have used a variety of capital management techniques to manage these flows in order, among other things, to help them escape the rigid constraints of the so-called "tri-lemma" (Ocampo, 2002; Epstein, Grabel and Jomo, K.S., 2005).

Leaving the exchange rate management directly to the unfettered capital inflows had led to misalignments and appreciation of the domestic currencies with a severe deterioration of the current account. And yet, over-obsession with inflation targeting

[‡] Due to space limitations I abstain here from a detailed assessment of the detrimental effects of premature openness of the capital account to short term ("hot") capital inflows. For a thorough discussion of these issues, see, *e.g.*, Stiglitz (2002), UNCTAD (1998), Epstein, Grabel and Jomo (2005). For an analytical assessment of the short term capital inflows see, Adelman and Yeldan (2000).

and with fiscal sustainability, while neglecting current account sustainability had proven to be a dangerous game as had been witnessed by the emerging market episodes post-2008. Under these conditions, it ought to be clear that price stability, on its own, will not suffice to maintain macroeconomic stability, as it cannot suffice to secure *financial stability and employment growth.* In the words of Akyuz (2006, p.46), '…the *source of macroeconomic instability* now is not instability in product markets but asset markets, and the main challenge for policy makers *is not inflation*, *but unemployment and financial instability*'. (*emphasis* added).

In conclusion

To conclude, let's recall the main shifts that had been witnessed over the last three decades in the world economy (the so called "reform" decades):

- Lower real wage incomes and the consequent rise in inequality;
- A big jump in consumption —a drastic fall in private savings;
- A big jump in private indebtedness
- Coupled with flexibilization of the exchange rate regimes and central banks' decision to surrender their instruments to the markets, which led to severe appreciation and deteriorating current account deficits;

We have summarized the outcome as *financialization* and the deepening of the financial glut with the advance of sub-prime mortgages, sub-prime credit, lax supervision etc etc, all of which had been collected under the term *toxic assets*.

Can we see a change of stance in the economics profession after the Istanbul decrees? —Not really. Yet, a failure to provide a re-focused attention away from the neoliberal dogmas to the realities of the global economy will prove all such attempts of change in the governance structure of the IMF or of the financial architecture futile.

We need to dispose of not only the *toxic assets*, but also the *toxic textbooks* from our curricula[§]…

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[§] Here, definitely, the coinage of the term "toxic textbooks" is not original, but has been borrowed from the web site http://www.toxictextbooks.com/

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