

GOVERNANCE AND CRISIS ¹

1. A review of how debt crisis are triggered around the world since the 1820's, there are a few features that can be recognized as constant:

- Massive negative net resource transfers.
- Sharp rises in interest rates
- Sharp falls in export prices
- Sharp rises in energy prices
- Fixed rate of exchange in spite of massive negative net resource transfers.
- Sharp drop in tax revenues due to a drop in GDP.
- A severe devaluation of the domestic currency
- A severe devaluation of the main trading currency while the debt is held in other currencies.(desencaje)

Normally these elements will change the country risk panorama dramatically without much advance warnings. Reaganomics changed the interest rates position from negative to positive in real terms and strangled most developing countries balance of payments, for instance.

2. The IMF was created in 1944 having the 1930's in mind, with the object of giving the world economy, stability. It has failed and that role has been taken over by the US Treasury from the 1980's onwards. Why has it failed? Was it too small to curtail the massive deficits of the leading economies? Or politically too weak to stop the largest economy from entering massive deficits that impact on the entire world economy?

3. The failure of renewed economic growth after the 1990's in most regions of the world except Asia –notably China that does not follow IMF recipes–, and the fear of recessions/depressions in the G7 countries starting from Japan and followed by France and Germany but maybe including the US brings around a shadow of world crisis that has been covering most consultations since 2000.

4. The issue of economic stability is two pronged:

The debtor State government wants to prevent its economy from collapsing à la Argentina.

The creditors want to prevent a default à la Thailand, with ripple effects that spread around the world leading to a switch in net resource transfers all around.

¹ This text is prepared for Financing for Development Multi-Stakeholder Consultation on Systemic Issues to take place at the United Nations in New York City, May 18 and 19, 2005.

5. The conflict here is that in order to maintain economic some growth, Governments choose to default before the going gets rougher, in an scenario of massive negative resource transfers. If it defaults too late, the amount transferred abroad can choke whatever growth there was. Private agents in this scenario perceive the possible default ahead of time leading to a speed up of the negative NRT.

6. Creditors in this light normally try to prevent the default by lending more at higher rates until it becomes unfeasible to put good money after bad.

7. The only way to prevent this cycle from happening is to stop it at the root.

1. This means higher tax pressures in developing economies and less profit tax loopholes for new investments together with additional easy to collect taxes like, for example the financial transactions tax that has turned out positive in Colombia. Argentina and Peru in recent years in order to reduce debt dependency.
2. The general agreement that consumption taxes are the way to increase revenue while direct profit taxes are reduced to promote new investment is leading to a tax race to the bottom, and increased income concentration world wide and within each country, as James Galbraith has pointed out.
3. For the existing debt, first, an international arbitration mechanism that will introduce the possibility of it calling for a freeze while all debts are restructured, before the domestic economy collapses, not after. There would need to be collective action clauses so that the majority of creditors represent all creditors thus preventing vulture fund attacks.
4. The criteria for a debt restructuring should be payback capacity with a realistic set of assumptions.
5. The protection of social expenditures should be guaranteed using a sort of Chapter 9 mechanism, in order both to meet the MDGs and to prevent further erosion of living conditions in developing countries which is leading to increased unwanted international migration.
6. This mechanism requires an international financial law much in the spirit of international trade law being built under UNCITRAL. This should prevent countries that do not want to subscribe to the mechanism from using its domestic legal power to force solutions which are suboptimal for the whole, but beneficial for itself.

The question of how to change the IMF from this view seems to stem from what kind of a new architecture is required in face of the changes after 1971 and 94. If Bretton Woods was dead in 1971, after 1994 and the new world of derivatives, existing international financial institutions seem to have no role in preventing debt crisis as was seen in Asia. The financial world is more volatile and voluble than ever and with far greater effects, as could be appreciated in Thailand.

Switching external debt to internal debt, as the new trend has it, only makes the matter more complicated, but does not really solve the problems. International interest rates are still domestic and really dependent on the monetary and fiscal policies of two nations. Switching debt from external to internal only makes the NRT more negative, further pressing the indebted economies backwards in terms of domestic savings and investment.

A new international financial architecture is required for the new global world, with one set of economic policy rules for all countries. Currently counter cyclical policies applied by G7 member countries are absorbing international resources from the developing world who cannot follow the same policies, finance with its surpluses those deficits. This is an absurd situation that must come to an end.

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Friday, May 13, 2005