

# Global Financial Crisis and the International Monetary Fund

## Abstract

**T**he global financial crisis began with the sub-prime mortgage crash in the United States (US). Speculative capital increased several fold. The relation between real material capital and fictitious capital became more and more distant that the latter almost assumed the form of an independent existence. The crisis, originating in the US soon spread throughout Europe and Asia. Finally, all countries, even those less immersed in the globalised economy were affected by the crisis. There is unanimous opinion that the present financial crisis is the worst since that of the 1930s. Its effect is greater since the world is more globalised and world population has grown much bigger.

The primary cause of the crisis lay in the new financial architecture caused by the explosive growth of fictitious capital and the deregulation of financial markets, especially capital account liberalisation. The whole ideology behind economic management was flawed. The whole ideology behind economic management was flawed. This ideology, this model was none other than neo-liberalism.

The flaw in this ideology was evident several years ago during the time of the East Asian crisis. The aftermath of the East-Asian crisis was a deep mistrust of the International Monetary Fund (IMF). The global financial crisis has lent a new legitimacy to the IMF and saved it from redundancy. The crisis has not only given an opportunity to stage a come back but is also a challenge, since its financial resources have not kept pace with the global economy in the recent past. At the G-

20 summit in London in 2009 it was decided to treble the resources available to the IMF. They decided to give US \$ 500 billion for that purpose.

Would the IMF be able to bail out the developing countries, with these changes and enhanced funding? In order to find an answer to this questions or find a way of finding an answer one has to study the governance system in the IMF. It is a moot point whether the US would be ready to give up its privileged position?

If, as Greenspan admitted, the theory was flawed, the IMF too should share the blame as it aggressively promoted the theory of neoliberalism at the behest of the US and other leaders of the West. In another two decades, China is to replace the US as the world's biggest economy. Already, real production has shifted from the developed world to the BRIC nations (Brazil, Russia, India and China). These developments are likely to have their repercussions on the world financial architecture. The crisis has already made the G-7 an anachronism. The G-20 is increasingly filling the vacuum, but it is the G-192 which should ultimately take the controls at the helm.

In the short-term, we could see a relaxation of IMF conditionalities in loan disbursement. This will be proportionate to, the strengthening of the developing nations in geopolitics and the growing strength of their position in the world economy. In the long-term, whether IMF would discard its neo-liberal policies or not would depend on the economic and political developments in the world. The reform of the IMF would also be protracted and long just as it would

**Jayatilleke de Silva**

**Editor,  
Daily News.**

be a long process for the world economy to get out of the present crisis.

## Introduction to the Global financial crisis

The global financial crisis began with the sub-prime mortgage crash in the United States (US). The crash was precipitated by the large number of foreclosures from March to September 2007. These foreclosures were a result of unprecedented high risks taken by fund managers and investment bankers in the wake of long term high investment growth and low financial market volatility. New credit instruments were innovated. These include hedge funds, derivatives etc.

The development of information communication technology enabled the electronic transfer of colossal sums of money across the globe at the push of a button. Speculative capital increased several fold. The relation between real material capital and fictitious capital became more and more distant that the latter almost assumed the form of an independent existence. The underlying relation between the two comes in bold relief at times of crisis when there is a run on money and a large part of the fictitious capital, i.e., bills of exchange, derivatives etc., becomes unredeemable and vanish into thin air. This is exactly what happened

with the advent of the present global financial crisis.

### Forecasts

Way back in 1993, when the financiers were celebrating the demise of the Union of Soviet Socialist Republics (USSR) and the end of history (or at least communism) H. Minsky prophetically wrote; "...the main purpose of those who controlled corporations was no longer making profits from production and trade but rather to assure that the liabilities of the corporations were fully priced in the financial market....The question of whether a financial structure that commits a large part of the cash flows to debt validation leads to a debacle such as that took place between 1929 and 1933 is now an open question...In the present stage of development the financiers are not acting as *ephors* of the economy, editing the financing that takes place so that the capital development of the economy is promoted. Today's managers of money are but little concerned with the development of the capital asset of an economy....Today's financial structure is more akin to Keynes' characterization of the financial arrangements of advanced capitalism as a casino". (Minsky, 1993)

What Minsky saw empirically one and half decades ago, Marx saw theoretically over a century and a quarter ago. In Capital Volume III he said: "In a system of production, where the entire continuity of the reproduction process rests upon credit, a crisis must obviously occur - a tremendous rush for means of payment - when credit suddenly ceases and only cash payments have validity....And in fact it is only a question of the convertibility of

bills of exchange into money. But the majority of these bills represent actual sales and purchases, whose extension far beyond the needs of society is, after all, the basis of the whole crisis. At the same time, an enormous quantity of these bills of exchange represents plain swindle, which now reaches the light of the day and collapses.." (Marx, 1894)

The daily turnover of financial markets exceeded US \$ 3 trillion. Financial capital received an unprecedented mobility. Global cross-border capital flows more than doubled between 2002 and 2007, with foreign investors holding one in four debt securities and one in five equities. (Blankenburg and Palma, 2009)

It is in this context that the subprime mortgage crash occurred. Soon the crisis spread to the entire non-bank financial sector or the shadow financial sector. Nor could the formal banking sector remain unscathed. The fall of Lehman Brothers, the bankruptcy of Merrill Lynch etc. became part of history. The contagion effect resulted in an unprecedented banking crisis.

The crisis, originating in the US soon spread throughout Europe and Asia. Finally, all countries, even those less immersed in the globalised economy were affected by the crisis.

The accumulation of toxic debt is enormous. US financial institutions have written off US \$ 1 trillion and are expected to write off another US \$ 3 - 5 trillion (Tett, 2009). According to Alan Greenspan, the aggregate equity loss of financial and listed corporate sector, non-listed corporate and unincorporated business concerns and homes

would exceed US \$ 40 trillion, equivalent to a two-thirds of the global Gross Domestic Product (GDP) in 2008.

The International Labour Organization estimates that worldwide unemployment could rise between 2007 - 2009 by at least 30 million people and could even rise up to 50 million, if conditions deteriorate.

There is unanimous opinion that the present financial crisis is the worst since that of the 1930s which followed the Great Depression of 1929. Its effect is greater since the world is more globalised and world population has grown much bigger. In fact it is the first such crisis after the new wave of globalisation set in. It is also the first crisis in the 21<sup>st</sup> century.

The primary cause of the crisis lay in the new financial architecture caused by the explosive growth of fictitious capital and the deregulation of financial markets, especially capital account liberalisation. Major developed countries including the US and the United Kingdom (UK) resorted to large-scale regulation of the banking system following the crisis, thus reciprocally proving that deregulation was a cause of the crisis.

There was much more. The whole ideology behind economic management was flawed. Former Chairman of the Federal Exchange Alan Greenspan admitted before a Congressional hearing that the ideology he believed in, the model he perceived was flawed. This ideology, this model was none other than neo-liberalism, first introduced with much fanfare by Margaret Thatcher and Ronald Reagan.

## **Economic liberalisation**

Economic neo-liberalism demands the deregulation of the economy, privatisation of state enterprises, free play of market forces and free mobility of capital, products and services, relaxing labour laws in favour of capital, cutting down of social welfare measures, emphasis on individual good instead of public good and increasing commodification of nature. The market is supposed to decide everything and the role of the state is reduced to the minimum. Of course, its role as protector of private property is left intact so as to guarantee maximum profits for multinationals and other entrepreneurs. This includes bailing out bankrupt private business enterprises through state funds. These principles are embodied in the Washington Consensus. Due to this heavy reliance on markets neo-liberalism is also known as 'market fundamentalism.'

In fact, the flaw in this ideology was evident several years ago during the time of the East Asian crisis. The IMF insisted that East Asian nations liberalise the capital account which paved the way for an influx of foreign capital but there were no regulatory mechanisms in place to administer capital flows. With doors wide open foreign capital flowed out with even greater speed at the first signs of financial instability. East Asia showed that free market deregulation was no panacea for all ills in all countries. Former World Bank Chief Economist Joseph Stiglitz criticising the approach of the IMF which was based on a 'one size fits all' prescription said that it failed to take into account the specific conditions in each country. Similarly in the case of Argentina

IMF prescriptions proved to be detrimental.

## **IMF in decline**

The aftermath of the East-Asian crisis was a deep mistrust of the International Monetary Fund (IMF) in the region. Almost all of them stopped going to the IMF for loans. A similar situation arose in Latin America and elsewhere following the crisis in Argentina with its widespread social repercussions. By 2007 Venezuela, Brazil and India had paid up their loans and were independent of the IMF. The IMF itself faced a financial crisis and was almost downsized. The IMF credit outstanding which stood (on an end-of-year at almost basis) at almost US \$ 100 billion at the end of 2005 declined to US \$ 10 billion (a 90 percent drop) by September 2008. (*Remarks delivered to the Tula Committee on Foreign Relations, United States, on January 22, 2009 and to the Dallas Committee on Foreign Relations on January 23, 2009 by Edwin M. Truman, Peterson Institute for International Economics*) Since the IMF's main source of income is the interest on loans, the demand for which declined progressively IMF's administrative budget had to be curtailed. This resulted in a reduction of the IMF staff by 20 percent in 2007 - 2008.

The third world countries were searching for complementary or alternative sources of funding to meet emergencies. For example, after the East-Asian crisis a proposal for an Asian monetary fund was considered. Though the proposal has still not reached the implementation stage, a lesser initiative called the Chiang Mai initiative was created in 2000 by the Association of South East-Asian nations (ASEAN), China, Japan, and the Republic of Korea. Since a

country could draw only up to 20 percent without being placed on IMF surveillance this is only a complementary mechanism. On the other hand, initiatives like the Banco de Sur (South Bank) in Latin America is an attempt to develop an alternative to the IMF.

## **Crisis gives new legitimacy to IMF**

The global financial crisis has lent a new legitimacy to the IMF and saved it from redundancy. Even countries which were reluctant to seek IMF assistance are looking forward to IMF assistance to get over their balance of payments difficulties and to augment their international reserves.

The crisis has not only given an opportunity to stage a come back but is also a challenge, since its financial resources have not kept pace with the global economy in the recent past. In fact, they declined. The IMF estimates that its reserves should grow up by approximately 55 percent if it is to reach the levels relative to the global output at the time of the Asian financial crisis.

At the G - 20 summit in London in 2009 it was decided to treble the resources available to the IMF. They decided to give US \$ 500 billion for that purpose. This could be further raised as the European Union (EU) announced in September 2009 that it has decided to increase its funding to the IMF from Euro 75 million to 125 million. (US \$ 178 Million). China signed an agreement with the IMF at the beginning of September 2009 to purchase US \$ 50 billion SDRs (Special Drawing Rights) in IMF notes. Japan gave US \$ 100 billion in February 2009. Brazil and India have promised to loan US \$ 20 and 10 billion respectively to the IMF.

Canada, Switzerland, Russia and Korea have also pledged US \$ 10 billion each.

The IMF says, it is changing in responding to the crisis. It has stepped up crisis lending. By September 2009 lending commitments had reached US \$ 160 billion. It also says that it has become more flexible by streamlining loan conditions. It has now doubled the member countries' access to fund resources and structural performance conditions have been discontinued for all loans from May 1, 2009. Structural reforms will be retained only in cases where they are critical to a country's recovery. Allocation of SDRs has been increased to an equivalent of US \$ 250 billion which is nearly a ten-fold increase in SDRs.

#### **Would the IMF succeed?**

In this respect a study undertaken by Yonka Ozdemir of the Political Science and International relations Programme of the Middle East Technical University provides some interesting insights into IMF crisis prevention strategy and evaluates its short-term and long-term effects on the client state. In a comparative study of the IMF handling of the financial crisis in Argentina and Turkey in the year 2001, she shows that IMF reaction to the crisis was different in the two cases. The study revealed that "While Turkey received a huge amount of IMF help right after the crisis, the Argentine crisis was left to degenerate before IMF help eventually came. The Turkish government strictly followed an IMF sponsored programme for its economic recovery while Argentina declared a moratorium and persistently challenged IMF and private financial institutions. Although in the short-term it seems that Turkey's

recovery was faster, when we evaluate the economic results of these two different strategies seven years after the crises, it appears that IMF has proven to be more a curse than a cure for Turkey. Despite its impressive growth rates, with its unsustainable levels of trade and current account deficits, Turkey is again among the riskiest emerging markets." (Ozdemir, 2009)

One more observation to be made here is that prior to 2001, both these countries have been regularly receiving IMF assistance. For example, Turkey benefitted from seventeen stand-by arrangements with the IMF before the crisis broke out in 2001 necessitating another bail out. In the case of Argentina it implemented a programme of radical neo-liberal restructuring from 1991 to 2001. this programme included *et al* a tax reform, privatisation of state owned enterprises, trade liberalisation, deregulation and the adoption of a currency board. The Argentine peso was made convertible and an exchange rate of one peso to one dollar was fixed. With the appreciation of the US dollar, the Argentine peso also appreciated, worsening the current account deficit and increasing the public debt. It was this currency appreciation that laid the basis for the 2001 crisis. As of October 31, 2001 Argentina became the world's most financially risky country. A month later, on November 30, 2001, a massive run on the banks resulted in a US \$ 2 billion fall in the Central Bank reserves in one day. Despite the immensity of the crisis the IMF kept silent and did not come to Argentina's assistance. It was only in January 2003 that IMF came to its assistance with an eight-month credit line of US \$ 6.78 billion. In the meantime, Argentina had seen the fall of

several governments and passed through extremely difficult economic situations.

Incidentally, the different approach to the crises in the two countries exposes the IMF's policy of favouring US's close allies and deserting others in crisis. Turkey played a strategically important role in the post-September 11 War on Terror, while Argentina was deviating from the neo-liberal path.

#### **Issues of IMF governance**

Though the IMF is indirectly linked to the United Nations (UN) system, it is actually independent from and far distant to the IMF. While the UN system is based on the principle of 'One member one vote', the IMF is entirely structured on a different basis. There, the members' votes are proportional to their subscription quotas which are assigned according to their size in the world economy.

Therefore, the voting system is highly unfavourable to the majority of its members who are developing nations. In September 2009 the percentage share of its leading members were as follows: The US - 16.77, Japan - 6.02, Germany - 5.88, the UK and France - 4.85 each, China - 3.66, Italy - 3.19. This means the US has a virtual veto power as important decisions require a majority of 85 percent of votes. In comparison developing nations such as Sri Lanka (which has 0.2 percent of the votes) have no say at all. So, they are forced to seek the patronage of the US, Japan and the EU. This is the big democratic deficit of the IMF (and other Bretton Woods institutions).

It is again a moot point whether the US would be ready to give up its privileged position? Though the US is heavily indebted and is facing a

severe crisis, its geo-political strength as the world's only super power and its unrivalled and unparalleled military strength give it a leverage to avoid relinquishing its position.

The US Congressional Research Service, in a report in July 2009 noted that "The combination of US military power, extensive economic and financial clout, its diplomatic clout, and its veto power in the IMF put the United States at the centre of any resolution to the global financial turmoil. (Nanto, 2009). However, the same report said that now "US policy makers are turning more toward the use of soft power (or what has is sometimes termed 'smart power') as "the ability of the US to induce other countries to coalesce around US goals may be diminished".

This increases the opportunities for newly-emerging economic powers such as those grouped together as BRIC or BRICS (Brazil, Russia, India, China and South Africa) to demand a greater say for them and the developing nations at the IMF.

Another reason that favours the building of a consensus on IMF reform is the security threat posed to the US by the financial turmoil. The same report said: "...on February 12, 2009, the US Director of National Intelligence, Dennis Blair told Congress that instability in countries around the world caused by the global economic crisis and its geopolitical implications, rather than terrorism, is the primary near-term security threat to the United States."

There is another aspect of IMF reform. It is in the area of policy. In fact, it is the main instrument which governs the international finance architecture. The IMF, the

World Bank and the World Trade Organization (WTO) taken together constitute the triumvirate of neo-liberal globalisation.

The global financial crisis has demonstrated the folly of developing nations following neo-liberal globalisation. The latter has been associated with lowering of living standards of the poor and transfer of wealth from the poor to the rich. In the international arena it was a corresponding process of transferring wealth from poor nations to the rich. The crisis has made the attainment of Millennium Development Goals less possible. It has thrown millions more to poverty and destitution. The struggle against Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome (HIV/AIDs) will suffer greatly.

A necessary corollary to these developments is the need to move away from the traditional policy framework of the IMF. This requires, above all a change in its voting structure, the elimination of the veto power enjoyed by the US and the US direct involvement in IMF activities. However, a change in the voting structure requires the amendment of the existing Articles of Agreement of the IMF. This requires approval of the United States Congress. That means it is not possible without arriving at a consensus with the US.

Another pre-requisite is a change in the composition of the staff at the IMF. Majority of its members are those who dogmatically adhere to the tenets of neo-liberalism. Since it had been the dominant ideology, even most of the apparatchiks from developing countries share US vision on most of the matters that come up within the Fund. It is necessary to staff

the Fund with members belonging tooter schools of thought too.

Besides, leading members in the Executive Committee, such as the Chairman and the Managing Director should be elected on a merit based system and it should be open to all member nationalities.

Another desirable reform is to limit IMF to its original function as a mechanism to monitor and ensure financial stability in the world. It should shed its political function of directing political and economic development in client states with neo-liberal prescriptions.

An analysis of IMF loan disbursements shows that it was easier for countries with good relations with the US to obtain loans. This may be due to the commanding role it has in the Fund. Very often, the developed countries take political issues, such as human rights to deny IMF facilities to member states. Yet, history shows that even dictatorial regimes which openly violated all norms of democratic governance and engaged in most brutal repression of the population, such as Pinochet's Chile, got IMF facilities. Such political considerations should not be the basis for loan disbursement.

### **Geopolitical realities and IMF reform**

Conceived at the Bretton Woods Conference in the US, the IMF was formally established in 1945. Though a result of consultations between the UK and the US, the IMF is mostly a US project. It reflected the geopolitical reality at the end of the Second World War when the US emerged as the world's

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most powerful state economically and politically.

The geopolitical reality today is much different. The bipolar world that emerged since the Second World War is dead and gone. Also the unipolar world that emerged after the demise of the USSR and other socialist states has undergone significant changes. What is emerging today is a multipolar world where China and India are emerging, as new giants. In another two decades, China is to replace the US as the world's biggest economy. Already, real production has shifted from the developed world to the BRIC nations, Eventually, the centre of gravity of the world economy will shift to China which would generate tectonic shifts in the world balance of forces.

These developments are likely to have their repercussions on the

world financial architecture. The crisis has already made the G -7 an anachronism. The G-20 is increasingly filling the vacuum, but it is the G-192 which should ultimately take the controls at the helm.

In the short-term, we could see a relaxation of IMF conditionalities in loan disbursement. This will be proportionate to, the strengthening of the developing nations in geopolitics and the growing strength of their position in the world economy.

In the long-term, whether IMF would discard its neo-liberal policies or not would depend on the economic and political developments in the world. The reform of the IMF would also be protracted and long just as it would be a long process for the world economy to get out of the present crisis.

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