The IMF's Switch in Time

JOSEPH E. STIGLITZ

The annual spring meeting of the International Monetary Fund was notable in marking the Fund's effort to distance itself from its own long-standing tenets on capital controls and labor-market flexibility. It appears that a new IMF has gradually, and cautiously, emerged under the leadership of Dominique Strauss-Kahn.

Slightly more than 13 years earlier, at the IMF's Hong Kong meeting in 1997, the Fund had attempted to amend its charter in order to gain more leeway to push countries towards capital-market liberalization. The timing could not have been worse: the East Asia crisis was just brewing—a crisis that was largely the result of capital-market liberalization in a region that, given its high savings rate, had no need for it.

That push had been advocated by Western financial markets—and the Western finance ministries that serve them so loyally. Financial deregulation in the United States was a prime cause of the global crisis that erupted in 2008, and financial and capital-market liberalization elsewhere helped spread that "made in the USA" trauma around the world.

The crisis showed that free and unfettered markets are neither efficient nor stable. They also did not necessarily do a good job at setting prices (witness the real-estate bubble), including exchange rates (which are merely the price of one currency in terms of another).

Iceland showed that responding to the crisis by imposing capital controls could help small countries manage its impact. And the U.S. Federal Reserve's "quantitative easing" (QEII) made the demise of the ideology of unfettered markets inevitable: money goes to where markets think returns are highest. With emerging markets booming, and America and Europe in the doldrums, it was clear that much of the new liquidity being created would find its way to emerging markets. This was especially true given that America's credit pipeline remained clogged, with many community and regional banks still in a precarious position.

The resulting surge of money into emerging markets has meant that even finance ministers and central-bank governors who are ideologically opposed to intervening believe that they have no choice but to do so. Indeed, country

---

Joseph E. Stiglitz is University Professor at Columbia University, a Nobel laureate in Economics, and the author of Freefall: Free Markets and the Sinking of the Global Economy.

© Berkeley Electronic Press/Project Syndicate
Brought to you by | Columbia University Library The Burke Library New York
Authenticated | 128.59.160.238
Download Date | 3/26/13 8:33 PM

after country has now chosen to intervene in one way or another to prevent their currencies from skyrocketing in value.

Now the IMF has blessed such interventions—but, as a sop to those who are still not convinced, it suggests that they should be used only as a last resort. On the contrary, we should have learned from the crisis that financial markets need regulation, and that cross-border capital flows are particularly dangerous. Such regulations should be a key part of any system to ensure financial stability; resorting to them only as a last resort is a recipe for continued instability.

There is a wide range of available capital-account management tools, and it is best if countries use a portfolio of them. Even if they are not fully effective, they are typically far better than nothing.

But an even more important change is the link that the IMF has finally drawn between inequality and instability. This crisis was largely a result of America's effort to bolster an economy weakened by vastly increased inequality, through low interest rates and lax regulation (both of which resulted in many people borrowing far beyond their means). The consequences of this excessive indebtedness will take years to undo. But, as another IMF study reminds us, this is not a new pattern.

The crisis has also put to the test long-standing dogmas that blame labor-market rigidity for unemployment, because countries with more flexible wages, like the U.S., have fared worse than northern European economies, including Germany. Indeed, as wages weaken, workers will find it even more difficult to pay back what they owe, and problems in the housing market will become worse. Consumption will remain restrained, while strong and sustainable recovery cannot be based on another debt-fueled bubble.

As unequal as America was before the Great Recession, the crisis, and the way it has been managed, has led to even greater income inequality, making a recovery all the more difficult. America is setting itself up for its own version of a Japanese-style malaise.

But there are ways out of this dilemma: strengthening collective bargaining, restructuring mortgages, using carrots and sticks to get banks to resume lending, restructuring tax and spending policies to stimulate the economy now through long-term investments, and implementing social policies that ensure opportunity for all. As it is, with almost one-quarter of all income and 40 percent of U.S. wealth going to the top 1 percent of income earners, America is now less a "land of opportunity" than even "old" Europe.

For progressives, these abysmal facts are part of the standard litany of frustration and justified outrage. What is new is that the IMF has joined the chorus. As Strauss-Kahn concluded in his speech to the Brookings Institution shortly before the Fund's recent meeting: "Ultimately, employment and equity are building blocks of economic stability and prosperity, of political stability and peace. This goes to the heart of the IMF's mandate. It must be placed at the heart of the policy agenda."

Strauss-Kahn is proving himself a sagacious leader of the IMF. We can only hope that governments and financial markets heed his words.

Letters commenting on this piece or others may be submitted at submit.cgi?context=ev.

Brought to you by | Columbia University Library The Burke Library New York
Authenticated | 128.59.160.238
Download Date | 3/26/13 8:33 PM