Extract from the report:

Building new foundations: Reimagining the International Financial Architecture

Views and proposals from civil society

How can we mend a broken system? Looking for ways to reform the international financial institutions

By Daniel Kostzer

With contributions from

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The future of the world is being questioned on a global scale, affecting countries of all income and development levels. The agenda of the 'golden years' of capitalism has drastically shifted and the notion of a 'rising tide that lifts all boats' has proven to be an illusion, in economic terms. New risks have replaced the former status quo.

There is an urgent need to reform the International Financial Institutions (IFIs) established by the Bretton Woods Agreements of 1944. The focus should be on creating a common agenda that fosters a 'win-win' situation for all, rather than imposing values from the Global North in a 'top-down' way.

Can this be achieved within the current institutional framework? Is it simply a matter of governance or does it require additional resources?

The quest for reforms of the Bretton Woods Institutions

The story of the creation of the Bretton Woods Institutions (BWIs) – the World Bank and International Monetary Fund (IMF) – is well known: Much has been written about the differences between the waning colonial power of the United Kingdom and the rising power of the United States, on the one hand; or the developments and even gossip of 1944-46, such as the role of the Federal Bureau of Investigation (FBI) in the still unwritten rule that the President of the World Bank should be an American, while the Managing Director of the IMF should be a European.[1]

There is broad consensus on the limited effectiveness of both institutions in achieving not only the original goals set out in 1944 but also the redefined goals that have been set out since then. These include the so-called 'Twin Goals' of ending extreme poverty by 2030 and promoting shared prosperity by boosting the incomes of the poorest 40 percent of the population in each country, as defined by the World Bank in 2013, or the Marrakesh inclusion of the "World free of poverty in a livable planet".[2]

How can the new challenges of a 'just transition' be met without abandoning the prevailing urgencies of crisis prevention and recovery, debt emergencies, poverty reduction and human development expansion within the current architecture? Can a new framework be built over the existing foundations of the Bretton Woods institutions?

The aim of this chapter is to highlight several key issues that must be addressed before considering a

1 There is evidence that, after President Truman announced H. Dexter White as the head of the newly formed IMF, the FBI raised the suspicion that the latter was a Soviet spy. Then Truman offered the Europeans the post of the IMF Managing Director, keeping the WB presidency for the US. The accusation was never proved. For references see: New York Times, 18 August 1948, p. 1 (https://www.nytimes.com/1948/08/18/archives/h-d-white-accused-in-spy-inquiry-dies-former-assistant-secretary-of.html?auth=login-google1tap&login=google1tap), Benn Steil in New York Times, 8 April 2012 (https://www.nytimes.com/2012/04/09/opinion/banker-tailor-soldier-spy.html), and Boughton (2024).

2 https://timeline.worldbank.org/en/timeline/eventdetail/3331

new or reformed architecture for the complex International Financial Institutions (IFIs). This list is not exhaustive but identifies critical aspects that need to be resolved for any proposal to gain global acceptance and support. Some of these solutions are less than intuitive and, while these issues may initially appear disconnected, a deeper understanding of how these institutions operate, their governance structures, financing mechanisms and priorities will reveal the interconnections. These interlinkages are crucial for developing a comprehensive and coherent reform proposal.

Objectives: How to align the Multilateral Development Banks to the new agenda

It could be argued that there is some broad consensus on the goals, objectives and thematic areas of the expected policy interventions. The Sustainable Development Goals (SDGs), their dimensions and indicators, summarize an agreed, consistent and practical framework for the interventions that are fully incorporated into the mandate of the IFIs, in theory.

The SDGs constitute a comparatively static proposal where the starting point was 2015 and there are a number of objectives to be achieved by 2030.[3] They are not a development programme, nor are there suggested ways or paths to achieve them. In terms of dimensions for intervention, goals and indicators, the SDGs constitute a first step in a planning process, where the analysis should define the instruments to use, synergies and potential contradictions between goals, and institutional settings to design, reform or draw on to achieve these objectives.

The IFIs should adapt them recursively to their existing activities, especially those that are either new or where experience has been unsatisfactory. This cannot be done in isolation in the ivory tower of Washington D.C., but in active interaction with the multilateral institutions that are the custodians of the different goals (in other words, the United Nations (UN) in general as well as the International Labour Organization (ILO), United Nations Children's Fund (UNICEF), United Nations Environment Programme (UNEP), United Nations Educational, Scientific and Cultural Organization (UNESCO), etc.), as well as national governments and other civil society actors, in which trade unions and workers' representatives play a key and active role.

Governance: Democratic voice and vote

One of the first and key points to consider is the process of decision making in the new/reformed setting. The current system of weighted voting based on shareholding is not adequate. This system only reflects the power of richer and donor countries over the so-called customers, or implementing partners of the IFIs. The voting power is also reflected in the number of directors on the Executive Board of the IMF (24) and on the Executive Board of the World Bank (25). The Board of Directors is ultimately responsible for taking the strategic and operational decisions that govern the institutions.

It could be argued that there is a circularity in the shareholding allocation according to 'objective indicators' such as Gross Domestic Product (GDP), trade or economic openness. All these give more shares, therefore more voting power, to larger countries and more consolidated economies.[4] This system underscores the unequal international structure, which, in theory, is meant to be changed with the interventions.[5]

This system of shareholding and voting becomes highly relevant when the time comes to make some

3 Comparatively static in that there are no clear definitions regarding the path to take or intermediate steps; there is no general trend. Each goal must be achieved based on national decisions.

4 The elements of the quota formula are weighted in the following way: 0.5*GDP + 0.3* openness + 0.15*variability + 0.05*reserves (see https://www.imf.org/en/About/Factsheets/Sheets/2022/IMF-Quotas).

5 The Governors of the World Bank Group endorsed in 2015 the so-called 'Lima Shareholding Principles' that developed a 'dynamic formula' and defined a time profile of five years for the planning and revisions. For the World Bank Group, in 2015 a new 'dynamic formula' was defined, which combines 80 percent economic weight (measured by GDP, averaged over five years and using a blend of market exchange rates and PPP of 60/40), and 20 per cent Development Contributions (measured by IDA contributions with most weight given to the three most recent replenishments).

crucial decisions. For example, during the COVID-19 pandemic, the IMF took a major decision to provide additional resources to member states to address liquidity and resource constraints. A general allocation of 465.5 billion Special Drawing Rights (SDRs) in 2021, equivalent to about US$ 650 billion, was important and timely. However, it was allocated in proportion to the shareholding, and not to the needs of the countries, and the intended 'voluntary redistribution' from richer to poorer countries did not work. For some rich countries the allocation was unnecessary, while for poorer economies, it was insufficient.

Although it is true that there is a share of basic votes – votes allocated equally to all member countries – these only account for just 5.5 percent in both the IMF and the World Bank. In principle, while the contributions to the IFIs should bear some relationship to the capabilities of countries to provide resources to help others, the decision making and voting power should be equitable, as in the UN or other multilateral organizations: one country, one vote. An alternative could be two-stage voting, similar to a *two chamber system*.[6]

The process of consultations with other organizations and institutions should transcend the mere formality. Trade unions meet annually with the IFIs to discuss their workplans, critique their publications and push for the workers' agenda. However, these efforts rarely influence the actual operations or policies of the IFIs, especially the IMF.

Main approach: from projects to programmes

The IFIs tend to have a project-based approach. The units of analysis and intervention are the projects, with their own allocation of resources, objectives, procedures, operating manuals, monitoring, etc. In many cases, they are even detached from the national and sub-national structures in which they should be embedded, creating dual structures when they should be building capacity. Although many studies highlight the interactions between policy interventions, the project-oriented approach limits the contextual analysis that could take advantage of the synergies.

This becomes more evident when the World Bank Group (WBG) also compartmentalizes actions in areas defined in its internal structure, without integration.[7] This could be achieved through the SDGs and indicators as a planning context of the interventions, but would require some significant structural changes internally and also changes in the interactions with countries, as well as multidisciplinary approaches to the programmes.

In the case of the IMF, the problem is slightly different since it recommends 'programmes' in an integrated form. The IMF's approach always ends with a set of policy recommendations –common to almost all countries, independent of their productive structure, level of development and prevailing institutions. These recommendations are based on ideologically biased pre-judgements and not always on the diagnostic performed by officials. For most countries, it is sufficient to check the Article IV consultations, and a common trend can be seen in the recommendations section.

Top priority: Debt management

Foreign debt has been an issue for developing economies since the crisis of the 1980s. Although there have been times of certain calm – for example, before the global financial crisis of 2008-2009, and more recently due to the consequence of a period of almost zero interest rates – funds from the Global North maintained a reasonable flow to the Global South. Homi Kharas and Charlotte Rivard point out that "(s)ince the 2009 financial crisis and the subsequent period of extraordinary monetary policies, many developing countries accessed private credit and bond markets to supplement (and in many cases replace) domestic savings".[8]

6 A two-stage system, such as the systems of modern democracies, where one chamber is based on population size (representative) and the other on equal representation. Decision making is based on a majority of votes cast in both chambers. This system would mean at least 50 percent of direct votes and more equitable decision making.

7 There have been many attempts to better integrate areas with the development of communities of practice as well cross-cutting areas, but the results have not been satisfactory.

8 Kharas/Rivard (2024).

In the aftermath of the COVID-19 pandemic, many countries began to show signs of debt distress. The need for funds to deal with the public health emergency, respond to supply constraints and to protect the income of the population had a profound impact on the debt of emerging economies. The 'flight to quality' by private investors, taking advantage of higher interest rates from central banks in the Global North, or the demand for 'buybacks' by large companies, increased the outflow of funds from emerging markets. According to Kharas and Rivard, private lenders (banks and bondholders) withdrew over US$ 300 billion from developing economies during 2022 and 2023.

According to United Nations Development Programme (UNDP), of the 88 developing countries that have been assigned a credit rating from at least one of the major rating agencies, almost 30 percent are at substantial risk of extremely speculative conditions, or worse, in actual default.[9] Moreover, 50 percent of those developing countries are either at high risk of 'over-indebtedness' or are directly in debt distress.

Considering public debt as a percentage of GDP, in half of the countries it exceeds 55 percent. Additionally, half of these countries will face interest payments that consume 9 percent or more of their annual public revenues. Upper middle-income countries are expected to see the most significant increases in 2024, driven by persistently high global interest rates.

According to the World Bank's International Debt Report 2023, developing countries spent a record US$ 443.5 billion to service their external public and publicly guaranteed debt in 2022.[10] The 75 poorest countries, which are eligible to borrow concessional loans from the International Development Association (IDA), paid US$ 88.9 billion in debt-servicing costs in 2022, which is also an historical record. For Indermit Gill, the World Bank Group (WBG) chief economist, this is an invitation to crisis: "Every quarter that interest rates stay high results in more developing countries becoming distressed—and facing the difficult choice of servicing their public debts or investing in public health, education, and infrastructure."[11]

There are many alternatives and proposals issued in relation to solving the debt crisis. The grim scenario, with even grimmer prospects, urge sustainable debt management, based on the Basic Principles on Sovereign Debt Restructuring Processes.[12] Adopted by the UN General Assembly in 2015, they set out the conditions under which the debt of the most vulnerable economies should be discussed and restructured. The inclusion of the debt issue under the UN framework is necessary for the agenda to come.

The funding of the MDBs

While the IMF gets its funds directly from government sources plus the surplus generated by the operations (interest rates, surcharges, etc.), the WBG – as well the regional development banks – must use other practices to finance their activities. The mechanics are as follows: WBG staff define the 'envelope' to be used in the coming five years and following the 'dynamic formula' that determines how much each country should contribute. These contributions are not in cash, but rather are what is known as 'callable', which is a commitment by member countries to provide this money if the institution needs it. As of 30 June 2023, the World Bank had a total of US$ 296 billion in callable capital, accounting for 93 percent of its US$ 318 billion total subscribed capital, with the remaining 7 percent, or US$ 22 billion, in paid-in capital.[13]

With those commitments by member countries, the WBG issues bonds, after getting an AAA rating by the major credit rating agencies sold in market opera-

9 See https://data.undp.org/insights/debt-in-developing-economies. The two major rating agencies are Standard & Poor's and Moody's. Although we disagree with their methodological approaches, they profoundly affect the 'business sentiment' of investors, and the credit allocation from the development banks.

10 World Bank (2023).

11 https://www.worldbank.org/en/news/press-release/2023/12/13/developing-countries-paid-record-443-5-billion-on-public-debt-in-2022

12 UN General Assembly (2015).

13 World Bank (2024), p. 1.

tions. The WBG has borrowed "in all of the world's major capital markets, as well as directly from member governments and central banks".[14]

This dynamic of bond issuing, although seemingly effective, implies a number of constraints due to the intervention of the credit rating agencies. With limited political or social scope to assess the impact of the projects implemented, the rating agencies took an extremely conservative approach. This exerted pressure on the WBG, which restricted the exposure to some countries, even though the WBG never has faced a sovereign default.

The situation is even worse when considering regional banks. For the Inter-American Development Bank (IADB), the Asian Development Bank (ADB) or the African Development Bank (AfDB), maintaining a good credit agency rating becomes crucial. Due to geographical concentration, they are more exposed to lending to certain countries. The weight of some countries (Brazil, Indonesia, Mexico, Nigeria, the Philippines, etc.) becomes detrimental to the rating obtained by each of the banks, limiting the bond allocation in the markets, hence, impacting their lending capacity. The management of these institutions found an ingenious way of sorting out these problems, by exchanging debt from their different members to other MDBs, with the objective of reducing the exposure and limiting the lending capacity. However, this is only a mitigating tactic.

Need for new unconditional resources: Where to find the funds?

The only way of expanding the MDBs' lending capacity is by providing new funds. The discussion around how much money countries should bring to the table to finance the new agenda, without abandoning the traditional objectives, takes a lot of time and effort. Shareholding reviews took a long time, and the capital increases were quite limited. The last WBG review was performed in 2018, but not all countries fulfilled their commitment pledged to the institution. In this respect, it is imperative to look for new sources of funding that are long-term and independent of the will of individual countries. A redesigned global tax system could offer some answers.

Taxing principles: what is expected from a taxing system?

Many things have been discussed in relation to a taxing system: Equitable, fair, progressive, unavoidable, etc. Most of these principles are confined to the national space, and many of the recommendations tend to focus on the control of tax avoidance, evasion and other forms of profit shifting. Few have in mind that the generation of global resources is needed to finance transition with justice and equity, to change the productive, socio-economic and environmental landscape.

Sound tax systems include four main characteristics: Simplicity, transparency, neutrality and stability. These *'qualities'* point to different objectives, but together confirm the strength of a taxing system. The idea is to enhance the effectiveness, fairness and efficiency of taxes benefiting both taxpayers and the economy as a whole.

Financial Transaction Tax to finance development: Low-hanging fruits?

A Financial Transaction Tax (FTT) on stock, bonds and foreign exchange trades, as well as on derivative contracts, is an alternative for gathering resources for the challenges of a comprehensive and just transition.

Financial markets have expanded significantly, but this growth has come with turbulence, crises and crashes. These markets are central to the deregulated, financialized capitalist system that has transcended traditional production and distribution to generate extraordinary profits.

There are different valuations of the volume of transactions on global stock and bond markets depending on the sources; all are above US$ 100 trillion per year, with regional distribution that shows significant con-

14 https://thedocs.worldbank.org/en/doc/e384d12cfea59bdcb3adf25487894197-0340022023/original/IBRD-Information-Statement-FY23.pdf

centration: The US accounts for 42.5 percent of transactions, while the EU and China have around 11 percent each; Japan and Hong Kong are around 5 percent each. These five jurisdictions represent three quarters of total transactions in 2023.[15]

This concentration is one of the main advantages of the Financial Transaction Tax (FTT) as a global tax: it can be easily collected and controlled. The stock and bond markets of these countries have a large tradition of regulation and oversight. So how can we increase the feasibility of implementation?

Policy objectives: What can be expected from an FTT?

There are several goals of an FTT, besides the most obvious one of collecting funds for financing for development and just transition. James Tobin defined its purpose as follows: "… throw some sand in the wheels of our excessively efficient international money markets."[16] This would reduce high volatility trading (high intensity trading), which triggers risky behaviour by investors, crowding out productive investment. The restoration of the rate of profits of the productive sectors can only be achieved by the curtailing of the rate of profits of financial speculation.

On the resource side, an FTT would allow governments to diversify revenue sources, reducing reliance on traditional taxes (income, wealth, etc.) and regressive indirect taxes. This could also be an important source of income and wealth redistribution, since the revenues generated would be spent with *'progressive'* principles.

Taxing foreign exchange operations may help to reduce a prolonged swing in exchange rates caused by investors' behaviour, preventing the potentially damaging economic consequences in developing economies that is associated with the over- and under-shooting of exchange rate adjustments. When the FTT is introduced as an integral part of the overall financial architecture, it can reduce the outcomes of bad economic and financial policies.[17] This mechanism will operate by correcting the short-term operations, hence addressing exchange rate volatility.

Another factor of volatility in the world economy is the so-called 'herd trading' where investors move according to noise and news, rather than evidence, generating random movements that harm the stability of the economy. An FTT would also help to reduce the market presence of some investors that are characterised by a high volume of short-term investments causing macroeconomic volatility.

Conclusion on the reform of the BWIs: The bank should be a fund and the fund should be a bank

The economist John Maynard Keynes stated in 1944: "I will not say that the establishment of the Bank for reconstruction and development is more important than the Monetary Fund but perhaps it is more urgent".[18] In conclusion, we can argue that, as Keynes highlighted during the discussions at Bretton Woods, the structure of the IFIs should be drastically changed.

The IMF should be transformed into a bank that operates like a commercial bank, where the 'client' writes a cheque, similar to an overdraft – and, according to the qualifications and limitations assigned – from a current account when balance of payments emergencies require it. Rather than imposing conditions, perhaps it would be better to provide some guidance on specific strategies to address the emergency, but limit the advice to that. Crucially, this should be done without relying on the neoclassical framework of austerity and neoliberal policies, which consistently produce negative outcomes.

The World Bank, along with regional development banks, should be restructured into substantial, unconditional resource funds aimed at addressing

15 https://www.weforum.org/agenda/2023/04/ranked-the-largest-bond-markets-in-the-world/
16 Tobin (1978), p. 154.
17 Palley (2001).
18 Keynes (1944).

developmental disparities between countries. These funds should focus not only on the environmental dimension, but also on socio-economic development. For example, they could be replenished through the Financial Transaction Tax and other internationally coordinated taxes. Allocation of these resources should prioritize human development through democratic, participatory and programmatic methods, moving away from the paternalistic approach where policy decisions are made by those who contribute the most, rather than by those facing the greatest need.

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Daniel Kostzer is chief economist of the International Trade Union Confederation (ITUC). His opinions do not necessarily reflect those of ITUC. Previously he was the Senior Regional Wage Specialist of the International Labour Organization (ILO) for Asia and the Pacific (2016-2021) and representative of Argentina, Bolivia, Chile, Paraguay, Peru and Uruguay at the Board of Directors of the World Bank (2014-2016).

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europe@globalpolicy.org
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Authors:
Juan Pablo Bohoslavsky, Bodo Ellmers, Matthew Forgette, Avantika Goswami, Chioneso Samantha Kanoyangwa, Daniel Kostzer, Maria Emilia Mamberti, Jens Martens, Patricia Miranda, Chenai Mukumba, Daniel Oberko, Ohiocheoya (Ohio) Omiunu, Oliver Pahnecke, Sehr Raheja, Maria Ron Balsera

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Vicky Anning, Tobias Gerhartsreiter, Paul Wege

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Bodo Ellmers and Jens Martens, Global Policy Forum Europe

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