

**A RE-EXAMINATION OF THE ARCHITECTURE  
OF THE INTERNATIONAL ECONOMIC SYSTEM IN A  
GLOBAL SETTING: ISSUES AND PROPOSALS**

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*Dr. Michael Sakbani*

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## ABBREVIATIONS

IMF	International Monetary Fund; the Fund (used interchangeably)
IBRD	International Bank for Reconstruction and Development; World Bank and the Bank (used interchangeably)
ITO	International Trade Organization (proposed but not created)
GATT	General Agreement on Tariffs and Trade
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization
TRIMs	Trade-related Investment Measures
TRIPS	Trade-related Aspects of International Property Rights
OECD	Organisation for Economic Co-operation and Development
WHO	World Health Organization
BIS	Bank for International Settlements
ASEAN	Association of South-East Asian Nations
EU	European Union
EMU	European Monetary Union
EMS	European Monetary System
IMS	International Monetary System
IFS	International Financial System
IRS	International Reserve System
SDR	Special Drawing Rights on the IMF second window, established in 1968
C20	A Committee of 10 developed and 10 developing countries that mirrored the constituencies of the IMF, established in 1972 by the Governors of the IMF to look into the reform of the International Monetary System
G7	Group of Seven major developed countries
G77	The group of Seventy Seven developing countries which was formed in 1964 in the United Nations General Assembly. It was instrumental in passing the GA resolution establishing UNCTAD in the same year.
G24	Group of Twenty-four, created by the G77 to follow closely IMF matters
FDIC	Federal Deposit Insurance Corporation, created in the United States as part of the banking reforms of the Roosevelt Administration in the 1930s
TNC	Transnational corporations
FDI	Foreign direct investment (long term investments in real assets)
PF	Portfolio investments

# A RE-EXAMINATION OF THE ARCHITECTURE OF THE INTERNATIONAL ECONOMIC SYSTEM IN A GLOBAL SETTING: ISSUES AND PROPOSALS

*Dr. Michael Sakbani\**

## *Abstract*

*The globalization of the world economy poses major challenges to the prevailing international economic system. The recent trade-investment system raises the issues of the marginalization of countries, firms, and agents if they are not capable to compete with large successful entities. The system engenders conflicts of interest in its interfacing with sovereign domains. In numerous cases such as employment and mutual trade benefits, it can produce zero sum outcomes. Consequently, significant segments of public opinion in many countries have mobilized against it. In the monetary and financial area, the system has from 1945 evolved on a piecemeal and ad hoc basis. In recent years, it has not been able to predict, prevent or effectively deal with financial crisis. It demonstrates a lacuna in global financial governance especially with respect to enforcing its rules on the major countries and bringing the private sector therein. The central institution, the IMF, is shown to be in need of basic reforms involving forging a global vision, reconsidering and updating conditionality, further democratization of political governance, and revamping the exchange rates and surveillance functions.*

## INTRODUCTION

The prevailing international economic arrangements are an amalgam of facts, rules and modalities created one at a time rather than as a holistic system of cohesive design. The monetary part is a transformation of the old Bretton Woods system, which came into actual collapse in August 1971, but was rescued by successive fixes from 1972 onward. It remains based on the United States dollar, and centred around the IMF<sup>1</sup> whose mission and philosophy have evolved at a politically controlled pace. The monetary and financial systems are covered institutionally by the IMF in monetary matters and by the World Bank in finance matters. Moreover, the World Bank, while an important source of development funds for the poor countries and an instrument for bringing their policies under the scrutiny of the dominant members, shares its role, de facto, with the private sector, which is, de jure, not a part of the official system and is in the business of profit making.

The trade part of these arrangements, issuing essentially from the GATT, was redesigned in its scope and its law by the WTO agreement. However, it has maintained numerous features of the old GATT; it is still based on the exercise of full sovereignty in granting or not granting concessions; it remains essentially one based on liberal trade access, on non-discrimination in treatment via the application of the most favoured nation clause; and it is now based on equal treatment of countries regardless of their trading capacities. There is yet no sub-system for dealing directly and explicitly with investments and the transfer of technology.

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<sup>1</sup> See glossary of abbreviations. p. iv.

The overarching theme of this paper is that some parts of the international system have become, under globalization, rather obsolete and sometimes mutually inconsistent. The system has shown itself incapable of anticipating or preventing financial crisis in a global economy. There is also a glaring asymmetry in the treatment of source and recipient countries. Alternatives and reform ideas are suggested with full cognisance of their political feasibility and analytic soundness.

The conclusions of this paper are as follows:

- The globalization process cuts into the sovereign control of Nation States and to a certain extent erodes their fiscal base, while imposing costly burdens and obligations upon them to husband and develop their productive capacities and preserve their respective social compacts. It also reduces their scope of policy choice.
- The system has an obvious need for international governance, but its major Nation States do not accept the implied limits on their sovereignties.
- Globalization confers considerable benefits upon the participants, but it pays no attention to developing production, technological and commercial capacities. Thus, it may lead to the marginalization of some States, firms and individuals.
- The WTO system, which is based on equal treatment and unfettered sovereign granting of concessions, in effect provides level playing field only to participants with equal trading capacities or with equal value of concessions. Some aspects of this system disallow, for example, environmental and industrial policies, thereby infringing upon domestic Nation State decision making and putting in question the objectives and purposes of domestic policies wherever they have international effects.
- The short run incidence of trade globalization might be harmful to employment in the job losing countries, with the result of placing globalization in domestic political contention.
- The globalization of financial flows and investments might enhance allocative efficiency, but it skews further equity and fairness in the use of international savings and might undermine macroeconomic discipline.
- The private sector is not brought into the system in a meaningful way, especially in the areas of handling financial crisis and working out debt problems. There is also a system lacuna in devising binding acceptable standards of behavior for private foreign investors who are critical actors in the stability of the global financial system.
- There is a manifest need to reform the IMF and bring up to date its conditionality, governance and surveillance functions as well as endowing it with the function of the bank of last resort.
- The empirical record of the exchange rate system and the balance of arguments about it, call for evolving it away from its current corner polarities (rigidly fixed or free floating) to a middle solution system.



It would do injustice to the issues involved to try to deal with all the issues at the same level of depth within the limited scope of this paper. Nevertheless, an attempt will be made to cover, with varying detail, a certain number of outstanding issues.

The paper is divided into two sections. Section I covers the “problematique” of globalization and examines the tensions and contradictions experienced in the three subsystems: trade, investment-production and transfer of technology. It also discusses the conflict between the international system and the national sovereign systems. Section II covers the international monetary system (IMS) and its managing institution, the IMF in more detail because of the interconnection of the issues involved and the technical nexus between them.

## I. THE PROBLEMATIQUE OF THE GLOBAL ECONOMIC SYSTEM

### A. The different facets of globalization and their manifestations

Globalization is manifested in four interrelated developments: (1) the increase in the international exchange of goods and services and the movements of human resources despite all the restrictions therein; (2) the internationalization of production and real investments; (3) the increased integration of financial markets; and (4) the relatively high degree of policy convergence among countries.<sup>2</sup>

The statistical evidence on these developments is truly impressive. In the trade area, the ratio of international trade to the GDP of practically all countries has more than doubled over the last two decades. Trade has substantially outpaced the growth of the GDP in all but very few years over the past 25 years. A major new phenomenon is the size of services in total trade, in particular financial services.

World trade grew at a real rate per annum of 5.5 per cent in 1985–1994. In the decade 1995–2004 it registered an annual real growth of 6 per cent.<sup>3</sup> This is well above the average growth of the GDP in the same periods. For individual countries, even in the large and relatively closed countries, there is the same trend. For example, in the United States, trade went from a mere 9 per cent of the United States GDP in 1970 to more than 23 per cent in 2003. In the small European countries and most of the small developing countries, trade has gone up from levels in the range of 40–50 per cent of the GDP in 1970 to levels in the range of 80–90 per cent in 2003. The increased importance of trade relative to the GDP is particularly striking in the developing countries. The twenty developing countries classified by an UNCTAD paper as the most dynamic have increased their share in total world exports from 9.5 per cent in 1980 to 24.3 per cent in 1998.<sup>4</sup> This is all the more impressive in view of the large growth of exports.

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<sup>2</sup> Financial market integration implies that securities of the same risk and characteristics are substitutes for each other. This would empirically mean that the uncovered margin theory should hold. The empirical tests, however, show that the margins are exceeded in most cases. Nonetheless, the violation of the condition does not run wide margins. One can conclude that financial market integration is high but less than perfect. For a review of the evidence see Daniels and Van Hoose 2002, Chapter 6, pp. 171–189.

<sup>3</sup> IMF 2003a, table on p. 201.

<sup>4</sup> Akyuz 2003, Chapter 1, p. 8.

In the exchange of human resources, the movement of labour across international borders, legally or illegally, together with the growth of immigration from poor to rich countries have reached such levels that immigration has become an explosive political issue in all the recent political campaigns of Western Europe. In the United States, a traditional country of immigration, the increased scale of economic immigration is beginning to be a standard feature of political campaigns and is heavily exploited by politicians in quest of electoral gains.

In the investment-cum-production area, the internationalization of production is currently manifest in the phenomenal increase of foreign direct investment (FDI) in the United States, in Europe, and in some twenty or so developing countries led by China. For example, China has experienced investment inflows reaching 7.9 per cent of the GDP in 1993 and 8.1 in 2003. This has taken place against the backdrop of real annual growth of China's GDP of 8–9 per cent. In some smaller economies, like Malaysia, these inflows had reached a high of 14.6 per cent of the GDP in 1993.<sup>5</sup> After dipping in 1997 and 1998, net inflows bounced back, but have not resumed a steady pace of growth after 2001. There is also a growing subcontracting of production and a spreading of production facilities by transnational firms.<sup>6</sup>

In the finance arena, businesses have increased their recourse to international sources as testified by the increased volume of flotation of foreign bond; the increased issuance of international bonds in the Euro markets, and the increased international lending in direct and indirect forms. Moreover, big companies have substantially increased their stock listings on the various public exchanges.<sup>7</sup>

The financial institutions, led by banks, have become truly international not only in doing international financing like their predecessors have done since the nineteenth century, but in addition, by locating in various countries through sometimes outright establishment or acquisition of local banks. On both the assets and liability sides of their balance sheets, banking is now international: loans and deposits are denominated in different currencies originating from and going to different points of the globe.

Just as telling perhaps but more typical, is the increased convergence of economic policies of governments. This is the result of several factors. First the complete triumph of the liberal model has narrowed the scope of choice in economic policies. All countries want to be seen pursuing the right policy model. Second is the emulate-thy-competitor syndrome. Countries match the concessions and benefits given by their competitors to foreign investors and transnational firms in order not to suffer a comparative disadvantage. Third is the relative short time the world has had to fashion policies based on some variations on the orthodox liberal model. The policy convergence however is stronger among smaller economies than the big ones because the big economies quite frequently pursue policies dictated by short term expediencies.

The spotty results of the government controlled model, already clear in the 1980's, and the collapse of the socialist economies in 1989, have brought about an almost universal acceptance of liberal and open market organization and a semi-consensus on economic policies. A rather extreme version emerged in the so-called "Washington Consensus". This was so called after the meeting in Washington of economists with views concordant with those of the IMF (the Fund) and the World Bank as to what model of economic policy to follow. Notwithstanding the challenge to this consensus by various other

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<sup>5</sup> See Woodward 1996, Table 3.1.

<sup>6</sup> UNCTAD, *World Investment Report 1996* and *2003*.

<sup>7</sup> For details see UNCTAD *World Investment Report 2003*, and previous issues.

economists,<sup>8</sup> there is a wide convergence of views today on what are bad policies and a spectrum of accord on what are good ones.

## **B. The problems and challenges of globalization**

If globalization is a non-stoppable train as many argue, it seems to be a rather selective one in admitting passengers aboard. Economies having skilled and educated manpower and endowed with well developed production and marketing capacities can get on board and be able to reap significant benefits if they have developed financial systems and access to technology. It is a system where the benefits accrue only to the capable and prepared. Those who do not have the products and services to sell or the means to market them will assuredly be left on the platform. The same is also true for individuals who have not invested in their human capital and have not obtained the requisite skills for global employment market. Thus, we are faced with the phenomenon of marginalization of people, of firms and of countries. The global system confers a large rent differential upon the participants and applies exclusion to non-participants.<sup>9</sup> Unless the means to spread around wealth and prosperity are built into the phenomenon of globalization, it will become the domain of the already established, of the capable and the skilled. Consequently, enabling capacity building in trade, technology and human capital is an important issue in the debate on globalization. Unlike export orientation, globalization involves the entire resource base and know-how of the economic agents. Thus, participatory capacity is an important issue.

Faced with the reality of the requirements of the global economy, Nation States confront a host of problems. They have to accept the relative loss of sovereign control and the erosion of the fiscal base if they want to keep up with competitors who grant tax holidays and waive social charges. At the same time, in order to enter into or to keep their presence in the global system they are forced to increase expenditure on infrastructure and education. To all these must be added the consequence of accepting global openness: national governments must install domestic safety nets to diminish the casualties of globalization – be it firms, banks or workers – if they are to maintain the social compact and preserve civil peace. These are contradictory demands on national governments.

Another problem concerns the timing and location of the short run benefits and losses in the trade sector. While the countries with higher wages and more exigent environmental standards stand to lose jobs as businesses shift some branches of industry toward cheaper locations abroad, higher paying jobs have not followed the lost ones in the short run. The theory of international trade asserts that higher value added jobs would replace the lost ones. But the theory does not have a clear timeline for working out of comparative advantage; it has always assumed that the replacement technology is

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<sup>8</sup> Joseph Stiglitz, the Nobel laureate, is a leading critic of the Washington Consensus. This has come to represent the collective views of many economists gathered around the Bretton Woods institutions, as to what should be the correct model of economic policies. Stiglitz and others like him do not agree that the liberal model followed by the IMF and the World Bank, is applicable in every case, and if so in the same way. On this view, it is argued that country specific circumstances and the complexity of the development process would call for nuanced and multi-dimensional paradigms that are suited to the particularities of various countries. In particular they disagree with the Consensus regarding the role of Government and the unadulterated application of the liberal model (Stiglitz 2002). Dani Rodrik of Harvard University expresses amazement as to how the IMF can still maintain a one-fit-all model, now that we begin to understand how and why things work in some countries but not in others (Rodrik 1999).

<sup>9</sup> This evaluation of globalization is not accepted by everyone. There are some who argue that in some areas like agriculture poor countries would stand to reap great benefits from globalization. However, the research on the implications of removing the European agricultural subsidies CAP shows that not all poor countries stand to benefit from it. The example of Bangladesh in textile is brought up to bolster this view for industrial sectors. The author holds that the case of Bangladesh presents a country well prepared in one specific area and is not in contradiction with the position of this paper. See UNCTAD 1996b and UNCTAD 1996c for a general summary of globalization and its implications. For a nuanced view, see Rodrik 2002, 1997a, and 1997b. For a non-critical view, see Bhagwati 2004. For a rejectionist view see Cavanagh and Anderson 2004.

available and the costs of conversion, in particular labour retraining, are insignificant. Obviously this is not so when replacement technologies are the private property of businesses which no longer have national allegiance and will use the technology and locate the jobs where they make the most profit. In today's world, the major concern of businesses is the overall global bottom line and the increase in the wealth of the stockholders.

The empirical evidence on industry replacement is hardly clear-cut in the short run. In the United States, evidence for the period 1992–2004 shows that the number of jobs that were lost is less than the number of jobs newly created.<sup>10</sup> This is true for the given period, but not necessarily true for a particular year. In the short run, job replacement seems to carry with it some complications. First, even when international firms own or have access to new technology, the relative cost difference between different locations might tempt them to relocate some jobs abroad. There is evidence on that in the low white collar jobs such as software and high information skill jobs. Countries such as India, which have invested in education and developed a large and surplus stock of skilled manpower, have succeeded in attracting lost jobs from global businesses on account of their low wages. Traditionally, wage levels and productivity gains have moved together. However, with openness it is possible that higher productivity might be associated with lower wages for skilled unemployed workers in a different country. We have therefore a break in the observed historical association between wages and productivity across countries with different cost of living. The historical pattern of investment in education is now playing a large role in the working out of the law of comparative advantage.

Second, the new jobs generated in the United States have an average hourly pay that is lower than the jobs lost. In fact, quite a number of the new jobs are in the services sector, with lower productivity and lower wage rates, than lost manufacturing jobs. For example the average hourly wage in some of the fastest growing service jobs, the food industry, is \$10.64 with a median of \$8.98 per hour, as compared to \$18.07 mean and \$17.10 median hourly wages for the lost jobs in production, construction and extraction works.<sup>11</sup> To be sure, information technology will eventually decrease its cost per unit thereby raising productivity in the service branches; but that will essentially be in the long run.

Third, surveys indicate that better paying replacement jobs at the higher end of wages in the services industry require higher information technology and education contents than the educational attainments of the replaced workers. On the other hand, available replacement jobs in the same sector, e.g. manufacturing, turn up in processes of considerable electronic and information complexity.<sup>12</sup> These two empirical observations mean that considerable personal retooling and educational development may be required to replace lost jobs. That would increase the cost of job retraining and even put replacement jobs beyond the reach of many former older workers. Hence, the simplistic application of the principle of comparative advantage would mask the significant losses to workers in the short run in particular countries.<sup>13</sup> Consequently, there are transitional costs to job migration that continue to be borne by displaced workers.

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<sup>10</sup> United States Department of Labor 2004a.

<sup>11</sup> United States Department of Labor 2004b.

<sup>12</sup> Raushenberger 2005.

<sup>13</sup> For a discussion of the empirical evidence in the United States on job losses and creations, and for a rather traditional free trade argument see the Economist, 14 February 2004. In this context, it is to be recalled how Greg Mankiw the top economic advisor to President Bush, received very cool reception from both parties in Congress when he used traditional comparative advantage to defend free trade and the NAFTA. For further discussion on the evidence see Glyn 2005. UNCTAD, using earlier data, also had reached similar conclusions (UNCTAD *Trade and Development Report 1995*).

There are also costly structural impediments to the transition to new jobs. Politicians and labour unions are highly adept at juxtaposing these costs to the immediate benefits accruing to the economies in which the new jobs are located. As a result of this non zero-sum country outcome, there has been a loud cry about the hollowing out in the United States. The risk of creating significant constituencies in democratic countries opposed to globalization, as witnessed in Genoa and Seattle, is becoming quite high. And that would render trade issues ever more contentious and at obvious tension with the social compact. The recent debate in the United States presidential race of 2004 with respect to open trade is a case in point. The same can be said of the recent debates on the constitution of the European Union in France and in the Netherlands.

It is evident that globalization necessitates both a large degree of international cooperation and coordination and an evolved consensus on international rules of behavior and codes of conduct. The inevitable consequence is the increased role of international organizations. However, this role is not welcomed by many of the major players. Nation States, especially big ones such as the United States, are not willing to follow international rules or to accept to cede sovereignty to international bodies when that does not suit their interests or when these impede their freedom of action. Thus, we are faced with the great conflict between the need for a global system of international governance on the one hand, and on the other, the refusal of major sovereign states to accept or even contemplate on the loss of sovereign control.

Finally, the asymmetric distribution of benefits across countries is breeding theories about disguised and new forms of economic domination under globalization. Even though such views are often not empirically demonstrated, nonetheless, they are voiced by important segments in open societies, which have become permanent and non-discriminating opponents of WTO and globalization.

### **C. Investment, transfer of technology and global business**

Transnational investment in both its forms – portfolio and foreign direct investment (FDI), has become a striking feature of globalization. Net external worldwide financing has gone up from less than \$10 billion in the early 1970s to a high of \$243 billion in 1996. It receded in 2001 from these historical heights but reached an estimated \$148 in 2003 and a forecast of \$149 billion in 2004.<sup>14</sup> Portfolio investment, foreign direct investment and external borrowing all exhibit the same trend.<sup>15</sup> These impressive figures mask to a certain extent the scale of the growth of gross inflows in the net receiving countries because the data are in aggregate net terms. Despite that, the figures remain quite impressive. In some developing countries such as China, trans-border investments, largely emanating from overseas Chinese investors, have accounted for 10–12 per cent of fixed capital formation. Consequently, they rendered possible the sustained high growth of the country over the last three decades. With few exceptions in closed economies, all countries developed and developing now welcome such investments, especially in the form of FDI.

The competition for foreign investment is keen enough that countries resort to competitive concessions and stills more uniformity in macroeconomic policies to attract the investors. The potential benefits of foreign investment as a supplement to domestic savings, as a source of technology transfer in the case of FDI and as a more efficient use of savings world wide, are undeniable. But such investments raise questions for the global system. In the case of portfolio investment, the Asian crisis has graphically shown how the wave can turn around, and cause panic flights of capital engendering

<sup>14</sup> IMF 2003b, Statistical Appendix, Table 33, p. 219.

<sup>15</sup> IMF, op. cit., p. 219.

balance of payments difficulties and currency crisis in the host countries. The work of Eichengreen cited below shows that such crises are usually at a scale much beyond the host country capacity to handle.<sup>16</sup> In the case of Latin America, the portfolio investment that poured into recipient countries, such as Argentina, did not translate into large real investment and higher economic growth; it went into the stock market and bank liabilities and subsequently disengaged with the same ease and speed.<sup>17</sup> This is essentially because there are no rules of the game or binding code on private investors except that of profit making and risk avoidance.

The Latin American and Asian crises also illustrate that there is sometimes a conflict between the interests of the investor and the host country. This is a long-standing problem raised throughout the failed negotiations of the Transnational Code in UNCTAD. Interestingly, while the UN based negotiations failed to produce a universal code of conduct, the OECD countries did succeed in approving the so called, “Guide Lines”, for their multinational corporate investments in 2000, and further approved the “Principles of Corporate Governance” in 2004. However, the question remains as to how such voluntary provisions without mandatory enforcement can become universal and binding on the transnational corporations (TNCs) in developing countries.

In this context, a world with massive cross-border flows might produce a more efficient allocation of investments; but it can also very well produce an unjust pattern in the use of international savings. It might also lead to laxity in the macroeconomic system where the global flow of investment funds undermines one particular aspect of macroeconomics discipline: – the identity between domestic savings and investments in the long-run income equation. Feldstein and Herioka have observed how the inadequate domestic savings of the United States in the 1980s did not stop the Reagan Administration from massively borrowing the savings of the rest of the world in order to finance the increase of its military budget thereby modifying the income equality.<sup>18</sup> Obviously, if global savings have to be allocated fairly, the developing countries ought to have an important share in them. In effect, there is nothing in the system that would stop a highly developed country like the United States from borrowing, *inter alia*, developing country savings if it can pay the going international market rate which is determined by the domestic interest rates of the big economies.

Another asymmetry is implicit in the agreement on TRIPS as negotiated in the WTO package. It protects the property rights of owners but does not fully address the twin issues of the impact of the protections on transfer of technology to developing countries, and the need to make possible and feasible the acquisition of drugs indispensable for public health. Quite naturally, the incidence of R&D favours the rich countries with their established capacity to develop and apply new technology and to use qualified cadres of educated people from all over the world. Since all new technology is essentially in private business hands, the TRIPS confirm the exclusion principle of the market place internationally. The AIDS crisis in Africa and the recent disputes between governments and drug companies protected by the certificates of intellectual property rights are examples in point. There is thus an undeniable need to bring the private holders of copyright, mostly the big transnationals, into some system of internationally controlled exploitation where, as a quid pro quo for copyright protection, they adhere to an internationally agreed code of behavior.

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<sup>16</sup> Barry Eichengreen in a recent paper for the Copenhagen Consensus calculates the losses from the Asian crisis at some 20 per cent of the GDP of Indonesia. He also calculates that the benefit from avoiding such crisis can save \$107 billion a year. *The Economist* cites an authoritative study to the effect that some 22 million people lost their jobs in the Asian crisis (*The Economist*, 17 April 2004, p. 76).

<sup>17</sup> See UNCTAD 1997.

<sup>18</sup> Feldstein and Herioka 1980.

Finally, the WTO system opens up the possibility of enmeshing the trade system into the investment and other subsystems in the application of trade law. Developing countries have long signalled their opposition to applying trade sanctions in disputes involving non-trade issues. By invoking the WTO dispute settlement mechanisms in non-trade disputes, the strong trading countries can exploit their trade dissuasion power (the trade capacity and the associated value of trade concessions) all across the issues; and that would create unexpected problems for those who negotiated the WTO law in good faith within the strict confines of the trading system.

#### **D. The interfacing of the national and international orders**

The establishment of the WTO revived sharply the old disputes regarding where lie the demarcation lines between the national and international domains and how they should interface. The IMF provided an early example of this tension but the WTO has escalated the debate. Its rules and obligations, and indeed the new international trade law – on the reasoning that some domestic policies have international consequences – step into areas of policy that were located squarely in national domains. Prime examples are to be found in industrial policies and agricultural subsidies, both of which violate the new WTO rules. To be sure, the essential purpose of industrial policies is to give added impetus to economic development; and of agricultural policies to impart balance to the use of the environment and to preserve certain modes of living and traditions. However, both policies are found contrary to international order because they violate the international principle of an even-playing field. In many countries, wide segments of society do not accept this encroachment upon the national sphere and place greater value on the accomplishment of the above-mentioned goals than on the rules and efficacy of the international system. Moreover, a certain historical duplicity is assessed upon the advocates of liberal trade in that many of them – Japan, the United States, the European countries and the Republic of Korea to cite some examples – have in the past practised and benefited from these same currently forbidden policies.

In the case of the IMF, certain conditionality targets such as ceilings on debt and money supply and the size of public budget are seen to be contrary to the sovereign right of governance and the self-determination of domestic affairs; governments accept them more by the pressures of need than by any conviction about their merits. The same is even more egregious in the IMF surveillance and conditionality provisions regarding countries that need Fund resources. For example, the recent Fund packages for Turkey and for Argentina get into budgets, pension reforms, privatizations, financial domestic regulations and social security – areas that countries not in need for IMF support would strictly keep under their sovereign prerogatives. It is clear that there are no ready or agreed criteria as to where the demarcation lines should be, since what might be required by international concerns is sometimes of a predominantly domestic nature and what might be done domestically could have large international implications. Nor could one make an easy trade off between the national interest and those of the international order because the national benefits are felt directly while the international ones are often felt indirectly.

## **II. THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEMS**

It can be argued that the international monetary and financial systems are the main driving force of globalization. That is manifest in the advanced degree of integration of the financial markets and the scale to which the global economy exhibits the financial and monetary interdependence of economies. It is evident that the free movement of capital affecting exchange rates and in the process, unsettling

financial conditions and economic policies, lead to boom and bust conditions and currency gyrations in most economies. It is also evident that in a global economy, the variation of economic policies and financial conditions in the major countries spill over into the small countries and overwhelm their small economies. Yet, the prevailing international monetary system was designed for the conditions of the world economy prior to the arrival of globalization.

The outstanding features of the two organizations established at Bretton Woods in 1944, namely the IMF and the IBRD and their underlying systems, can be succinctly described. The International Monetary System (IMS) was to have no resources of its own, contrary to the original proposals of Keynes and the British Treasury. It was instead based on national quotas negotiated with members upon entry, which constitute the key to resource contributions and to decision making as well as to access to the financial facilities. The IMF was to be essentially concerned with the area of current account adjustment and current account flows, though Article IV of the Articles of Agreement, provided that one of its main purposes was establishing a framework for capital exchange among members. The exchange rate system was to be initially fixed, but eventually adjustable. The United States dollar was put at the centre of the international reserve system, to be later on complemented by other key currencies.

The IBRD evolved from a post-war reconstruction agency for post-war Europe, as the name says, to a development funding institution called the World Bank, essentially concerned with developing countries. Interestingly, it was not endowed with much authority in the governance of the global financial system. Once again, the quota system was enshrined at the centre of its resources, its operations and its governance.

This system, repeatedly patched up here and there, has survived to the present day without a fundamental change in its character. To be sure, there has been many facilities added and subtracted, the resource pool has increased 12-fold, the membership more than tripled, the conditionality evolved, but still the system often has no overall cohesiveness and its various members have contradictory expectations of it.

In 1972–1974, a window of opportunity opened up to revamp the system in order to bring it up to date and render it consistent with the evolution of capital markets, the exchange rate experience, the development issues and the evolution of international trade. This however, failed again to secure consensus agreement, with the United States and Germany objecting to different sets of recommendations made by the Committee of Twenty (C20).

The reform issue was subsequently put on the back burner for more than a decade. The system has had two amendments to the Articles of Agreements: to create the SDRs as the system currency and unit of account in 1968 and to legalize ex post facto floating in 1978. In the wake of the Latin American and the Asian crises of 1997, many authorities, and even some states, called for a new architecture of the system more suitable to the global economic conditions. Many worthwhile ideas have been put forward since 1972, and particularly after 1997. However, despite all that has been said about the inadequacy of the old system under the new global conditions, there has been no official agreement on substantial reforms.

The outstanding issues in this area can be listed under the following headings: (a) the governance and regulation of the capital and monetary flows; (b) the management of financial crisis and the function of the bank of last resort; (c) the foreign exchange system; and (d) the reform of the IMF. In the



limited scope of this paper it is hardly possible to cover in depth all these issues. Nevertheless, an attempt will be made to highlight the important and interconnected aspects of each of them.

### **A. The governance and regulation of financial flows**

The Bretton Woods system provided no governance for international financial flows. Although Keynes was quite keen on the topic, the other conferees did not seem in 1944 to be much concerned about it. However, the achievement of capital account convertibility in the advanced countries as of 1959 (some four years after realizing current account equilibrium) and the subsequent development of capital markets in the 1960s, 1970s and 1980s, propelled this issue to the fore. In the wake of the Asian crisis in 1997, and the demonstrated globalization of financial markets, it could no longer be ignored.

The Articles of Agreements of the IMF contained disparate references to financial flows in Articles IV and VI. As indicated above, Article IV made the free exchange of finance among member states a fundamental objective of the IMF. Article VI provides permissibility of capital controls as long as they do not impede or restrict payments made for the current account transactions (the balance of trade and unilateral transfers). It also disallows the use of the resources of the Fund to support large capital outflows.

The concern with the growth of financial instability impelled the G7 (the group of seven major industrial countries) in February 1999 to establish the “Financial Stability Forum” with the aim of promoting international financial stability through improved exchange of information, cooperation with respect to financial supervision and surveillance, and streamlining standards and norms in the various participant countries. Naturally, this work cannot be confined to financial flows and the financial institutions, as it has direct implications with respect to macroeconomic policies, the various standards of the financial system and its judicial framework.

In each of the various areas, a key standard was established with a lead institution responsible for developing the necessary codes, rules, norms, and standards. Consequently, the BIS has over the last decade been the forum in which officials from the participating countries and international organizations, without the presence of private sector agents, have concluded numerous agreements aiming at establishing cooperative modalities for systematically collecting information on capital and monetary flows and disseminating them to members and the public. The Bank for International Settlements (BIS) has reached numerous agreements on codes of behavior such as the code of “Good Practices on Transparency in Monetary and Financial Policies”, and the same for transparency in fiscal policy. It reached agreements on financial regulation and supervision such as “The Core Principles of Effective Banking Supervision” and those of security and insurance. It also agreed on regulation standards for insolvency, for corporate governance, for auditing and accounting and principles to deal with money laundering. It also agreed to rules and procedures for the treatment of important financial concepts such as risk and exposure as well as setting up modalities of cooperation among officials of member states.<sup>19</sup> An important part of what was achieved is the collection of data and the establishment of a shared database.

Unfortunately, the private sector was not involved directly in devising the new rules and principles. Nor was it asked to share any responsibility. Further, no modalities were agreed upon to secure its

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<sup>19</sup> For a detailed discussion and analysis see Cornford 2000 and 2001.

continuous involvement in financial governance, let alone setting up a non-voluntary code of investors' behavior.

All of this work, with all its due importance, amounted in effect to organizing in the source countries the supervision of their institutions and setting up financial regulations and behavior standards for their institutions. Naturally, global financial governance involves conduct in crises, obligations on the source authorities as well as the recipient country authorities and above all, setting up proper models of conduct and codes of standards for private investors. But this was not to be, as the private sector participation remained strictly voluntary.

As noted earlier, the increased globalization of the world economy and the evolved integration of financial markets have resulted in the enormous increase in cross-border financial flows, with a concomitant increase in financial instability and frequent eruptions of financial and currency crises. No doubt the purpose of the new codes and standards is to increase financial stability and prevent, or at least, forewarn of impending crises. The implicit logic of this work is that a unified system and symmetrical rules would create systemic checks and controls.

This work has added significantly to the literature and helped to identify many of the systemic issues that have not been actively explored since the reform exercise of the Committee of Twenty (C20) in 1972–1974. However, the reluctance of a major country to take private financial flows into the official public system and accept sharing control with others over private financial participants forestalled moving these discussions outside the BIS into the IMS framework.

In this context, several other proposals have been put forward to set up a system authority to carry out and enforce financial governance since the 1980s. Some proposals suggest the creation of a worldwide supervisory and regulatory authority, the “World Financial Authority”, to regulate and supervise all institutions and markets.<sup>20</sup> Another variant more concerned with system issues and policies, developed proposals to establish a super agency over all the relevant international organizations to be responsible for the whole system: its policies, regulations, supervision and crisis management. Many specialists, including this author, have published proposals in this genre.<sup>21</sup> Another set of proposals aimed at establishing insurance schemes for international participants modelled along the lines as the United States FDIC.<sup>22</sup>

All these proposals share the aim of establishing a global authority with a global perspective and enforceable authority to deal with the application of regulations, codes of behavior, methods of controls and rules of functioning on radically different basis than the piecemeal, patchy approach of the present institutions. It is argued that the globalization of the world economy now calls for such an approach.

The test of the BIS forum achievements arrived with the eruption of the Asian crisis. Unfortunately, the system failed to anticipate the crisis. Worst still, it showed that despite the evident transparency of macro policies in the stricken countries and their appropriateness as far as the IMF prescriptions go, the crises were not prevented.

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<sup>20</sup> Eatwell and Taylor 2000.

<sup>21</sup> Sakbani 1985, pp. 149–193.

<sup>22</sup> Soros 1997 and 1998.

In application, it turned out that the new and old system measures and rules were asymmetrical as regards the source countries and the recipient ones. Most of what was put in place in the crises threw the burden on the recipients by imposing duties, restrictions on action and by providing sanctions and incentives for particular choices of policies. There were no concomitant treatment on the same basis of the institutions and the investors in the source countries. Surely the openness to the external world implied by the rules of the monetary system would mean that the monetary policies of the source countries and their financial conditions will inevitably spill into the recipient ones. Yet, there is no built-in reach to the source country policies unless they need the IMF. Moreover, while the advanced countries can, on account of the size and strength of their economies, absorb mutual inconsistencies in their respective policies, such inconsistencies unsettle the recipient economies, being small and underdeveloped.

Another problem concerns the treatment of the private sector. Since private investors and speculators in the source countries are responsible for the bulk of the financial flows, the voluntary character of the application of the established rules and codes to them stands in stark contrast to the summons to obey with consequent sanctions addressed to the recipient and their private concerns. A code of behavior for investors would be an enormous development. However, there are several objections to such a binding code. The first argues that it is exceedingly difficult to enforce it. The second is an efficiency argument about the distortion of allocation of international investment funds in the case of involuntary controls. The third concerns the deterrence to capital movements it might bring about, in particular, inflows to the poorer countries. The fourth is the desirability of avoiding bureaucratic decision making and conflict of jurisdictions in case of crisis. The counter arguments are familiar from the work of the BIS and the literature on capital controls and the Tobin tax.<sup>23</sup> Briefly, it is argued that feasibility is an open empirical question; that the efficiency argument assumes that a code-free system is optimal and is already in place and that the fear of bureaucratic conflicts is exaggerated.

On balance a universal code applied by all and enforced by an impartial international authority such as the IMF should be feasible. It should have minimal rules and be invoked only when there is a system risk. Models of such a code have been under study and development in the BIS and the Financial Stability Forum over the last five years.<sup>24</sup> It would seem that the basic contribution of such a code lies, besides the profit motive, in setting a reference model for voluntary investor behavior.

Upon examining these rules, codes and standards, one cannot escape the impression of an implacable liberal character. There is insistence on openness under all circumstances and on currency convertibility at all times. The recipient countries are admonished if they violate the tenets of the system but the source countries whose policies are at least partially responsible for the problems are not addressed. It is difficult not to conclude that the diagnosis of the problems and the remedies are lopsided; often they compensate for inefficacy by increasing restrictions. The highly audible censure voiced out in respect of Malaysia when, contrary to the Fund's prescriptions, it abandoned temporarily unrestricted openness and convertibility and imposed temporary capital controls, cuts a poor figure of the open-mindedness of the prevailing financial governance. Finally, there is a serious concern that all these regulations and rules are gradually, but surely seeping into IMF conditionality.

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<sup>23</sup> Schmidt 2000, Akira et al. 2000, Kaplan and Rodrik 2001.

<sup>24</sup> On investor's code of behavior, see, Financial Stability Forum, *Compendium of Standards*, in <http://www.fsforum.org> and BIS 2005.

## **B. The management of financial crises: the bank of last resort**

This topic is intimately related to that of the International Reserve System. Without a reserve system which has its base in the Fund, any arrangement will ultimately depend on the political decisions of the dominant Fund members in accepting or not to fulfil this function. In the event, this function is exercised on a case-by-case basis. In other words, it is not an established and regular system function. And it will not be a system function until and perhaps unless the IMF has the capacity, like any national monetary authority, to initiate action on its own with its own resources in its capacity as the custodian of the international monetary and financial systems. For this reason the first amendment to the Articles of Agreement in 1968 introduced the SDRs as the base of the system. However, despite much improvement in their characteristics and much extension in their use within the Fund, SDRs have remained a mere 2 per cent fraction of international reserves. The last time one heard of the SDRs was in 1994 when M. Camdessus, the Managing Director of the Fund then, proposed a third issue of the SDRs destined primarily to the newly joint Eastern European countries. That proposal was scuttled by the developing countries who objected to the preferential treatment accorded to the new members. Politically speaking, the issue remains on the back burner and for the time being, there seem to be no advocates.

From inception, the IMF was created without resources of its own. Even prior to the Bretton Woods, the Keynes' vision of an autonomously financed Union with flexible and discretionary resource base was abandoned in view of opposition by the United States. In its place, the United States concept, articulated by Under-Secretary Harry Dexter White, was to enshrine an institution based on a resource pool contributed and controlled by the countries with majority quotas. Consequently, the IMF resource base and its modalities of decision making have been unsuited for this role from inception. Thus, the new global conditions in financial and currency markets have thrust the institution into areas for which it has no adequate resource base independent of the political decisions of its major members. Experience has shown these countries to be willing to act only on case-by-case basis with full regard to their political links to the countries involved.

Nonetheless, the frequent occurrence of financial crises and the fact that the IMF is the only institution with a semblance of a supranational central bank have brought up this topic with a surprising vigour. In recent years, several proposals have been formulated to deal with this lacuna, the most ambitious of which is the proposal of the Meltzer Commission set up by the United States Congress. There are also a host of published contributions to make a case for this role.<sup>25</sup>

There are a number of issues to be pointed out in this context: some political, some institutional and some technical. The lender of last resort role requires not only resources, but enforceable control on all countries as well. It is doubtful that an international consensus on granting an international institution such powers will emerge in the near future. The institutional issues involve a radical transformation of the IMF functions and its concept of international adjustment. Very specifically, the IMF has to adopt a global vision of the pattern of adjustment of the current accounts, i.e. which countries have to adjust and what size deficits (or surpluses) can the system tolerate. This cannot, of course, be isolated from a global perspective of the positions of the capital accounts and their evolution. This realization has led the major countries, in particular the United States, to propose moving the Fund into the capital account area. In fact, the Meltzer Commission suggests substituting a capital account role for the present practice of emphasizing the current account.

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<sup>25</sup> Fischer 1999.

The other institutional matter is to revamp the surveillance function so as to apply it to all countries whether they are in need or not of Fund resources. The technical issues concern the fashioning of an operational model for contra-cyclical policy and its operational procedures. Other technical questions concern measuring the degree of country risk, placing limit on the size of a country loan in terms of some valid yard stick such as the GDP and the conditionality to be applied and last but not least, the obligations of the private sector if it is involved.

Under the pressure of circumstances, the IMF has become involved in handling financial crises in the last decade. The cost of crises is such that the systemic dangers of losses of 9–20 per cent of the GDP of the affected countries could not be ignored. Nevertheless, the emphasis has been on rescue operations rather than on preventive *ex ante* action. Towards this end, two facilities were established: the Supplementary Reserve Facility and the Contingency Reserve Facility. The first is to help countries already in crises while the second, which did not endure, is to prevent or to anticipate them.

The crises in Asia and in Latin America have informed our judgement of their salient features and provided examples of the kind of policy packages on offer in the system. The crises were of two varieties: financial and debt payment. In order of magnitude, the former are much more important than the latter even though they are less frequent. Except for the asymmetrical emphasis on the debtors and the failure to involve the private sector on non-voluntary basis and the absence of standstills, the rules of debt working out call for minor changes. In this context, note ought to be taken of the proposal on working out the debt crises made by UNCTAD in 1986 and brought up again in the UNCTAD 1998 *Trade and Development Report*. It involves imposing a standstill and the application of procedures similar to those in Chapter 11 of the United States code, in restructuring and recapitalizing, under proper supervisory authority, illiquid firms. It is a proposal which still merit attention today. The situation, however, is quite different in financial crises.

The financial crises in Asia and Latin America have some common features and similar sequences. They were predominantly crises in the financial system. In the majority of cases in Asia, there was no macroeconomic policy mismanagement signalled by the Fund in its prior surveillance consultations with the members. Typically, there was a malfunctioning domestic financial system interacting with the typical behavior of the open international financial system. Usually, the start is ignited by banks carrying on their books a great deal of large assets that are non-performing. This leads in short order to failure of the banks to cope with servicing liabilities denominated in foreign exchange. Swiftly, a currency crisis explodes and the balance sheets of the banks and other institutions suffer severe deterioration in their domestic currency net worth. The swift and simultaneous reaction of creditors to these developments ushers in a country balance of payments crisis and usually requires severe adjustment. The crisis soon propagates into all sectors of the economy and spills over into other countries by, *inter alia*, altering the risk perception of international investors. The international official system then becomes involved to stem possible systemic risk. As a result, rescue packages would be negotiated with the stricken countries. These seem to have some important common features.

It is fair to say there have been some important shortcomings to the rescue packages. The first is that a compulsory role for the private sector is usually not there: creditors are invited to participate voluntarily in implementing the package. Clearly, such participation is a cardinal requirement especially when large private debt sums or significant foreign owned liabilities are involved. The second has been the one-sided emphasis placed on the stricken countries and not equally on the major countries whose economic policies and conditions are also responsible in part for the crises. This creditor bias is rather incongruous; that given the degree of integration of international capital markets

the packages overlooked the monetary and exchange rates policies of the major countries and the financial developments in their economies. These major countries affect international interest rates, international risk perception and international flows of capital and shape the emergent pattern of adjustment of the balance of payments. It is to be recalled that the major countries are also more capable because of the size of their economies, than the typical stricken countries, of bearing the cost of crisis adjustment.

The third problem has been the liberal model prescriptions and the resulting selective official approbation. The example cited above, of censoring and criticising Malaysia which made one of the most successful recoveries for its non-adherence to the liberal one-prescription-fits-all philosophy as it suspended temporary cross-border capital flows, is a case in point. In this context, it is in good order to recall the disastrous consequences reaped by Mexico after its full-scale and non-graduated liberalization of its financial system. The massive movement of financial flows across the border threw the country on the ropes.<sup>26</sup> Fourth, in the crises management of Latin America and Asia, the stricken countries sought unlimited support, and, in the event, the IMF seems to have granted that. Since the private sector would be a major beneficiary of the support money, such unlimited support raises the question of moral hazard and unfairness in distributing the burden. More specifically, unless the private sector accepts to share in the cost of the rescue, unlimited support furnishes debtors with the capacity to continue servicing their debt without demanding a quid pro quo from creditors who therefore might get away without paying for the mistakes they made. By contrast the taxpayers in the rescued countries will end up paying the ultimate bill. In addition there are questions of moral hazard and system fairness with regard to countries that have not needed help in managing their affairs. There is therefore a manifest need to bar or at least limit creditors' access to IMF resources, except as a part of a debtor-creditor shared package.

The rescue packages have had some prescriptions that, in the light of the crises developments, are in need of revision. Among such prescriptions are: hiking, often by several points to double digit order, the domestic interest rates; the absence of short term capital account restrictions in general and the frequent absence of standstills in paying the debtors. The Asian crisis revealed the large size of the foreign exchange risk that faced the mal-performing financial system. It also showed a large exposure to interest rates risk and various manifestations of liquidity risk.

Examining the micro and macro consequences of the measures recommended would be instructive. For one thing, the unrestricted servicing of debt and other liabilities by the indebted financial institutions sits badly with the short term illiquid status of the rest of their balance sheets. For another, dramatic increases in interest rates, damaging to the macroeconomic performance in the first place, increase greatly the interest rate risk of debt and other fixed income securities and inflicts large capital losses on the balance sheet of banks and other financial institutions of the debtors. It should be recalled that financial institutions in the stricken countries do two types of transformations: maturity transformation and a unit of account one. The dramatic deterioration of the exchange rate increases by the same proportion the servicing of liabilities in domestic currency terms. Simultaneously, the maturity transformation results in duration gaps between assets and liabilities. Given such wide

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<sup>26</sup> Liberalization in Mexico resulted in severe pressure on the Peso which engendered large capital outflows. To stem the currency crises, short term instruments called "tesobonos" were issued to raise funds for repaying the short term debt. But these were to be repaid in United States dollars. As the Peso slid down, the domestic currency value of these mounted and Mexican reserves declined to only \$6 billion in 1995, far below the \$30 billion due debt repayments in the year. President Clinton in his autobiography describes vividly the unfolding of the crisis and the United States response to it (Clinton 2004).

duration gaps, the hiking of interest rates inflicts a net capital loss on the asset side. The result is severe deterioration in banks balance sheet that might wipe out their net worth.

This problem has recently attracted a good deal of attention. For example, Barry Eichengreen of Berkley has just published a proposal to float bonds denominated in a synthetic unit of account based on a basket of developing country currencies for choosy investors unwilling to invest except in bonds or securities denominated in key currencies. The effective exchange rate of such bonds is more stable than individual currencies. These bonds would further entice the creditor banks to carry them for reducing their exposure to country risk. He calculated that the increased premiums to be paid would be a small fraction of the cost of the Asian crises.<sup>27</sup>

There are also systemic questions which have not received due attention. These concern the criteria by which to judge whether a country crisis constitutes a systemic risk or not. Most likely, the size of the economy, the size of the debt, if that is the problem, or the probability of contagion to others, will all have to be factored in choosing the criteria. Thus a two-tier system would be created: one for the big countries and one for the small and less important ones. It would not be a small political matter to secure the cooperation and the political approval of the small countries in such an international effort.

### **C. The foreign exchange system**

The foreign exchange system used to be one of two major topics of discussion regarding the IMS in the 1960s; the other was the international reserve system. These discussions emphasized the choice of regimes – fixed or floating. After the breakdown of the old Bretton Woods system of fixed but flexible rates in August 1971 there was no official willingness to suggest radical changes in the prevailing system. The first Smithsonian agreement of December 1971 amounted to tinkering with the old parities, while the second Smithsonian in 1972 was a surrender to reality, as major currencies started floating against each other in March 1973. In 1978, the agreement embodied in the second amendment to the Articles of Agreement of Jamaica, aimed ex post facto at legalizing the status quo. The revision of Article IV on surveillance laid such vague guidelines as to amount to generalities. There was no statement of obligations, no standards to judge misalignments and no authority to enforce action on countries that are not in need for IMF resources.<sup>28</sup> It was left to macroeconomic policies to carry the burden of arriving at orderly conditions.

Most unexpectedly, the C20 did not fare much better; it recommended the same old system but with a new parity grid and some guidelines and quantitative indicators for adjustment. The failure of the C20 to come up with a solution is symptomatic of the underlying problem; to wit, the problem of the misalignment of the major currencies as a result of the underlying mutually incoherent, more diplomatically, mutually inconsistent macroeconomic policies.

Under the circumstances, the minor developing country currencies, more than half of which are tied to one of the three main currencies, suffer instabilities resulting from the mutual incoherence of the pegs. The solution on offer by the IMF New Article IV is to lay adjustment on the minor country macroeconomic policies, leaving outside the scope of surveillance, the macroeconomic policies of the major countries and their resultant exchange rates. Thus, the gyrations in the exchange rates of the major currencies have not made possible the realization of orderly conditions, the term of New

<sup>27</sup> See a summary of Barry Eichengreen's proposal in *The Economist*, 17 April 2004.

<sup>28</sup> The late Robert Triffin had similar views on Jamaica (Triffin 1976).

Article IV, and has neither saved reserves nor insulated the various economies as hoped by the advocates of floating.

The instability of real exchange rates, defined by any statistical measure of volatility, has increased under floating, thereby spilling over into developing countries, and in the event, unsettling their macroeconomic and financial conditions.<sup>29</sup> The IMF estimates that more than half of the volatility of developing country exchange rates is explained by the volatility of the real exchange rates of the G3 countries, i.e., the dollar, the yen and the Euro. It also holds that “the greater volatility of real exchange rates has been associated with greater real effective exchange rates misalignment”.<sup>30</sup>

During the past thirty years, the major currency countries undertook only two coordinated interventions following the Plaza Accord of 1985, and the Louvre Accord of 1987. In all other instances, where volatility aroused concerns, the major countries refused to intervene on the argument that intervention does not resolve the fundamental problems and that the markets are better at deciding the parities. This is an argument that rejects dealing with the manifestations of the symptoms but says nothing about how and when it will deal with the problem.

In 2003, almost half of the emerging market economies used an intermediate peg system, i.e., one of pegged but adjustable rates. According to the former chief economist of the Fund,<sup>31</sup> this is a decline from the level of more than two-thirds in 1991. Simultaneously, the proportion of countries using a hard peg (a fixed peg with narrow limits), or free-floating regimes has risen to 58 per cent.<sup>32</sup> It is not difficult to see the reason for this shift: the floating of major currencies unsettles the financial conditions of the small economies; it creates boom and bust gyrations and overshooting of their exchange rates. Against such a backdrop, the Meltzer Commission, created by the United States Congress, recommended that the Fund should encourage emerging economies to adopt either a full float or a rigid Currency Board (CB) regime. Views along with the lines of the Meltzer Commission were articulated by Lawrence Summers, the former United States Secretary of the Treasury, in the Bank-Fund annual meetings of 2001.<sup>33</sup> However, these two corner or polar solutions are not workable and, for the reasons mentioned below, might be quite harmful to many emerging economies. It would be quite useful to concentrate on developing intermediate solutions (currency pegs with wide and changeable margins) together with securing the conditions for their workability.

The proposals of reform in this area are a market basket variety of currency bands and intervention limits around them together with guidelines of misalignment, such as price movements, and quantitative triggers of action.<sup>34</sup> There are also some old but still valid proposals aiming at a system solution that can be considered politically feasible; the Ethier-Bloomfield reference rate proposal comes to mind in this respect.<sup>35</sup> What is essentially required is to have the IMF refashion its surveillance function so as to pass over the validity of the exchange rate of countries. That requires calculating fundamental equilibrium exchange rates and establishing wide margins around them. This is essential after the experiences of France, Denmark, Italy and the United Kingdom in the European Monetary System (EMS). Several policy instruments can be used to track these rates. Among such instruments are: sterilized intervention, where assets are not perfect substitutes, temporary capital

<sup>29</sup> Williamson 1983, 5:11–22 and 1979, Chapter 8; IMF 2003a, p. 94.

<sup>30</sup> Ibid.

<sup>31</sup> Fischer 2001.

<sup>32</sup> Ibid., Figure 2.

<sup>33</sup> Summers 2000.

<sup>34</sup> The proposal by Ethier and Bloomfield – the Reference Rates is still current (Ethier and Bloomfield 1975). See also the discussion in Williamson 1979, Chapter 8 - The Future.

<sup>35</sup> UNCTAD 1987.



controls and in the longer term, interest rates and monetary policy.<sup>36</sup> Naturally, an important requirement is to have an anchor either in the form of exchange rate or another quantitative policy anchor.

There have been in practice three types of solution: the Currency Boards (CB) solutions followed by Argentina and others, the regional solution following the example of the European Union, and the intermediate solution, advocated here and by, inter alia, John Williamson.<sup>37</sup> The CB solution is a short term way out for countries with credibility problems and a history of inflation. As the Argentine example shows, it leads in time to overvaluation and consequently to a balance of payments problem. It also exposes the pegging country to the external shocks hitting the country of the chosen peg without having monetary policy tools for dealing with them.

The European Union solution is promising, but requires economic policy convergence and a high degree of intra-zone openness in trade, capital and labour movement. Perhaps more important, it needs the political will to do it – a solution difficult to marshal in the absence of some specific political or economic payoffs. In Southeast Asia and the Andean group in Latin America, interest has been expressed in regional solutions modelled on the European experience.<sup>38</sup> However, no concrete actions have been taken to push such an exercise forward in Asia, and the proposal to establish the Andean Peso has not found common acceptance. The intermediate or middle solution is worth exploring; it does not seem that its political feasibility is untenable.

The system is therefore slated to continue placing the burden of adjustment on the policies and exchange rates of the minor countries leaving the three major peg currencies free to move against each other in any and whatever way it comes.

#### **D. The reform of the IMF**

There are three main issues in this area: (1) governance of the IMF; (2) the surveillance and conditionality and the reserve system together with the function of the bank of last resort. This paper has already dealt with the last topic above.

##### **1. Governance of the IMF**

The Fund governance has been a contentious issue between the developing and developed countries since the mid-1950s.<sup>39</sup> The familiar argument of the former is that the quota system is not fair as a key for decision making and access to resources. The response of the latter is that it is only normal and fair that each country's share in decision making be commensurate with its contribution to the Fund resources. Between these symmetrically reasoned positions, there is room for two considerations.

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<sup>36</sup> Many economists doubt the financial efficiency and the efficacy of temporary capital controls unless they are pervasive and isolate the economy. Others doubt any effect of intervention. Some economists hold that calculating fundamental equilibrium exchange rates is both difficult and unreliable. While it is true that intervention cannot correct fundamental problems, it can, in the short run and when assets are not perfect substitutes, have effects, thereby giving some time for policy. This author does not share the view that calculating the equilibrium rates is that difficult and it should be stressed that any rates will have to be changed in time. What is difficult politically is for the big countries, in particular the United States, to accept any surveillance by the IMF over their economic policies. It is hard to imagine the United States accepting any approbation of its current fiscal policy.

<sup>37</sup> Williamson, op cit. 1983, pp. 63–72.

<sup>38</sup> Recently, Asian countries in the ASEAN scene have expressed desire to establish a regional currency model inspired by the success of the European Monetary System. No concrete measures have yet been taken.

<sup>39</sup> See various issues of UNCTAD *Trade and Development Report*, especially 1986.

First, quotas can still be the key to fair decision power if each country is given a common minimum weight plus votes proportional to the size of its quota. This is like the system of bi-chamber representation in, say, the United States, whose purpose is to protect the small states against the majority dominance of the big ones. Second, the negotiated nature of the quota both initially and when revised makes it somewhat more of a political question than one of fairness.

There are, in my judgement, limits to this debate. The economic system is one in which states are not equal, some are certainly more economically important than others even though they all have “equal” political sovereignty. This holds in fact when it comes to the contribution of member states to the system. It also holds in economic theory in analysing big economy influence over international adjustment. The economic conditions and policies of the major countries fundamentally affect the international economy. Similarly, the effects of global economic changes are more important for the big economies. It is uncontroversial to assert that a decision by the IMF requires more the assent and active cooperation of the large economy countries than the small ones. Economic analysis explicitly distinguishes between large and small economies when it comes to the international influence of their macroeconomic policies.

There is political economy validity to the distinction made between the model of representative and that of participatory democracy.<sup>40</sup> The constituency system of the IMF enlists under the model of representative democracy. In international affairs, representative democracy is not less valid, given its conditions, than participatory democracy. By adopting the bi-chamber type of weights, one can narrow but not eliminate the distance between the two. As a matter of wise pragmatism on the part of developing countries, they should not contest the preponderance of the major industrial countries in the IMF, not just because that reflects the facts of the world, but as a matter of political strategy on their part to secure their participation in the system and their acceptance of the resultant restrictions on their actions. In return, the industrial developed countries gain system legitimacy. The value of this system legitimacy has been amply demonstrated by the foreign policy of the United States from World War II until recently. The United States has used the international system legitimacy to co-opt others to participate along their side in actions, organizations and international rules which serve their interests. A reformed and strengthened international system is largely in the interest of the weak members; if it comes to have sufficient resources and sensible authority, it will serve the interest of its small members relatively more than the large ones.

The developing countries have created two institutional modalities to strengthen their influence on the IMF: the Group of Twenty Four and the Development Committee. The G24 was established more than three decades ago by the Group of 77, which had founded the United Nations Conference on Trade and Development. It has had a good working program supported by UNCTAD and other international secretariats as well as by the service of independent experts of distinction. It is fair to say that it has had beneficial influence on the IMF and has, to certain extent, served the interests of developing countries. However, the G24 has shown a degree of institutional acculturation to the IMF and the Bank, as gleaned from the different tonality of its views regarding the operations of these Washington institutions than what is heard usually from the developing country representatives in other fora. The criticism of the Fund by the representatives of the developing countries in other fora has always had sharper and more accented tones than any thing voiced by the G24. Perhaps it would be worthwhile for the G24 to invite to some of its meetings representatives of developing countries active on monetary and financial issues in other fora to enrich its deliberations and contribute to its work.

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<sup>40</sup> Sakbani 1985, Part II.

The Development Committee was established in the Jamaica meeting of 1976 and became functional in 1978. The purpose was to bring into the Bretton Woods institutions an increased emphasis on the development dimension of their work. The Committee meets semi-annually at the time of the IMF meetings, and is attended by representatives of developing countries and relevant international organizations. At the close of the meeting, it issues a public communiqué summarizing its deliberations and conclusions. The Committee serves essentially the role of a public forum for moral suasion. It has no means to make a daily input to the IMF processes and its decision making. However, the existence of the Committee has deflected legitimate possible criticism from developing countries and served, perhaps unwittingly, to distance and undermine contributions by other organizations primarily concerned with development and possessive of operational capabilities that can be deployed assiduously in the pursuit of the work of the IMF. After more than 26 years of operation, developing countries ought to take stock of the results, and if need be, devise ways and means to revitalize and refashion the modalities of this forum

One more political reform deserves attention. Some big members, in particular the United States, have not hid their willingness to use the IMF as a tool of their foreign policy. United States officials are on record reiterating that they will help some countries they consider friendly obtaining access to the resources of the IMF, and impede countries they deem unfriendly, or on some black list, from access to its resources. This might seem repugnant to earnest souls, but is a part of world real politique. Indeed, if one were to run a correlation between the countries that have gotten big help from the IMF over the years and their degree of friendliness to the United States, the coefficient of correlation would certainly be quite high. There is no reform that can eliminate this political bias. But an IMF in charge of its resources and endowed with global authority and mission provided for in its agreement, would undoubtedly go some way towards minimizing this bias.

## **2. *Surveillance and conditionality***

Conditionality was developed by the IMF in the early 1950s to ensure the paying back of members' purchases, thereby preserving the revolving character of its resources. Some time later, in the 1960s and 1970s, a paternalistic aspect to conditionality came into evidence as the IMF meant to guide the countries under its adjustment programs towards what it regarded the correct path to equilibrium using the correct model.<sup>41</sup> In the 1980s as the debt crisis erupted in Mexico, and later on in other indebted countries, conditionality expanded beyond current account problems to cover many aspects of financial accounts and to bear on disparate aspects of domestic economic policies. The debt crisis brought domestic financial systems and policies under the purview of conditionality. At the behest of the dominant members, policy reform emerged into the forefront at the close of the 1980s and beginning of the 1990s. The Fund acting in coordination with the World Bank began to lay restrictions and performance clauses on macro and micro economic policies and the two institutions divided the enforcement work among themselves. By the 1990s, the avowed intent and priority of conditionality was placed on policy and structural reforms and new facilities were created to finance such programs. The programs suggested were all conceived within a liberal model in whose validity in all cases, the IMF has accentuated its conviction.<sup>42</sup>

The protestations of many member states and qualified experts against this cumulative accretion of conditionality prompted the International Monetary and Financial Committee (the Interim Committee) to call in 2001 on the Executive Board to refocus the conditionality on the most essential issues. So

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<sup>41</sup> For detailed exposition of the IMF programmes and conditionality, see Williamson 1982.

<sup>42</sup> See Rodrik 1999.

far, there is no indication of how far this refocusing has gone. At any rate, it has not yet resulted in noticeable changes in conditionality practices. As a matter of fact, the recent packages for Turkey and Argentina have delved into the areas of trade, social security, privatization and pension funds reform, which are in the remit of other organizations and lie in the traditional *chasse gardé* of sovereign matters.

As to the surveillance of exchange rates, it was argued above that the IMF has not covered the exchange rate policies of the major currency countries, thereby omitting one of the principal causes of disorderly conditions of developing country exchange rates. Nor has the Fund extended its surveillance remit to the macroeconomic policies of the major countries to assure that these policies are mutually consistent and their resultant exchange rates not misaligned. However, there now appears to be more concerted moves afoot to address this hiatus. Without surveillance symmetry, it would be a pure accident if the pattern of global adjustment, which depends fundamentally on the macroeconomic policies of the major countries, were such as to enable a healthy and sustained growth of the world economy.

A beneficial fallout of symmetrical surveillance is that it would subject the IMF concepts, procedures and standards of evaluation to the scrutiny of its powerful member states whose views it cannot ignore. These members will judge whether the rules and practices of the Fund Surveillance and the Fund's economic model are suitable or not. They will also determine the limits to which they will allow the institution to intrude into their domestic policies. This would be a welcome externality for the weak members who have always demanded equal treatment.

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