Ewart Williams: Globalization and the international financial institutions - issues and challenges

Address by Mr Ewart Williams, Governor of the Central Bank of Trinidad and Tobago, to the John Clifford Sealy Memorial Lecture, 30 April 2003.

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It is an honor to be invited to participate in the Clifford Sealy Memorial Lecture Series. I read a booklet of the Eight Memorial Lectures issued by the Foundation, and I got the impression that most of the lecturers knew Clifford Sealy well and they dealt with themes of Caribbean life and development, which were part of Clifford Sealy's intellectual interests.

Unfortunately, I did not know Clifford Sealy, although when I was briefly at the Central Bank in 1988/89 as Advisor to William Demas, I would often hear him make mention of their friendship, of Clifford's intellect, his literary interests and his popular bookshop.

I must also apologize for going further afield than Clifford Sealy may have liked and talking not about Caribbean issues but about changes taking place in the international economy. **My excuse is that we really have become a global village.**

What I would like to do in my presentation tonight is to take a look at some of the reforms that have been taking place in the international financial system over the past few years.

The reforms have been prompted by the rapid pace of globalization, which have spawned several financial crises. The cries of developing countries, citing a widening gap between rich and poor and increasing marginalisation, have added to pressures to reform.

Not unexpectedly, the dissatisfaction has been focused primarily on those institutions: the IMF, the World Bank and the WTO - which are considered to be at the core of the system. Forgive me if most of my references are to the IMF since it's the one that I know most intimately and basically there is not too much of a cultural difference between it and its sister organizations.

Let me first address the issue of the origins of the reform initiative. I think one can say that the multilateral agencies first got serious about reform around 1994/1995, when the global economy was blind-sided by the Mexican crisis.

Here was a country that was doing very well, had just signed on to NAFTA a trading bloc with the US and Canada: was the darling of the financial markets, receiving sizable short term capital inflows: had followed almost all the policy prescriptions of the multilateral agencies: and literally found itself in crisis because investors suddenly became uneasy about the politics, and all the capital left. The exchange rate went through the roof, interest rates went beyond one hundred percent, and the banking system collapsed leaving economic stagnation and unemployment in its wake.

What's worse, the Mexican crisis carried contagion effects and all Latin American economies began to experience capital flight and its repercussions.

I think that this was the first clear evidence of the risks of globalization and the need to rethink the policies of the international financial agencies.

Of course, after the Mexican crisis, came the Asian crisis in 1997/1998 raising new questions about globalization and IMF policies in emerging markets. Here was another case of widely recognized success stories (the East Asian miracle, you remember) that suddenly went sour.

In a way the Asian crisis undermined the mystique and the self-confidence of the IMF and World Bank as even they began to second-guess themselves. By this time, of course, developing countries, the NGO's and all the critics that always had concerns about globalization and the "Washington consensus" felt that they were vindicated: that globalization and the IMF policies were responsible for increasing poverty and the widening of the gap between rich and poor.

The massive protest at the WTO meeting in Seattle brought it all to a head and began an intensive process of soul searching among all the institutions.

Professor Joseph Stiglitz, the 2001 Nobel Prize Winner in Economics and former Chief Economist of the World Bank, and chief critic of the IMF is a strong supporter of "globalization", which he sees as a positive force that must be harnessed. He, however, also holds the view that the failure of "the

Washington consensus" contributed to increasing poverty in many developing countries and caused financial crises in emerging market economies. He cites the IMF's biggest sin as its "**market fundamentalism**". In his view, the IMF became too obsessed by a belief in the perfection of markets and the imperfection of governments. He also believed that the Washington Consensus put far too much emphasis on fighting inflation or ensuring that Western banks got repaid, "without showing feelings for the people whose lives were affected by policies".

Of course, the IMF has a different spin on what prompted reform. The Fund admits that it made some mistakes of judgement but insisted that it had nothing to do with the model, and that certainly, it **was not a case of uncaring bureaucrats serving the narrow interests of the western financial community**. The Fund would concede on hindsight that:

(i) it lacked sufficient appreciation of the workings of international capital markets and as such underestimated the speed with which funds would flow in and out of open capital markets;

(ii) with its excessive focus on fiscal policy, it paid inadequate attention to the importance of the soundness of financial systems and the propensity that these had for spreading crises;

(iii) it showed excessive zeal in encouraging countries to open up to short term foreign capital, without recognizing that the volatility of these flows could have devastating economic effects;

(iv) it could have put more emphasis on poverty alleviation and the need for social safety nets in periods of adjustment; and

(v) it needed to improve its understanding of institutions and political dynamics in member countries.

But so much for who was to blame and why.

What has changed in the way in which the Bretton Woods institutions manage the global system?

In principle, one could separate the range of reforms into two parts. You would recall my saying that from the Fund's view the main justification for reform was the fact of recurring global crises - first Mexico, then East Asia, then Russia. In these circumstances, the Fund took the view that the **first responsibility of reform was to put in place a system that offered hope for avoiding crises and of resolving them quickly when they occurred**.

The second set of reforms has had more to do with how the Fund operates - its internal procedures and its relationship with its members.

Let's first deal with the reforms to the international financial system - these come under a grandiose title of "The New Global Financial Infrastructure".

(i) In view of the evidence that a weak financial sector is an invitation for financial crisis, which invariably has an extremely high social cost, **the IMF undertook to make the focus on financial sector soundness to be a main pillar of its operations both in developed and developing countries**. Now all countries - and we here in Trinidad and Tobago are no exception - are investing significant resources in trying to identify vulnerabilities in their financial systems and taking corrective action. **The plan, here at home, to bring the insurance companies and pension funds under the authority of the Central Bank must be seen in that light.**

(ii) A second innovation to the system is the establishment of internationally-accepted standards and codes as "rules of the game" for all economies. Thus, working with other international institutions, we now have codes of good practice for monetary policy, fiscal transparency, insurance and payments systems, securities, corporate governance, accounting, statistics, bank supervision etc. We are in the process of adopting some of these standards.

(iii) A major innovation to the financial infrastructure which is now being put in place is a new mechanism for dealing with crisis countries that have acute external debt servicing problems. In the case of the Mexican and Asian crises, the Fund and the World Bank provided most of the resources and in so doing faced the criticism that they bailed out western banks. To avoid this and to preclude prolonged negotiations with creditors the international community embarked on an intense search for a sovereign debt resolution model - essentially a kind of bankruptcy court for countries. The idea is that countries in acute financial crisis can have an orderly debt workout so that they quickly start a process of recovery, not over-encumbered by debt.

As to the other changes that have taken place.

1. **The Bretton Woods institutions have become a more open transparent institution and now strongly encourage** countries to implement greater transparency: now most of the their deliberations and internal reports about the workings of the institution are published. In turn, they now strongly encourage countries to publish the IMF reports about themselves. As for the IMF (as the criticism was less so for the World Bank).

2. It has become a **more humble** institution because of its recent experience; less dogmatic in terms of its policy dialogue; **less ideological** in terms of its policy prescriptions and much more willing to listen to country suggestions. Thus, for instance, while there is a preference for **flexible exchange rates**, it is more willing to accommodate other exchange rate regimes: while it still sees merit in **capital account liberalization**, it now emphasizes to countries the potential risks of such a move. I should also note that the IMF certainly does not see exchange rate depreciation as the preferred instrument of demand adjustment as it was wont to do in the past.

3. The IMF is now insisting on "**national ownership of adjustment programmes**". This new focus on national ownership thus provides more room for the discussion of policy options and for programmes that take into consideration the social and political constraints. (A way of dealing with the "one size fits all" phenomena. But there is another implication, it tells authorities that you could no longer justify unpopular measures by saying that they were IMF impositions.

4. One major qualitative change is the recognition of the approach that "**growth with macro-economic balance may not be enough to reduce poverty**" and that often what must be added are well focused social interventions aimed at income re-distribution with this recognition.

To underscore its commitment to poverty eradication, the Fund and the World Bank recently, launched a new initiative which involved **forgiving the debt of the most heavily indebted poor countries, on condition that the resources released are allocated to poverty reduction programmes** that have been worked out and agreed between the Government and civil society. In the context of the programme, all creditors - bilateral and multilateral - are committed to provide the debt relief. It is the first instance in which the Bretton Woods have voluntarily provided debt relief to countries. As you know, the basic principle underlying these institutions is that even when bilateral creditors reschedule or forgive debt, they need to be paid, because of "the revolving character of these resources". Some thirty-four countries are involved in this initiative.

So these are what I consider to be the major initiatives that have taken place in the international financial system and its centerpiece, the International Monetary Fund.

Now you might say that these reforms don't go far enough and perhaps they don't. But I can tell you that even the Fund critics and long time Fund staff and ex-staff members, like myself, have recognized these as **quantum leaps - in transparency, in public debate, in its openness to alternative policy options, in dealing with civil society**.

I must concede that implementing these reforms, in practice, is not always as simple as it appears, and in reality presents major challenges.

Take the issue of **dialogue with civil society**. One question that arises is whether any multilateral institution **should insist that a sovereign government conducts a full dialogue with its domestic stakeholders before it adopts a policy to be put forward as part of a programme for support**. Is that respecting the sovereignty of the Government?

The issue of "**national ownership of an adjustment programme**" also presents a challenge in its practical application. The fact is that, over the years both the IMF and World Bank have become institutions run by **industrial creditors** but where the majority of the members are **developing country borrowers**. In practice, the creditor countries, would like to lend as little as possible and with a hardening of conditionality. The borrowing developing countries, on the other hand, see "national ownership" to mean, being able to choose the pace of adjustment; sometimes postponing difficult policy decisions because of their political impact; and sometimes opting for less adjustment than the imbalance requires. The fact is that the success of the programme invariably depends on the strength of policies so **national ownership cannot be an excuse for weak policies**.

The issue of ownership is also related to the reform of "**standard setting**" or best practices. I think there are obvious benefits to individual countries and to the global economy to have a set of standards or accepted rules of the game. The industrial countries, through the various international agencies, have taken the lead in setting these rules. Developing countries have, however, expressed concerns that sometimes these standards and codes are too inflexible, that they do not allow for differences in institutional development, legislative frameworks and different levels of development. **The developing countries feel that setting principles rather than rules may be more effective in ensuring compliance.**

Finally, the issue of **greater transparency** in dealings between these institutions and governments is not always as simple as it sounds. Many discussions with country officials are about confidential, sensitive issues. **Should the Fund insist that in the interest of transparency then, even these confidential issues (for example: about exchange rates, about privatization plans) are included in Fund reports and published?** If it did, then governments may not be prepared to have open candid discussions on certain issues.

In the continuing search to establish an international financial framework conducive to helping developing countries eliminate poverty, the international community, in early 2002 came up with a new paradigm which, in principle, could signal a **new partnership in international co-operation between the multi-lateral agencies, the industrialized and developing countries**.

Essentially, the agreement - called the **Monterrey Consensus** - says that if developing countries meet their responsibilities by adhering to principles of good governance, building sound institutions and pursuing sound policies, the international community (defined as the multilateral agencies and the industrial countries) should be prepared to provide comprehensive support.

The agenda of comprehensive support set for the industrialized countries included the following:

(i) **Addressing the trade issues** of particular concern to developing countries such as: opening up of markets for imports of agricultural products and labour-intensive manufacturers, the need to give special and differential treatment to developing countries and to reduce subsidies to agriculture. This is clearly within the WTO framework and would determine whether the Doha round is successful.

(ii) The agreement called for increasing the availability of IMF resources, through an increase in Fund quotas. And this is important for debtor developing countries since there tends to be a trade-off between financing and adjustment.

(iii) The industrialized countries undertook to increase Overseas Development Aid (ODA - grant assistance) from the current level 0.2 percent of GNP to 0.7 percent of GNP.

(iv) The agreement challenged the Bretton Woods institutions to improve corporate governance by increasing the participation of developing countries in their decision-making processes. Essentially, this would require a major re-distribution of shares and Board representation both in the IMF and in the World Bank. One proposal, for instance, is that since the countries of the developing world are the only borrowers, they should have at least one-half of the total shares which would give them some influence in the formation of the conditionality policies.

The evidence suggests that the industrialized countries have not started to keep their side of the bargain and this is of concern. For example, since the Monterrey Conference the US increased various agricultural subsidies and the EU postponed reducing theirs until 2006. Moreover, few of the industrialized countries have begun to make good on their commitment to increase aid to developing countries. You may be surprised to know that the level of agricultural subsidies in the EU is six times greater than the level of overseas development aid.

Nevertheless, the developing countries remain optimistic about the Monterrey Consensus which they still see as an excellent vehicle for achieving their development objectives. They are calling on the international financial institutions to set up systems to try to monitor compliance. So we will see.

Let me end with a brief summary examination of how the latest globalisation trends and the reform initiatives have impacted on the Caribbean region.

Guyana is one of the 34 countries benefitting from the programme of special debt relief for heavily indebted countries (HIPC). You would recall that the essence of this initiative was that once the country could work out a suitable economic programme with the IMF, it would be entitled to a certain measure of external debt relief. Guyana has, therefore, been getting external debt relief from the multilateral and regional agencies (IMF, World Bank, CDB and IDB) as well as from bilateral creditors. The bulk of the bilateral relief (about US$ 360 million) is coming from Trinidad & Tobago. Why? Because Trinidad & Tobago happens to be Guyana's largest creditor, through oil-facility loans extended in the late 1970s and early 1980s - during the first oil boom.

Jamaica is perhaps the country in the region that has been most negatively affected, by capital account liberalization and by the judgements of the private capital markets. Capital outflows, along with weak institutions, are cited as two important factors leading to the financial sector crisis of 1996. The restructuring of the financial sector is estimated to have cost the government some 40 percent of GDP: the recurrent interest cost of 6 percent of GDP, has seriously compromised the Government's efforts at fiscal consolidation.

The Eastern Caribbean States (the OECS) have been facing acute economic difficulties over the past few years and are confronting a very challenging economic outlook. In many respects, their situation typifies the kind of special challenge that small, developing states face, given the current rules of the international financial system.

Firstly, they are very micro states with very small quotas in the IMF and World Bank so their borrowing capacity from these institutions is fairly limited.

Secondly, because of their relatively high per capita income they are not eligible for the HIPC initiative or for concessional World Bank loans (from the International Development Association). Moreover, the little ODA (development grants) that they used to receive over the years have all but dried up.

Thirdly, as producers of either sugar or bananas, they have suffered from the secular decline in the prices received for these commodities. As you know, the preferential arrangements that they enjoyed for many years in the EU are scheduled to be unwound soon - victim of the new trade liberalization arrangements under the WTO.

These states have tried to diversify into tourism over the last several years but tourist arrivals have been down, what with 9/11, global slowdown, the Iraq war and now SARS. In addition, Cuba and the Dominican Republic have been making sizable inroads into their tourism market - **impact globalization**.

Most of them also tried to earn foreign exchange as offshore financial centers. They have now been caught by the "standards and codes" that have been set by multilateral agencies, such as the Financial Action Task Force (FATF) (concerned about money laundering and the financing of terrorism); the OECD (concerned about Harmful Tax Competition); and the Financial Stability Forum (concerned about transparency and information transfer etc.). Under this onslaught, the attractiveness of these centers has declined and their continued existence now seems in jeopardy.

All these, on top of their own home-grown problems, which have ranged from overly expansionary fiscal policies in some cases, to excessive external borrowing in others.

I must note that the Caribbean has raised its voice in the reform exercise, in particular, in pressing for special recognition for the problems of small states and for participation in the formulation of the standards and codes for the offshore centers.

Notwithstanding the reforms I have outlined, the old image of the IMF in the Caribbean has prompted several governments to avoid entering into formal financial arrangements. However, by and large, the Bretton Woods agencies are now well accepted in the region as partners for policy dialogue and as sources for capacity building. Many countries in the region now formulate home-grown programmes which are submitted for the approval of and monitoring by the multilateral agencies.

There is a current proposal in the region for a Regional Financing Mechanism (a kind of regional IMF) to fund programmes that are monitored by a regional agency, working in collaboration with the IMF or World Bank.

But, that's a discussion for another time.