The global economic system: asymmetries and inconsistencies

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Abstract

Purpose – To provide a systematic analysis of the contrasts, imbalances and suggestions for corrective action in the present globalized economic system and monetary and financial order in the framework of a conference organized by Webster University, Geneva (Switzerland) dealing with the outlook for international order.

Design/methodology/approach – The paper is divided into two parts. The first provides an overview of the general characteristics of the globalized economy, of the interdependence of national and international orders and policy making and the issue of investments, technology transfer and global business. The second part contains a more detailed analysis of the international monetary and financial order, including the evolving role of the International Monetary Fund (IMF). While the paper provides a rigorous analysis of the institutional and policy issues, the analysis and the conclusions are accessible also to the non-specialized reader.

Findings – The paper focuses on the inconsistencies and asymmetries in the working of the international economic and monetary order and of the policies of the principal international organizations with respect to different groups of countries, and in particular the advanced, developed countries, on the one hand, and the developing countries, on the other hand. The corrective measures suggested by the author are in the interests of both groups of countries and thus of the system as a whole.

Originality/value – The paper provides suggestions for improvements in the economic and monetary order of a globalised world on the basis of systematic policy analysis, anchored in economic theory, rather than political rhetoric.

Keywords International economics, International finance, International Monetary Fund, Countries

Paper type General review

The prevailing international economic order, largely an ad-hoc arrangement, is a system of facts, rules and modalities created one at a time rather than as a result of a cohesive and holistic design. Its monetary part is a transformation of the old Bretton Woods system, which came into limbo in July 1971, but was rescued by successive fixes from 1972 onwards. It remains based on the US dollar, and centered around the IMF whose mission and philosophy have evolved at a politically controlled pace. The trade part, issued essentially from the GATT, was redesigned in its scope and its law, but not in its orientation and decision making. It remains essentially based on liberal trade access, on non-discrimination in treatment and on exchange of concessions among and between members through sovereign state action with equal treatment regardless of trading capacity. Obviously, members have different powers of retaliation and different worth of concessions. A cardinal change to the GATT system is the equal treatment of all members under the same rules irrespective of their degree of development once they join, allowance being made for various periods of transition. There is only little room in this system for considering the development of trading capacities, and none for considering the development process as a deliberate goal of the international trading system. In this system, the technology part is essentially missing, and the environmental, health and labor standards are left to a case-by-case ad hoc treatment, with private participants out of the remit of the rules.
The financial system is only partly covered by the work and rules of the World Bank, an important source of development funds for the poor countries and an instrument for bringing their policies under the scrutiny of the dominant members. All the rest is left to private agents who are in the business of profit making and have no agreed code of conduct or rules of the game to follow at the risk of system sanctions.

It would do injustice to the issues involved to try to deal within the scope of this paper with all of them. Nevertheless, an attempt will be made to cover a limited number of outstanding issues currently under discussion. The paper is divided into two parts: Part I covers globalization and three sub-economic systems; while Part II covers the international monetary system and the IMF in more detail, in view of the technical nature of the issues.

Part I – the problematique of the globalization of the economic system

Globalization is manifest in four interrelated developments:

1. the increase in the international exchange of goods, services, and despite all restrictions therein, the movement of human resources;
2. the internationalization of production and real investment;
3. the relatively high degree of policy convergence among countries; and
4. the high, even though imperfect, integration of the financial markets and, to a lesser degree, other markets.

The statistical indicators of these manifestations are revealed in more than doubling the ratio of international trade to the GDP of practically all countries over the last two decades, the more or less sustained growth of international trade above that of the GDP’s by more than two percentage points on the average (IMF, 2003) and the increased trade in services as well as the galloping pace of financial services. For example, the USA, a large and relatively closed economy, has seen its trade go from a mere 9 percent of its GDP in 1970 to more than 23 percent in 2003. In the small European countries and most of the small developing countries, trade has gone up from levels in the range of 50 to 60 percent of GDP in 1970 to levels in the range of 80 to 90 percent of GDP in 2003. The increased importance of trade in GDP is particularly striking in developing countries. The 20 countries classified as the most dynamic among them have seen their share in total world exports increase from 9.5 percent in 1980 to 24.3 percent in 1998 (Akyuz, 2003). In the exchange of human resources, the movement of labor across international borders, legally or illegally, together with the growth of immigration from poor to rich countries have assumed a political moment in all the European countries. Even in the USA, a traditional country of immigration, the volume of economic immigration is beginning to raise numerous debates and is exploited by politicians in quest of electoral gains.

In investments and production, the internationalization of production is now manifest in the phenomenal increase of foreign direct investment into the USA, Europe, and some 20 or so developing countries, led by China. For example, China, whose GDP has been growing at an average of 8 to 9 percent over the past 20 years, has experienced investment inflows reaching 7.9 percent of its GDP in 1993 and 8.1 in 2003. In some smaller economies, like Malaysia, these inflows have reached 14.6 percent of GDP in 1993 (Woodward, 1996, table 3.1). After dipping in 1997 and 1998, net inflows resumed their pace of growth in 2002. The aggregate net flows have increased from less than $10 billion in 1970 to $243.1 billion in 1996 and an estimated $147.5 billion in 2003 (IMF, 2003). There is also a growing subcontracting of production and a spreading of production facilities by transnational firms.

In the finance arena, businesses have increased their recourse to international sources as testified by the increased volume of foreign bond floatations, the increased issuance of international bonds in the Euro markets, the increased international lending, direct and indirect, and the more and more frequent international listing of transnational companies’ stocks on the various public exchanges[1]. The financial institutions, led by banks, have become truly international not only in doing international financing like their predecessors in the nineteenth century, but also by locating in various countries through outright
establishment or acquisition of local banks. On both the assets and liabilities sides, banking is now international, its loans and borrowings denominated in various currencies, its scope and reach covering the whole globe.

Perhaps just as telling, but more atypical, is the increased convergence of economic policies of governments. This is the combined result of the narrowing scope of national control over economic agents; that is, the diminished sphere of exclusive national control, the triumph of the liberal order in policy making and the increased strictures of liberal openness on official entities. The poor results of the interventionist model, already clear in the 1980s, and the collapse of the socialist economies in 1989 have brought about almost a universal acceptance of liberal and open market organization and a semi-consensus on economic policies. Notwithstanding the recent challenge to this consensus, there is a wide convergence of views today on what are bad policies and a spectrum of accord on what are good ones.

The challenges and problems of globalization

If globalization, as many say these days, is a non-stoppable train, it seems to be a rather selective one in admitting passengers aboard. Economies endowed with well-developed production capacities and international marketing networks, with access to new and advanced technologies and to reliable financial resources, and possessing skilled and educated cadres, can get on board to reap significant gains. It is a system where the benefits largely accrue 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 in the station. And the same is true for individuals who do not have the human capital and requisite skills for global jobs. Thus, we are faced with the phenomenon of marginalization: it is true for people, for firms and for countries. The global system confers a rent differential upon participants and applies the exclusion principle to non-participants. Unless we can build into it the means to spread around the benefits, it will become the domain of the already rich and capable, the skilled and educated. Capacity building thus emerges as an important issue.

Faced with this reality, national states face 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 wave social charges. At the same time, they are forced to increase their expenditure on infrastructure and education to enter or keep their presence in the global system. To this must be added the systemic consequence of accepting global openness: national governments must extend a safety net for taking care of the casualties of globalization, be it firms, banks or workers, if the system is to maintain social concord and preserve domestic social peace.

Another problem concerns the timing of the incidence of short run benefits and losses. While the countries with higher wages and more stringent environmental standards stand to see in the short run a shift of some branches of industry abroad, it does not seem clear that higher value replacement industries are following on their heels. The theory of international trade does not have a clear timeline for the working out of comparative advantage; it has always assumed that the replacement technology is available and the costs of conversion, in particular labor retraining, are insignificant. This is all the more difficult in an environment where private business is the owner of the requisite technologies and has largely become so without national allegiance and with a dominant concern for its global operations bottom line. The empirical evidence on industry replacement is not clear-cut in the short run. Consequently, there are transitional costs to job migration borne for a while by displaced workers in one country and immediate benefits to the newly employed in a different country. Consequently, the national sum is often not zero (Sakbani, 2004). This risks creating opposed constituencies in democratic countries, thereby rendering trade issues contentious and at obvious tension with the social compact. The current debate in the US presidential race in respect to open trade is a case in point.

It is obvious that globalization necessitates 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. National states, especially
big ones such as the USA, are not sanguine about following international rules and accepting to cede sovereignty to international bodies when that does not suit their interests or impedes on their freedom of action. Thus, we are coming on a great conflict between the need for a global system and the political acceptance of major sovereign states of its inevitable restrictions.

Finally, the asymmetric distribution of benefits across countries is breeding conspiracy theories about disguised and new forms of economic domination. Even though such views are often without foundation, and in many respects contrary to long-term economic reasoning, they are, nonetheless voiced by important segments in open societies. These have become permanent and non-discriminating opponents of globalization.

The interfacing of the national and international orders

The establishment of the WTO revived sharply the old problem of where lies the demarcation between the national and international domains and how should they interface. The IMF was an early example of this tension, but the WTO has escalated the debate. The rules and obligations of the trade organization, and indeed the new international trade law, step into domains of policy squarely in the national domains, but have international consequences. Prime examples are proffered by industrial policies and agricultural subsidies. To be sure, the essential purpose of industrial policies is economic development, and of agricultural policies environmental balance and the preservation of certain modes of living and traditions. However, both policies are found contrary to the international order because they violate the international principle of even playing field. There are wide segments of modern societies that do not accept this encroachment on the national sphere and place value on the accomplishment of their goals. Moreover, there is a certain historical duplicity assessed upon the advocates of liberal trade in that many of its current advocates, e.g. Japan, the USA, European countries and South Korea, to cite some examples, have in the past practiced and benefited from these 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 auto-determination in domestic affairs. Governments accept them more as a result of pressures than by conviction about their merits. The same is more evident with respect to the IMF surveillance of macroeconomic and exchange rate policies of countries needing the Fund resources and its conditionality packages. For example, the recent packages for Turkey and Argentina contain restrictions on budgets, social security, pension funds, privatization and so on. It is clear that there are no ready or agreed criteria as to where should the demarcation lines be. Nor could one make an easy trade off between the national interest and the international order interest because the national benefits are direct and the international ones are indirect.

Investment, transfer of technology and global business

Transnational investment has become a striking feature of globalization. Foreign direct investment (FDI), portfolio investment and net bank lending all exhibit the same rising trend. According to the IMF, net aggregate external finance has gone up from less than $10 billion in the early 1970s to a high of $243.1 billion in 1996 and an estimated $147.5 billion in 2003 (IMF, 2003, table, p. 219). In some developing countries such as China, trans-border investment has greatly contributed to the explosive growth of the country over the last three decades. With few autarkic exceptions, all countries, developed and developing, now welcome this investment, especially in the form of FDI. The competition for foreign investment is keen enough that countries resort to competitive concessions and more and more uniformity in macroeconomic policies to attract investors. The 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 investment raises 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 balance of payments difficulties and currency crisis in the host countries at a scale much beyond their capacity to handle[2]. In the case of Latin America, 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 banks, and disengaged with the same ease and speed (UNCTAD, 1996). This is essentially because there are no rules of the game or binding code on private investors except that of profit making.

In these crises, international public money was put in the safety net laid out by the IMF and the World Bank to protect the countries and the creditors all the same. Yet this might have been avoided if the architecture of the international monetary system were different and if some kind of code of behavior for investors, together with instruments to deal with such crises, were built into the system. The liberal order in place calls for remedies based on policies of continuing openness made possible by astronomically high interest rates and massive balance of payments support funding. This of course is not available to every country, nor possible if the crisis involves several countries at the same time. The ensuing corrections take place in weak economies, bereft of a substantial portion of their previous GDP level. Ironically, the Asian adjustment shows that Malaysia was one of the most successful countries in recovering from the crisis despite violating the tenets of the IMF recommendations and imposing temporary controls on capital movements. In other words, the recipes did not fit all and were not necessarily the best in the trade.

The Latin American and Asian crises also illustrate the fact that there is sometimes a conflict between what investors want and what the host country deems to be in its best interest. This is a long-standing problem raised throughout the long but failed negotiations of the Trans-National Code in UNCTAD.

The global flow of investment funds undermines one particular aspect of macroeconomic discipline: the identity between savings and investment in the income equation. As Stein and Herioka have shown, the inadequate domestic savings of the USA in the 1980s did not stop it from borrowing massively the savings of the rest of the world to finance the expansion of its military budget. Yet, if global savings have to be allocated efficiently, the developing countries ought to have an important call on them. There is nothing in the system that would stop a highly developed country like the USA from borrowing, inter alia, developing country savings if it can pay the market rate.

The agreement on the TRIMS, negotiated in the WTO package, protects the property rights of the owners but does not fully address the twin issues of the impact of such protections on the transfer of technology, especially to developing countries, and the need to make possible, indeed feasible, the acquisition of drugs indispensable for public health. Quite naturally, the incidence of R&D favors 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 of the new technology is essentially in private business hands, the TRIMS confirms 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 intellectual property rights trade-mark certificates, are examples in point.

Finally, the WTO system opens up the possibility of enmeshing the trade system with the investment and other sub-systems in the application of the trade laws. Developing countries have long signaled their opposition to applying trade sanctions in cases of disputes involving non-trade issues. By invoking the WTO dispute settlement mechanisms in all disputes, the risk is that strong trading countries can exploit their trade dissuasion in non-trade matters. And that would create problems which the negotiators did not bargain for.

Part II – the international monetary and financial systems

The international monetary and financial systems are perhaps the most important driving force for globalization. That is not merely in terms of manifestation, but in the extent to which the global economy affects different countries unevenly and distributes the burden of adjustment unequally. It is evident that the free movement of financial flows, in and out, unsettles the exchange rates especially in the smaller economies and that the variation of macroeconomic policies in the major economies affect strongly the economic conditions in the small ones in the new global setting.
The current international monetary and financial arrangements are pragmatic evolutions of the old Bretton Woods system. The New Hampshire meeting, via its three committees, sought to establish three bodies, respectively responsible for the international monetary issues, the financial issues and the trade issues. In the event, the reports of only the first and second committees were approved, and the result was to establish only the IMF and the IBRD. The complexity of the topics thrashed out in the third committee made it advisable to refer the trade matters to a subsequent conference to be held in a year’s time in Havana, Cuba. The Havana meeting did indeed take place in 1947, but the US Congress objected to the provisions of its proposed agreement, and consequently, the proposed International Trade Organization did not come into being. In its place, a provisional trade organization, called the GATT, was established in 1949 on the basis of chapter four of the Conference report. The GATT was meant to be temporary until an agreement was reached on the prospective ITO. However, it proved difficult to reach an accord during more than 15 years of intermittent discussions, and thus, developing countries pushed in 1964 for the creation of a development-trade organization to complement the GATT, as a conference of the UN General Assembly, which came to be known as UNCTAD. This two-legged trade arrangement lasted until the coming into effect of the WTO.

The outstanding features of the two related organizations of Bretton Woods, 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, as Keynes had proposed. It was to be based on quotas which constituted the key to its resources, its decision making and access to its financial facilities. The IMF was to be 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 to establish a framework for capital exchange among members. The exchange rate system was to be primarily fixed, but eventually adjustable. The US dollar was at the center of the international reserve system, to be later on assisted by other key currencies.

The IBRD evolved from a post-war reconstruction agency for Europe to a development funding institution concerned with developing countries without much authority in the governance of the financial system. Once again, the quota system was enshrined at the center of its operations and governance.

This patched-up system has survived to the present day with pragmatic touches here and there but without a fundamental change in its character. There has been many facilities added and subtracted, the resource pool has increased 12-fold, membership almost tripled, conditionality evolved, but no radical change was effected. In 1972-1974, a window of opportunity opened to revamp the system in order to bring it up-to-date with the evolution of capital markets, the exchange rate experience, the development issues and the evolution of international trade. This failed again to secure common agreement. The reform issue was subsequently put on the back burner to flutter about now and then, but without being systematically taken up again. The system has had two amendments to the Articles of Agreement:

1. to create the Special Drawing Rights (SDRs) as the system currency and unit of account; and
2. to legalize *ex post facto* floating.

In the wake of the Latin American crisis and the Asian crisis of 1997, many authorities, and even some states, called for the reform of the system. Many worthwhile ideas have been put forward since 1972, and particularly after 1997. Much has been said about the inadequacy of the old system under the new global conditions. However, there has been no official agreement on substantial reforms.

The outstanding issues in this area can be listed under the following headings:

- The governance and regulation of capital and monetary flows.
- The management of financial crises and the function of the bank of last resort.
The foreign exchange system.
The reform of the IMF.

It would be quite impossible to cover in depth all these issues in the limited space of this paper. Nevertheless, an attempt will be made to highlight the important aspects of each of them.

The governance and regulation of financial flows

The Bretton Woods system had no governance of the financial flows. Although Keynes was quite keen on the topic, the other conferees did not seem to be much concerned about it in 1945. The achievement of capital account convertibility in the advanced countries as of 1959 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 Agreement of the IMF contained disparate references to financial flows in Articles IV and VI. As indicated above, Article IV made the free financial flows among member states a fundamental objective of the IMF. Article VI provided permissibility of capital controls as long as they did not impede or did not restrict payments made for the current account transactions. It also disallowed the use of the resources of the Fund to support large capital flows.

In the last decade, the Band for International Settlements (BIS) has been the scene of numerous agreements and discussions aiming at collecting information on capital and monetary flows on a systematic basis and disseminating them to members and the public. Its forum has reached numerous agreements on codes of behavior, standards of supervision and control of financial institutions. 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 (Cornford, 2000). These have straightforward implications on macroeconomic policies, financial regulations and supervision, accounting and auditing standards and the legal systems of insolvency and liquidation. But all of that, with all due respect to the work, has neither forewarned of the Asian and Latin American crises, nor prevented them from happening.

The increased globalization of the world economy and the evolved integration of financial markets have resulted in an enormous increase in financial flows across the borders of developed and numerous developing countries. A concomitant increase in financial instability and frequent eruptions of financial and currency crises were to be expected. The renewed interest in how to prevent crises and how to handle them has produced various proposals from disparate sources. They have 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 C.20 in 1972-1974. Some proposals suggest the creation of a worldwide supervisory and regulatory authority, the World Financial Authority, to regulate and supervise all institutions and markets (Eatwell and Taylor, 2000). 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. The author of this article published a proposal in this field in 1985 (Sakbani, 1985). Another set of proposals aims at establishing insurance schemes for international participants modeled along the same lines as the US FDIC (Soros, 1997, 1998).

All these proposals aim to establish a global authority to perform with a global perspective and vision endowed with enforceable authority to deal with regulations, codes of behavior, methods of controls and rules of functioning on a 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.

As indicated above, the IMF and the BIS have indeed put in place in the last decade a sundry of codes, standards, rules of treatment as well as means of institutional enforcement for international financial governance. In addition, an information base was developed...
together with its channels of communications. However, in practice, these measures and rules were applied unequally as to the source and recipient countries. Most of what was put in place puts the burden on the recipients by imposing duties, restrictions on action, sanctions and incentives for particular choices, without concomitant treatment on the same basis of the institutions and investors in the source countries. Since private investors and speculators in these countries are responsible for the bulk of the financial flows, the voluntary character of their application of established rules and codes, stands in stark contrast to the summons to obey with consequent sanctions addressed to recipients. There is also serious concern that all these measures and rules are gradually, but surely, seeping into IMF conditionality.

Examining the common aspect of these codes, rules and regulations, one cannot escape the impression of their implacable liberal character; there is insistence on openness under all circumstances and on currency convertibility at all times. The contagion of the policies of the source countries is coupled with a restrictive choice of remedies sanctioned by the liberal system. The highly audible censure directed by the IMF at Malaysia for choosing policies different from the Fund’s prescriptions, in particular the condemnation of the temporary suspension of full freedom of cross-border financial flows and currency convertibility, cuts a poor figure of the openness of mind in the prevailing financial governance.

Several problems stand out in what has been done: first, the detailed rules seem to place an asymmetric burden on the countries in crisis without anything regarding the unstable and often inconsistent monetary and exchange rate policies of the advanced countries. Surely the openness to the external world implied by these rules 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 countries. Moreover, while the advanced countries can, on account of the size of their economies, absorb mutual inconsistencies in their respective policies, this unsettles the recipient economies, being small and underdeveloped. Second, the private sector compliance is basically voluntary without any enforcement teeth in the source countries.

The management of financial crises: the bank of last resort

This topic is the flip side of the coin of IMF reform. Naturally, it is intimately related to the topic of the international reserve system. Without a proper reserve system with a base in the Fund, any arrangement will ultimately depend on the political decisions of the dominant Fund members in fulfilling or not fulfilling this function from case to case. In other words, it will not be a functioning system until, and perhaps unless, the IMF has the capacity to initiate action as a custodian of the international monetary and financial systems. For this reason, the second amendment to the Articles of Agreement in 1968 introduced the SDRs as the base of the system. However, after much improvement in their characteristics and much extension in their use within the Fund, the SDRs remain a mere 2 percent fraction of international reserves. The last time one heard of the SDRs was in 1994 when Mr Camdessus, the then managing director of the Fund, proposed a third issue of the SDRs, destined primarily to the Eastern European countries. That proposal was scuttled by developing countries who objected to the preferential treatment accorded in the proposal to the new members. Politically speaking, the issue remains on the back burner and there seems to be no advocates for the time being.

Considering the issues involved, it is remarkable how pertinent and prescient the discussions and proposals made by the C.20 in its 1974 Report were, even in today’s optic. From inception, the IMF was created without resources of its own. 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, which would inevitably be on a case-by-case basis involving a high degree of politically motivated preferential treatment.
Even before Bretton Woods, the vision of Keynes of an autonomously financed Union with flexible and discretionary resource base was abandoned in view of the opposition of the USA. In its place, the US concept, articulated by Under-Secretary Harry Dexter White, of a resource-pool institution controlled by the countries with majority quotas, was enshrined. Consequently, the IMF resource-base and its modalities of decision making have been unsuited for this role.

Nevertheless, the frequent occurrence of financial crises and the fact that the IMF is the only institution with a semblance of a supra-national central bank have brought up this topic with a surprising vigor. In recent years, several proposals have been formulated to deal with this lacuna, the most ambitious of which is the Meltzer Commission. There is also a host of published contributions to make the case for this role (Fischer, 1999). There is a host of issues to be pointed out in this context, some political, some institutional and some technical.

The Bank of Last Resort's role requires not only resources, but enforceable control on 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, it should adopt a global vision of the pattern of adjustment of the current accounts and a global perspective of the positions of the capital accounts. In fact, the Meltzer Commission suggests substituting this capital account role for the present practice of emphasizing the current account. The other institutional matter is to revamp the surveillance function so as to apply it to all countries whether they are in need for the Fund's resources or not. The technical issues concern the fashioning of an operational model for contra-cyclical policy and its operational procedures, the problem of measuring the degree of country risk, the limit on the size of a country loan in terms of some valid yardstick such as the GDP, the conditionality to be applied and 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 such crises is such that the systemic dangers of losses of 9-20 percent of the affected countries’ GDP 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 for helping countries already in crisis, while the second is for preventing the occurrence of such crises or anticipating them.

The crises in Asia and Latin America both have informed our judgment of their salient features together with the major provisions of the rescue packages. The crises were of two varieties: financial and debt payment. By order of magnitude, the financial crises are much more important even though they are less frequent. Except for the asymmetrical emphasis on the debtors, the failure to involve the private sector on a non-voluntary basis and the absence of standstills, the rules of debt working out call for minor changes. However, this is not so in financial crises.

The financial crises in both Asia and Latin America have some common features and similar sequences. They were mostly crises in the financial system. In the majority of cases in Asia, there was no macroeconomic policy mismanagement but a malfunctioning domestic financial system interacting with the way the international financial system operates. Typically, the start is ignited by banks carrying on their books many large size and non-performing assets. This leads, in short, to the failure of coping with servicing foreign exchange denominated liabilities. Swiftly, a currency crisis explodes and the balance sheets of the banks and other institutions suffer from severe deterioration of net worth. The swift and simultaneous reaction of creditors to these developments ushers in a balance of payments crisis and calls for severe adjustment problems leading to a fully blown country crisis. The international system then becomes involved to stem out possible systemic risk. As a result, rescue packages are negotiated with the stricken countries. They have some common features across various cases.
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 debts or significant foreign owned liabilities are involved.

The second shortcoming is the one-sided emphasis placed on the stricken countries and not on those which are also partly responsible for the crisis. It is rather incongruous that, given the degree of integration of international capital markets, the packages overlook 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 together with the emergent pattern of adjustment of the balance of payments. It is to be recalled that the major countries are also more capable, on account of the size of their economies, than the typical stricken countries, to bear the cost of crisis adjustment.

The third problem is the liberal model prescriptions and the resultant selective official approbation. The example of censoring and criticizing Malaysia, which made one of the most successful recoveries, for its un-adherence to the liberal one-prescription-fits-all philosophy when it suspended temporary cross-border capital flows, is a case in point.

Fourth, in the crisis 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 the debtors with the capacity to continue servicing their debt without a quid pro quo on the part of the creditors. The creditors might therefore 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 is a question of system fairness regarding countries that have not needed help in managing their crisis. There is therefore a manifest need to bar or at least limit the creditors’ access to IMF resources, except as a part of a debtor-creditor shared package.

In this context, note ought to be taken of the proposal of working out the debt crisis made by UNCTAD in the 1998 Trade and Development Report. It involves imposing a standstill and the application of procedures similar to those in chapter 11 of the US code, in restructuring and re-capitalizing, under proper supervisory authority, illiquid firms. It is a proposal still meriting attention today.

The rescue packages have had some prescriptions that, in light of the crisis developments, are in need of revision. Among such prescriptions are: hiking, often by several points, 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 ill-performing financial system. It also showed a large exposure to interest rates risk and various manifestations of liquidity risk. These facts should bear on the actions recommended.

For one thing, the unrestricted servicing of debt and other liabilities is in tension with the short-term illiquid status of the balance sheet of financial institutions. For another, dramatic increases in interest rates, damaging to the macroeconomic performance of the crisis economies, increase greatly the interest rate risk of debt and fixed income securities and inflicts large capital losses on the balance sheet of banks and other financial institutions. It should be recalled that financial institutions in the stricken countries undergo two types of transformation: maturity transformation and a unit of account one. The deterioration of the exchange rate increases dramatically the servicing of liabilities in domestic currency. Simultaneously, the maturity transformation results in duration gaps between assets and liabilities. Given such wide duration gaps, the hiking of interest rates inflicts a net capital loss on the asset side. The result is severe deterioration in a bank balance sheet that might wipe out its net worth. This problem has recently attracted a good deal of attention. For example, Barry Eichengreen (2004) of Berkeley 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 crisis.

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, or the probability of contagion to others, will be part of the list. This then creates a two-tier system: 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 in and the political approval of these countries in such an international effort.

The foreign exchange system

The foreign exchange system used to be one of two major topics of discussion regarding the IMF in the 1960s, the other being the international reserve system. These discussions emphasized the choice of regimes: fixed or floating. After the break-down of the old Bretton Woods system of fixed rates, in August 1971, the first Smithsonian Agreement of December 1971 amounted to tinkering with the old parities, while the second Smithsonian Agreement 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 not in need of IMF resources (Triffin, 1976)[3]. It was left to macroeconomic policies to carry the burden of establishing orderly conditions.

Most unexpectedly, the C.20 did not fare much better; it recommended the same old system but with a new parity grid and some guidelines for adjustment. The failure of the C.20 to come up with a solution is symptomatic of the underlying problem; to wit, the real problem is the misalignment of major currencies as a result of the underlying mutually incoherent, or, 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 is to lay adjustment on the minor country 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 major currencies have not made possible the realization of orderly conditions 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 the macroeconomic and financial conditions in the minor currency countries (Williamson, 1979, 1983; IMF, 2003). 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 G.3 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” (IMF, 2003, p. 94).

During the past 28 years, the major currency countries undertook only two coordinated interventions (Plaza accord of 1985 and Louvre accord of 1987). In all other instances, where volatility aroused concerns, the major countries have 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.

At this time, about half of the emerging market economies adopt an intermediate regime, i.e. one with fixed, but adjustable peg. This contrasts with two-thirds in 1991 (Fischer, 2001). This
decline is sensible in view of the fact that free floating is more feasible under conditions
where the major peg currencies are moving in each and every direction. Consequently, the
menu is either to choose free floating or a rigid currency board or an intermediate solution. It
is quite problematic for the small economies to choose free floating, and the currency board
solution applied by Argentina and others has proven to lead to overvaluation, balance of
payments problems and exposure to external shocks via the peg currency. Hence, it is in
order to call for an exploration of the potential of intermediate solutions for the system.
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 (Williamson, 1979). There are also some old
but still valid proposals such as the Ethier-Bloomfield Reference Rate proposal which has
substantive and political feasibility (UNCTAD, 1987)[4].

Nevertheless, there have been two types of solutions in practice: the Currency Boards (CB)
solutions followed by Argentina and others, and the regional solution following the example
of the European Union. 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, as a result, to balance of payments problems. It also exposes the
pegging countries to the external shocks hitting the country of the peg without monetary
policy tools to use in 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 labor movement. Perhaps more
important, it needs the political will to do it, difficult to marshal in the absence of some
specific political or economic pay-offs. In South East Asia and the Andean group in Latin
America, interest has been expressed in regional solutions modeled on the European
experience (Akyuz and Flasbeck, 2002). However, no concrete actions have been taken to
push such an exercise forward in Asia and the Andean Peso proposal has come to nothing.
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.

The reform of the IMF
There are three main issues in this area:
1. the governance of the IMF;
2. the surveillance and conditionality; and
3. the reserve system together with the function of bank of last resort.
This paper has already dealt with the last topic above.
The governance of the IMF. The Fund governance has been a contentious issue between
developing and developed countries since the mid-1950s. 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 share
in decision making and be commensurate with its contribution to the Fund resources.
Between these symmetrically reasoned positions, there is room for two considerations,
namely, that quotas can still be the key to 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 USA, whose purpose is to protect the small states
against the majority dominance of the big ones. The other consideration is the negotiated
nature of the quota both initially and when revised. This makes it, to an extent, a political
question rather than one of objective key.
There are, in my judgment, 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 fact is true when it comes to the contribution of
member states to the system, their influence on international economic conditions and the
effects of the international economy on them. A decision by the IMF requires the assent and active cooperation of the large economy countries. Economic analysis explicitly distinguishes between large and small economies in analyzing the consequences of macro-action upon international adjustment. As the author of this article argued in a published paper on this topic in 1985, there is political economy validity to the distinction made between the model of representative democracy and the participatory one in international affairs (Sakbani, 1985). The constituency system of the IMF enlists under the model of representative democracy. Representative democracy is no less valid, given its conditions, than the participatory model of democracy. One can narrow the distance between the two by reforms such as suggested above, but not entirely eliminate it. As a matter of wise pragmatism on the part of developing countries, they should not contest the preponderance of the developed countries in the Fund, not just because that reflects the facts of the world, but as a matter of political strategy on their part to buy their participation in the system and their acceptance, in return of the resulting legitimacy, of the implied strictures and obligations the system entails. A reformed and strengthened international system is mostly in the interest of the weak members. If it comes to be with sufficient resources and sensible authority, it will serve the interest of its small members relatively more than the large ones.

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 Seventy Seven, which founded UNCTAD. 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 a beneficial influence on the Fund and has, to a certain extent, served the interests of developing countries. However, the G24 has shown a greater degree of institutional acculturation to the Fund gleaned from the different tonality of its views on its operations than what is heard usually from developing countries. Criticism of the Fund by representatives of developing countries in other forums has always had sharper and more accented tones than anything voiced out by the G24. Perhaps it would be worthwhile for the group to invite to its meetings representatives of developing countries in other forums active on monetary and financial issues to enrich its deliberations and contribute to its work.

The Development Committee was established in the Jamaica meeting of 1976 and came into being in 1978. The purpose was to bring into the Bretton Woods institutions increased emphasis on the development dimension of their work. The Committee meets semi-annually at the time of the Fund 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 Fund processes and its decision making. Furthermore, 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 possessing operational capabilities that can be more assiduous in the pursuit of the work of the Fund. After more than 25 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 large members, in particular the USA, have not hidden their willingness to use the Fund as a tool of their foreign policy. American officials are on record reiterating that they will help some countries they consider friendly to obtain access to the resources of the Fund and will impede countries they deem unfriendly, or on some blacklist, from accessing the Fund. This might seem repugnant to earnest souls, but is part of realpolitik in the world. If one were to run a correlation between the countries that have received big help from the Fund over the years and their degree of friendliness to the USA, the coefficient of correlation would indeed 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 a long way towards minimizing this bias.
The surveillance function and conditionality

Conditionality was developed by the Fund 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 as the correct path to equilibrium using the correct means (Williamson, 1979)[5]. 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 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 Fund had accentuated conviction (Rodrik, 1999)[6].

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 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 gardée of sovereign matters.

As to the surveillance of exchange rates, it was argued above that the Fund 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 remit to the macroeconomic policies of the major countries to assure that these policies are mutually consistent and their resultant exchange rates not misaligned. 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 fall-out of symmetrical surveillance is that it would subject the IMF concepts, procedures and standards of evaluation therein to the scrutiny of its powerful member states whose views it cannot ignore. These members will judge whether the rules of surveillance and the Fund’s standards are suitable or not. They will also review the limits to which they will allow the Fund to intrude into their domestic policies. This would be a welcome externality for the weak members who will surely demand equal treatment.

Notes

1. For details, see UNCTAD (2003), and previous issues.
2. Barry Eichengreen, in a recent paper for the Copenhagen Consensus, calculates the losses from the Asian crisis at some 20 percent of the GDP of Indonesia. He also calculates that the benefit from avoiding such a 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.
3. The late Robert Triffin had similar views on Jamaica. See Triffin (1976).
4. The proposal by Ethier and Bloomfield on The Reference Rates is still current.
5. John Williamson (1979) provides a historical description of how the system evolved.
6. Don Rodrik (1999) of Harvard expresses amazement as to how the IMF can maintain a one-fit-all model, while we are now beginning to understand how and why things work in some countries but not in others.
References


Eichengreen, B. (2004), *The Economist*, 17 April, p. 76.


