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Governance of the International Financial System: Objectives, Issues and Process

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Sixty years after the Bretton Woods Conference, much has changed.

- The European colonial empires have been dismantled, greatly expanding the number of nation-states.
- The development of the European Union of twenty-five tightly linked nations, twelve of which use a common currency, with the prospect of still more broadening and deepening ahead, has introduced a fundamentally new structure into the global political economy.

The division of the world into two economic ideologies has been bridged.

- The world of fixed exchange rates that was envisioned at Bretton Woods has been replaced by one where floating exchange rates are considered the norm.
- The extensive capital controls that were foreseen at Bretton Woods as a permanent fixture of the financial order have been dismantled in the OECD member countries and radically scaled back, if not removed, in the emerging markets. This development together with leaps in communications technology has led to the development of global banking and capital markets with the potential for massive cross-border capital flows.

But three fundamentals of the Bretton Woods Agreements still hold today. First, the International Monetary Fund (IMF) and World Bank remain the core global institutions in the monetary and financial domain. They have adapted to change, indeed the greatest genius of their creators was to provide for change. Although these institutions have many critics, serious people do not call for their dissolution or replacement. If the Bank and Fund did not exist, we would have to invent them. And it is extremely doubtful that they would be invented today more sound than the Bank and Fund that we have. The right course for the world is to continue the process that has been working almost since their creation, a process of evolution in the light of a changing environment while complementing the two institutions with less formal and ideally less permanent structures, such as the G-7, G-10, G-20, G-24 and the Financial Stability Forum.

Second, we live still in a world where legitimacy and accountability for economic outcomes rest with sovereign states, noting some qualification for the European Union. Nations make laws, undertake social programs, raise taxes, spend on behalf of the public and choose their monetary institutions. It would be neither right nor welcome for these responsibilities to be assumed by global supranational authorities.

Third, economic and financial interdependence mean that states do not pursue their objectives independently. What one does affects others. This is true for large actors or "systemically important" countries. It is also true for aggregations of smaller countries behaving in similar ways in response to a common environment. Indeed, with increased trade and financial openness, interdependence has never been greater.

In considering how financial governance might be improved, it is important to examine three aspects: 1) the assumption that one makes about the *objectives* of governments, 2) the *issues* that it is most important to resolve at any given time and 3) the *process* by which coordination takes place among sovereign governments. I have some observations to offer on each of these, but only have concrete proposals on the third. On the matter of process, I will draw on a report, to be published in September, which I have prepared together with Peter Kenen, professor at Princeton University, Sir Nigel Wicks, former IMF and World Bank Executive Director and long-time G-7 Deputy for the United Kingdom and Charles Wyplosz, Professor and Director of the International Center for Monetary and Banking Studies at the Graduate Institute of International Studies in Geneva. Our Report, titled "International Economic and Financial Cooperation: New Issues, New Actions and New Responses" is sponsored by the International Center for Monetary and Banking Studies in Geneva and the Center for Economic Policy Research.[2] It focuses on process issues. As we say, "if we don't get the process right, we won't get the policies right." I nevertheless want to lead up to that report's principal recommendations with some observations on objectives and issues for which I will not hold my co-authors responsible.

[2] Peter B. Kenen, Jeffrey R. Shafer, Nigel L. Wicks and Charles Wyplosz (2004). International Economic and Financial Cooperation: New Issues, New Actors, New Responses. Geneva Reports on the World Economy 6. International Center for Monetary and Banking Studies and Center for Economic Policy Research.

1. Objectives of Economic and Financial Policy

The assumption on which the Bretton Woods institutions were built is that governments seek to improve the economic welfare of their populations broadly, weighing the interests of future generations as well as their current citizens. They may make mistakes that the officials of the Bank and Fund could warn them about, but governments were presumed to be well intentioned. Good governance at the national level was not explicitly questioned. This is a naively idealistic view of the world.

This presumption of good governance or the practice of ignoring seriously flawed governance has come increasingly to be questioned in recent years. Improved governance has become an objective of some World Bank programs, and governance considerations have crept into Bank and Fund programs more broadly. For example, structural conditions imposed by the IMF on borrowers during the Asian crisis were partly directed at confronting cronyism in its various forms – institutionalized family corruption in Indonesia and the power of the chaebol in South Korea. Strong criticism of these aspects of IMF programs by Jeff Sachs, Joe Stiglitz, Marty Feldstein and others has led the IMF to pull back from conditions of the sort used in the Asian crisis. But the problem of governance failures remains and will sap the effectiveness of the Bretton Woods institutions in the future if they turn a blind eye to them.

Notably, it is still considered the role of the Fund to curb one governance failure found even in vigorous democracies, where elected leaders are presumably attuned to the economic interests of voters: that is, the political business cycle. Thus, IMF fiscal conditions typically seek to impose an intertemporal budget constraint that may not be felt strongly by elected officials who may not think beyond the next election. This constraint may also not be imposed by financial markets if IMF-led support packages are available.

Governance problems are, however, much more problematic for the programs of the Fund and Bank than this. Corruption that results in the loss or diversion of the proceeds of Bank loans and leaves a country's citizens without benefits but with future debt service obligations continues to be a serious problem. Reform efforts to date have not alleviated concerns on this point. Extreme situations of institutionalized discrimination where governments systematically prevent people from disfavored ethnic groups and religions or women from full participation in economic life, or of predator states whose governments loot the resources of the people to enrich an elite, or of failed states in which governments do not effectively protect life and property may lead to disengagement by the Bretton Woods Institutions. If transferring resources to government hands is the only means of intervention, there may be no reasonable alternative. But a rigid policy of not putting resources into a high-risk environment means that the international community abandons people most in need of help. There is a dilemma here.

I do not have solutions today. But the problem of governance failure, which I take to mean that government leaders may pursue other objectives than the economic welfare of people across the entire population and over time, is serious and it is pervasive. The issue needs to be kept out in the open. And it should be addressed by a process that is seen to be representative and legitimate. The experiments with structural conditionality during the Asian crisis were criticized, in part, because they seemed to be largely the result of U.S. Treasury pressure. I believe that this is an extreme exaggeration. But there is a need to develop broad support for governance conditionality while not giving dysfunctional states the capacity to form a blocking coalition as they have been able to do, for example, in the United Nations General Assembly (UNGA). Only then can we have reasonable assurance that the objectives of the Bretton Woods institutions of furthering the economic wellbeing of a country's people broadly will be achieved.

2. Issues

The central issues concerning the international financial system have shown some continuity, but have also changed markedly over sixty years. Four issues stand out as most important today. First is the adjustment process.

Whether considering what to do in the current situation or longer-term systemic reform, the balance-of-payments adjustment process has been at the heart of much of the debate in international finance from the beginning. What should countries in different positions be expected to do, if anything, when there is evidence of a serious international disequilibrium? To start with, what is considered disequilibrium has been debated and views have changed – is it indicated by reserve inflows or outflows? A misaligned exchange rate, however measured? A current account imbalance? A fiscal imbalance? Inflation or deflation? High unemployment? Whatever the answer, the adjustment process is a matter of perennial concern because what one country does affects others. This can happen in three ways: First, some countries are so large that what they do affects the world. They are the elephants among smaller animals. The United States has been seen this way since Bretton Woods, and over the years, a large part of the debates on the adjustment process has had in the background the question: "How can the United States be made to manage its economy less disruptively for others?" Within Europe, Germany has often been seen as the heavyweight, while in Asia, Japan has been a regional elephant and China is rapidly becoming one. Second, countries heading in the same direction can have important combined external effects. Herds of smaller animals can be as disruptive as elephants. Thus, for example, the huge current account imbalance between the United States and emerging Asia is widely dispersed around Asia. The focus in the United States on China is misplaced since China has only a small external imbalance. But adding up current account surpluses over the region produces a large imbalance. The U.S. elephant could not adjust, if it were inclined to, without the Asian herd moving too or other large imbalances appearing somewhere else. Third, there may also be times when two herds move in opposite directions. In these cases, the adjustment process is asymmetrical with intense pressure on countries in deficit, but little on those in surplus.

Another externality, beyond direct effects of one economy on another, arises out of the actual or prospective use of "IMF resources" to support the adjustment process. The resources, of course, are not the Fund's, they are transferred from one member to another. Their use is a matter of concern to creditors of the IMF for this reason if for no other. In addition, the terms and conditions of the uses of Fund resources in each case set precedents, alter expectations and thus have externalities. This makes the use of Fund resources to support adjustment a matter of concern to all. The importance of the adjustment process to all: large countries and small, those in surplus and those in deficit, means that the process for considering change and implementing it, should be broadly representative.

One aspect of the adjustment process has been especially troublesome: surveillance. Despite emphasis on the need for an effective surveillance process going back at least as far as I can remember, problems frequently go unrecognized until they become critical. Moreover, when a country has no need of International Financial Institutions' (IFI) support, it can resist calls to adjust. This is true of small countries as well as large. The coming of transparency to once secret international monetary affairs may make it harder to ignore developing problems in the future since markets are watching, but I do not believe this is a cure-all. For one thing, it does not deal with the asymmetry of pressures. And another trend is disturbing: countries have been brought into chronic dependence on Fund programs, with the justification that it gives the IFIs leverage over policies. It would be much better to foster independence maintained through sound policies.

A more recent set of global financial issues involves the supervision, regulation and functioning of domestic banking systems and capital markets, and their interactions in a global financial system. Since banking authorities first confronted the unavoidable need to cooperate following the failure of Bank Herrstatt in 1974, the range of issues on which cooperation has been pursued has grown spectacularly: supervisory responsibilities, capital requirements, lender-of-last-resort responsibilities, payments systems, anti-money laundering, strengthening domestic banking systems in emerging markets, supervision of financial conglomerates whose activities cross the jurisdictions of multiple functional regulators as well as national borders, disclosure and accounting standards in global capital markets, corporate governance, privacy... A rapidly changing financial landscape has demanded a response. And there has been a strong response, with central banks leading the way. The establishment of the Financial Stability Forum has brought focus and some coherence to disparate activities. This may become the new heart of international financial cooperation going forward.

A third issue has become more important as global financial markets have become broader, deeper and more mature, but it has received only limited attention. This issue is: in a world where private capital is available, many would say too available, to any country with reasonable political stability, sound policies and not too great a debt burden from past laxity, what is the role for the World Bank? It is hard to make a case for "gap filling" today, as was done in the 1960s when channels for private capital to flow to developing countries were shallow. Capital still does not flow to the poorest countries, but this is because the rate of return is low and the risk is high in the absence of supporting institutions and human capital. This situation does not provide favorable conditions for official lending. We have learned that official capital flows often leave more costs in the form of debt burdens than benefits in development progress. IFI debts are having to be forgiven to alleviate the accumulated burdens. Recognition of the limited debt carrying capacity of the poorest countries has motivated calls for International Development Association (IDA) loans to them to be replaced by grants. This is surely what is needed. We shall see if the required resources are forthcoming.

For countries that have achieved market access, the World Bank Group (including the International Finance Corporation, (IFC)) faces the question of how it can make its lending additional and not simply crowd out private sector flows. It is not going to do this as a preferred creditor, because repayment obligations to the Bank reduce capacity to service other debt, unless it can boost debt servicing capacity by more than private sector flows do. This is an immense challenge to the Bank staff, especially when it is called upon to focus on poverty reduction. The Bank may seek to achieve additionality in terms of development impact by spreading the benefits of economic growth more widely in the population, even at some sacrifice of overall transfers. But the requirement that such efforts be highly effective in addition to being well-intended is a high hurdle. It is not often cleared. I expect that these issues will receive even greater attention in the coming years.

The issue that I have seen most often highlighted in sixtieth anniversary events is what to do with countries that clearly cannot maintain full servicing of their debts. Both middle income and the poorest countries are of concern. There are answers emerging that have a reasonable chance of proving workable.

For middle income countries, liquidity crises when debt burdens seem reasonably manageable over the longer term are likely to be less common than they were in the 1990s, since countries have seen the huge costs of losing market access even temporarily, and they maintain much higher reserves together with longer term debt structures in order to guard against such a crisis. If a crisis does occur in a country with a sustainable debt burden, large scale financing by the IMF should, and I suspect will, be forthcoming. Regional arrangements, such as the Asian swap network, may provide a second line of defense. Such rescues will not be so smooth, however, as to avert considerable short-term costs. Hence they should not give rise to serious moral hazard.

For countries that build up excessive debt burdens, official lending in a crisis will not provide lasting relief, and it could give rise to moral hazard as private creditors lend on the strength of official support. However, the arrangements for sovereign workouts that have emerged over recent years are likely to prove serviceable in these cases. The world has rejected formal arrangements in favor of creating conditions favorable to bringing debtors and creditors together – collective action clauses, IMF lending policies for countries in arrears, etc. When governments faced with unmanageable debts have sought a fair resolution even without collective action clauses, they have been able to restructure debt remarkably quickly because the private sector has been inventive in finding ways to get a very high response to an exchange offer. Uruguay shows this clearly. Neither new techniques, however, nor an IMF-run process such as the lapsed proposal for a Sovereign Debt Restructuring Mechanism, nor any other set of formal arrangements is likely to achieve results when a government is defiant. One can only hope that the cost of this approach will make it rare. Interest in formal bankruptcy arrangements is likely to fade, as existing restructuring processes are refined. The most difficult problem, how to recognize when more IMF lending is not the solution and debt reduction is needed, will continue to be difficult to resolve. Countries may struggle on too long with market access artificially preserved through IMF programs. I am not optimistic of a solution to this problem.

These are the main issues on the agenda today. My crystal ball is not clear enough to see what new ones will arise. But I am sure that we will have new issues to deal with in the future. The institutions for dealing with them, the IMF and World Bank, will need to remain flexible.

3. Process

As I said at the outset, my co-authors of the Geneva Report and I looked at what needs to be done to have a better process to support international financial and economic cooperation going forward. I am not going to be able to go through the full reasoning behind our recommendations. Besides, I want you all to read the Report when it is published in September. What I will provide are the main recommendations with a bit of additional context. These emerged from an effort to find a tradeoff closer to the frontier of *effectiveness*, *legitimacy*, *accountability* and *representativeness* in global governance. Our focus was on the set of issues generally thought of as the province of the IMF. Thus we talk about the World Bank only tangentially and have even less to say about the future of the World Trade Organization (WTO), the Organization for Economic Co-operation and Development (OECD) and United Nations economic and development bodies. We reject transfers of sovereign powers to global supranational organizations. We favor evolution over revolution and in this spirit would keep the IMF as the multilateral implementing agency for international cooperation in the monetary sphere.

We do have two concerns about the Executive Board of the IMF, which could apply as well to the Bank. One is that it is not representative of today's world. 32% of the voting power and 15 of 48 Executive Directors represent the recently enlarged European Union. Even at its new size, the EU is overrepresented. The creation of the Euro has made the multiplicity of European voices around the Board table even more anomalous. Although, this state of affairs would seem to give Europe too much power – nearly twice that of the United States on votes and 7.5 times the seats at the table. In reality, the situation undercuts rather than strengthens European power while leaving Asia underrepresented. With so many voices, Europe has by most accounts much less influence on the IMF than the United States with its smaller but consolidated vote.

Our second concern about the Board is that its members are too removed from the governments they represent. We believe that in today's world it is feasible to have a non-resident Board that could meet every six weeks, with resident alternates for day to day business. This would engage the senior officials directly responsible for policy in capitals directly in overseeing the IMF. Board discussion could lead to consensus being developed in real time rather than only in messages back to capitals.

We look especially closely at the G-7 in both its Summit (now the G-8) and Finance Minister and Central Bank Governor manifestations. We see these bodies as having been effective at times in the past, but becoming less so over time with the emergence of new important players. These groups are accountable to the citizens of their democratic members but they were never representative and hence they have lacked legitimacy in the eyes of many. The G-7 as a body for dealing with adjustment issues has been effective at critical times in the past, for example at the Plaza, when it was still the G-5, because it included all of the elephants and no mice, even though it lacked a strong counterweight to the United States. The G-7 no longer includes all of the elephants since the emergence of Asia as a powerful trading area and China as an increasingly dominant trading economy alongside Japan. Meanwhile three of the G-7's European members have adopted a common currency together with nine others and should speak with one strong voice. Consequently, we call for the establishment of a Finance Ministers and Central Bank Governors G-4 – The United States, the euro area, Japan and China – to continue the process of dealing with adjustment issues. It should return to the G-5 practice of meeting discretely, normally without communiqués.

We see an ongoing role for the G-7 Finance Ministers and Deputies to deal with debt issues from the side of the principal providers of useable currencies to the IMF and shareholders whose callable capital backs the funding of the World Bank. G-7 leadership is still important for continuing to move forward on the debt problems of the Heavily Indebted Poor Countries (HIPC), as well as to deal with any new sovereign debt crises.

At the level of the Summit, we see the G-7/G-8 as having never, after the first summit (of the G-5) at Rambouillet, played as important a role in global economic and financial affairs as the attention these meetings once drew would suggest. And in recent years, leaders have spent most of their time on issues other than the global economy. The G-8 may continue to meet to deal with more political issues, but we would create a new group to consider policy requirements needed for the global economy on an ongoing basis. This would essentially be an agenda setting and agreement ratifying group - others would do the work.

We call the new group the Council for International Financial and Economic Cooperation (CIFEC). It would be comprised of finance ministers, although an occasional meeting at the level of heads of state or government might be appropriate. It was the particular people at the heads of G-7 governments in the mid 1970s who brought finance issues to the summit level. Finance issues have rarely commanded the enthusiastic attention of summit participants since then, and they would be better dealt with by finance ministers, except when extremely political issues arise. We do not see a need to have central bank governors in the CIFEC. They now, for the most part, pursue independent, reasonably clearly defined policies in a critical but narrow sphere. While no adjustment discussion is meaningful without them, they are not responsible for the broader issues that the CIFEC would deal with.

We think a small group is important for effectiveness, but we are concerned that the CIFEC be more representative than the G-7. We would strike this balance with a group of no more than 15. We would have some standing members and other rotating members to ensure that the CIFEC is representative of small countries as well as large.

The G-20, created as a broader forum by the G-7, might be seen to fill the role we intend for the CIFEC. We do not see it doing so effectively, however, in large part because of its size – forty people at the table are too many. In addition, the G-20 has not been given the support and attention from the G-7 countries, which is needed for it to play the role that we see for the CIFEC. It is important to have a global agenda setting group that is effective. So we want to try again.

We look at the response of the leading countries to the emergence of financial supervisory, regulatory and systemic issues and see much to approve of. Groups with the requisite expertise, increasingly involving the systemically important economies and not just the outdated G-10, have been created to deal with a wide range of issues. The establishment of the Financial Stability Forum, which brings a political element as well as newly important actors to these issues, was an important step that recognized the growing importance of cooperation in this area. We make some suggestions to strengthen what has been achieved, but the most important thing is to recognize the growing importance of issues in the financial area over the past ten years. This trend has been met with an ad hoc, flexible response. This sort of response is likely to be needed in new areas in the future, and we believe that a CIFEC could bring this about more effectively and more legitimately than the G-7 can.

Finally, we suggest that a newly established CIFEC undertakes a review of all of the existing groups that continue to meet, some of which play no uniquely important role. We liken the present international financial and economic scene to an overgrown English Garden. We do not propose turning it into an orderly French Garden, but it needs some serious pruning after sixty years of creating new groups and almost never terminating them. So many meetings demand too much of the time of busy officials and diffuse attention.

These are our main proposals. As I said, they embrace evolution and maintain the Bretton Woods institutional structure of sixty years. They focus more on the informal arrangements that have grown up around it. And they put particular emphasis on continued flexibility to meet changing demands.