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This paper will be revised following discussions and comments at the Technical Group meeting

Can More Representative Governance Improve Global Economic Performance?

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Abstract

The governing structure of the BWIs was determined in 1945 when a few industrial countries accounted for the bulk of world output, trade and capital flows This is no longer the case.The developing countries and economies in transition account for the same volume of output as the G7 countries, in terms of purchasing power parity, and for 84 percent of the world's population and can no longer be dismissed as a minor partner in the global economy. The lack of adequate representation of the developing countries in the governance of the global economy has adverse consequences for world economic growth and stability.

The paper discusses seven key problems of the international monetary system; namely, correction of global imbalances, combating deflation through countercyclical policies, financial crises prevention and resolution, negative flows of capital to developing countries, management of international liquidity, commodity shocks, and the problems of the poorest countries. It is argued that optimum solutions in these areas require the participation of both developed and developing countries. The correction of global imbalances by (Plaza type) agreements among a few industrial countries is found to be no longer feasible and solutions arrived at without the full participation of developing countries, are unlikely to work (i.e. the CCL, the SDRM, the HIPC strategy) Solutions to global problems require the full involvement of developing countries in a manner commensurate with their economic importance.

Global Economic Transformation

Over the past half century the world economy has become increasingly interdependent. Developments in the economy of one country or region are transmitted to other countries through high levels of international trade and financial flows. This integration differs from the patterns of a century ago in that a growing number of multi-national firms have spread their production processes over a number of countries. As a result intra- firm trade and intra-industry trade have risen sharply as a proportion of international trade. Developments in information technology have erased distances and the integration of capital markets has proceeded to essentially create a single international capital market. The volume of financial transactions has grown exponentially and currently greatly exceeds the volume of flows in trade of goods and services. The close integration of the global economy presents new and difficult economic challenges.

The transformation of the global economy has not been matched by a parallel evolution of the mechanisms and institutions of global economic governance. The current government structure of the World Bank and the IMF is the result of a political settlement at the Bretton Woods Conference in 1944, and given the changes that have taken place in the world economy since then, the present structure is not representative of the size and importance of the economies of the member countries in terms of GDP, population, share of world trade, reserves or of their ability to contribute financial resources. This inadequate representation of their membership undermines the credibility and legitimacy of the two institutions.

Some of the most important changes that have taken place in the world economy since 1944 include the following:

1. The US which was the only large capital surplus country up to the sixties, and thus the main provider of resources for the IMF and World Bank, has become a net debtor as its external liabilities exceed its assets abroad and today is the world's the largest debtor country.

2. The European Common Market, which was later to become the European Union, has introduced a common currency but the voting shares of countries in the Euro area were not adjusted to reflect this change. According to the 1944 Bretton

Woods formulas, international trade is a major factor in the determination of IMF quotas. This resulted in the members of the EU having 74 percent greater voting power than the US despite having a smaller GDP. However, trade within a single currency area is akin to trade within a domestic market and cannot give rise to balance of payments imbalances. When the calculated quotas of the Euro zone countries are adjusted to exclude intra-euro zone trade, the voting power of EU members declines by 40 percent.

3. The G7 industrial countries which have effective control of the IMF and World Bank represent less than 14 percent of the world population and account for about 44 percent of world output in 2002. The developing countries and economies in transition account for more than 84 per cent of the world's population and the same proportion of world output as the developed countries measured in terms of purchasing power parity[1]. For this reason, decisions taken by the G7 countries without the participation of the major developing countries are often perceived as having limited legitimacy.

4. The developing countries have registered higher GDP growth rates than the industrial countries and have increased their share of world GDP, measured in terms of PPP from 30 percent in 1950 to 39 percent in 2002 and to 44.2 percent, if economies in transition are included[2] The developing countries have increased their share of world exports from 26 percent in 1972 to 37 percent in 2002.[3] Particularly noteworthy is the rise of output in Asian economies-excluding Japan-which accounted for only 9 percent of world output in 1950 and today represents almost 23 percent of global GDP.[4]

5. The volume of reserves held by developing countries has risen from SDR 33.3 billion in 1972 to SDR1,132.3 billion at the end of 2002, and greatly exceeds that of the industrial countries which stood at SDR 749.5 billion on the same date.

[1] Developing countries alone account for over 39% of world GDP.Source IMF, WEO data base.
[2] World Development Indicators 2003, World Bank
[3] IFS Yearbook, IMF
[4] World Development Indicators 2003, World Bank

> The reserves of Asian countries showed an extraordinary increase from SDR 7.9 billion in 1972 to SDR 720.1 billion in 2002.

The growing breach between the distribution of world economic and financial realities and the governance structure of the Bretton Woods institutions makes reform necessary to enhance their effectiveness and restore their legitimacy. A more representative and inclusive governance structure of the World Bank and the IMF, by enhancing the participation of developing in the solution of the major problems confronting the world economy in money and finance would improve global economic performance in terms of securing a more effective international adjustment process, higher rates of utilization of global resources, higher rates of growth and employment, greater macroeconomic stability, increased support for primary producer countries subject to commodity shocks and for the elimination of world poverty.

Correcting Global Payments Imbalances

Under the Bretton Woods system, structural balance of payments disequilibria were to be corrected by exchange rate movements. Surveillance over exchange rates and exchange rate arrangements was one of the key functions of the Fund. Following the breakdown of the Bretton Woods system of fixed parities, the world moved into a “non-system” in which each country was free to pursue the exchange rate regime of its choice.

Surveillance is the means by which the international community ensures that all countries and particularly, those that exert a major influence on the world economy pursue policies that are conducive to sustained growth with stability, without detrimental effects on other countries. Through its surveillance function, the IMF acting on behalf of the international community, assesses the situation of a country’s economy, reviews the monetary, fiscal, exchange rate, trade and other policies pursued by it, and offers advice on what would be the appropriate policy measures for the country to adopt. Article IV consultations are the main instruments of surveillance.

The effectiveness of the IMF is being questioned with regard to its ability to

(i) Persuade the United States to undertake measures to reduce its large fiscal and balance of payments deficits

(ii) Suggest measures to correct the growing payments imbalances between China and other Asian countries that peg their currencies to the dollar and the US, and to reduce the impact on the euro area which operates a floating currency regime

(iii) To prevent financial crises in emerging market economies. The fact that these have recurred on average at the rate of more than one a year over the last decade suggests the IMF has not been successful in either preserving the confidence of financial markets or inducing countries to make timely changes their policies.

Yet in the words of the Articles of Agreement, the purposes of the Fund include "giving confidence to members by making the general resources of the Fund temporarily available to them…thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity"[5].

The effectiveness of the IMF's role in surveillance has been weakened by asymmetries in power and compliance and by the fact that surveillance has not been applied in an evenhanded way. Paul Volcker, former Chairman of the Federal Reserve System has observed "When the Fund consults with a poor and weak country, the country gets in line. When the Fund consults with a big and strong country, the Fund gets in line"[6].

The growing asymmetries in surveillance are reflected in the way that it is conducted today. [7] Bilateral surveillance, which is the most direct one, has been primarily exercised over countries that can be characterized as less developed, particularly those that have a program with the IMF and are dependent on IMF resources and support in seeking debt relief. In addition, in the nineties, the recurrence of financial crisis, that mainly ended in

[5] Article I Section (v)

[6] See 1992, P. Volcker and T. Gyoten "Changing Fortunes", Random House , New York

[7] There are three levels of surveillance, as described in 2003 IMF Annual Report: (1) country or "bilateral" surveillance, (2) global or "multilateral"[7] surveillance, and (3) regional surveillance[7]. Each layer responds to a different economic arrangement and thus has an impact in surveillance enforcement and effectiveness.

major currency depreciations, encouraged the use of surveillance in order to prevent financial crisis. It was then that the international community gradually accepted the dissemination of surveillance appraisals. As a result, countries with open capital accounts have become more sensitive to changes in "market sentiment". Thus, with the publication of its surveillance conclusions, IMF surveillance influences countries wishing to gain or maintain market access. "Multilateral" and "regional" surveillance have been more analytical than operational in character, since they have not had a direct impact on the domestic policies, especially in larger countries or groups of countries with greater influence on the global economy.

Under its "multilateral" surveillance function, the IMF has highlighted the risks for the international economy of growing US fiscal and payments imbalances in the 2002 and 2003 World Economic Outlook. In a recent report[8], noting the increasing world dependence on US growth, the IMF highlights how the US current account deficit and growing debt –if not corrected- could have a negative impact not only on US but also on the global economy: "Although the dollar's adjustment could occur gradually over an extended period, the possible global risks of a disorderly exchange rate adjustment, especially to financial markets, cannot be ignored. Episodes of rapid dollar adjustments failed to inflict significant damage in the past, but with U.S. net external debt at record levels, an abrupt weakening of investor sentiments vis-à-vis the dollar could possibly lead to adverse consequences both domestically and abroad"….[9]

The response of the US Treasury to the IMF report made it clear that the Treasury did not consider any correction in its domestic policy necessary.[10]

In recent years, growing US current account deficits have been financed mostly through sales of government paper to Asian central banks that have pegged their currencies to the US dollar and have been accumulating high levels of international reserves. As a result, the burden of dollar depreciation has fallen on countries with floating exchange rate

[8] IMF Occasional Paper 227, January 2004
[9] IMF Occasional Paper 227, page 9, 2004
[10] The Treasury considered the report was a "breathless hyperbole" adding "The paper seems to conclude that if everything goes wrong in the U.S. economy, and no one does anything about it, that would be bad. That's not exactly groundbreaking analysis." as quoted by IMF, Morning Press, January 9th, 2004.

regimes, which have seen their currencies appreciate substantially, i.e.: the euro area, and a few industrial countries and developing countries, mostly in Latin America. In contrast, countries with managed and fixed exchange rate regimes -like most Asian countries- have been able to keep their currencies undervalued, generating growing demands for protection from labor unions and some industrial sectors in the EU and the US that are loosing jobs and market shares. In order to ease global adjustments, the IMF has recommended not only a correction of US imbalances but also greater exchange rate flexibility among Asian countries.

In a recent paper (2003) Dooley, Folkerts-Landau and Garber[11] explain the reason why countries in Asia may not be willing to follow IMF recommendations. They suggest that in order to maintain an export-led development strategy, Asian countries and China in particular, fix the exchange rate to the dollar to ensure a competitive edge. As a result, they have run large current account and capital account surpluses and are accumulating international reserves at a fast pace. In the case of China, this policy has been sustained without giving rise to over-heating and inflation. They believe that the primary motivation in China's export-led strategy has been the absorption into the modern sector of a substantial proportion of the labor force from the farming sector that is currently underemployed.

Global payments imbalances can no longer be corrected by exchange rate adjustments among the major industrial countries with flexible exchange rates. Dooley et al (op.cit.) consider that with the collapse of communism and protectionism and the ensuing integration of Asia and Latin America into the world economy, these countries must be seen as a new driving force:

…"now the Asian periphery has reached a similar weight (as Europe-Japan in the 1950s): the dynamics of the international monetary system, reserve accumulation, net capital flows, and exchange rate movements, are driven by the development of these periphery countries. The emerging markets can no longer be treated as small countries, weightless with respect to the center." (op.cit)

[11] M.Dooley, D.Folkerts-Landau, and P Garber "An Essay on the Reveived Bretton Woods System"NBER Working Paper Series, Working Paper 9971, September 2003

Asian countries have maintained very high rates of export growth and large trade surpluses; this in turn, has attracted private investment flows. As a result they have run large trade and capital account surpluses and since they have not allowed their currencies to appreciate, they have accumulated high levels of international reserves which have been heavily invested in US Treasury paper, thus financing the US twin deficits and making them sustainable, at least for the time being.

A number of problems /risks are apparent in this situation:

1) The depreciation of the US dollar has become an impediment to the recovery of the EU and other countries with floating currencies.

2) The dollar depreciation has given rise to rising trade tensions and calls for protection in Europe and other countries whose currencies have appreciated.

3) The rapid growth of Asian exports of textiles and other goods has also given rise to calls for protection in the US. Thus there is a risk of a rise in protectionism in response to unemployment and political pressures in countries whose industries are unable to compete with Asian goods.

4) There is the risk that at some point the demand for dollars as a reserve currency will collapse as monetary authorities and private investors choose to hold reserve assets that maintain their value: euros, yen or gold. This substitution could take place in industrial, oil exporting countries and developing countries that cannot justify their capital losses, arising from the loss of value of the dollar, with gains from higher rates of growth, employment and industrialization. But it could eventually, also take place in Asian countries that have pegged their exchange rate to the dollar and are accumulating very large stocks of reserves denominated in dollars. This could be a response to the mounting quasi-fiscal costs arising from the differential between domestic interest rates and returns on US Treasury paper plus the capital losses arising from the depreciation of the dollar.

5) A disorderly depreciation of the dollar would lead to a sharp rise in dollar interest rates that would put a sharp brake on the recovery of the US economy and the growth of Asian and other countries dependent on the US market.

6) Although flexible exchange rates contribute to the international adjustment process, the volatility of exchange rates among major currencies discourages trade and above all investment flows that require a medium term planning horizon, since hedging instruments are unavailable for longer maturities. The euro/dollar rate has fluctuated between by more than 50 percent (from 0.82 to 1.28) since its introduction.

The IMF's "multilateral" surveillance has not had a major impact on US domestic or on Asia's exchange rate policies. Neither has it influenced the domestic policies of the EU or Japan. As long as there were no major imbalances and the reserve currency countries followed policies broadly consistent with internal and external stability, the ineffectiveness of surveillance did not give rise to significant tensions.

In order for current risks to be overcome and major imbalances to be corrected in an orderly manner, it is essential that IMF surveillance become more effective and evenhanded. The effectiveness of "multilateral" surveillance could be enhanced through discussions with full participation of all the relevant developing country players. An IMF with more representative governance could be firmer, and more effective in dealing with imbalances that have a systemic impact, than an IMF run by a few industrial countries.

Combating Deflation and Low Global Aggregate Demand

The IMF was established to combat a market failure, that is, the collapse of domestic demand, and to counter attempts for countries to emerge from balance of payments problems through the adoption of protectionist measures, competitive depreciations and other "beggar thy neighbor policies". However, once the industrial country members no longer needed to resort to the use of Fund resources, Fund resources were allowed to decline as a proportion of world trade from 58% in 1944 to an estimated 3% at present and conditionality increased. In order to preserve their share of the voting power, the industrial countries were reluctant to allow rapidly growing emerging market countries and other developing countries to increase their quota shares and their contribution to

Fund resources. As a consequence of smaller resources and increased conditionality, the rate of non-compliance with Fund programs, measured by the failure to fully disburse approved drawings, rose sharply, reaching 86 percent in the late nineties.

The purposes of the Fund include "To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy", [12]however, the Fund has been ineffective in combating the recession prevailing in the international economy over recent years. A number of major industrial countries (US, France, Germany, Japan, UK and others) have pursued their own counter-cyclical policies and an economic recovery appears to be on the way in these countries but GDP growth rates remain low in much of the rest of the world outside India, China and some East Asian countries.

The IMF's recent passivity in the face of international recession can be contrasted with the active counter-cyclical stance adopted by the IMF in the mid seventies. With the world economy emerging from three years (1969 to 1971) of a combination of recession and high rates of inflation, the sharp increase in oil prices in 1973 and 1974 which deepened the recession and fueled inflation, posed for the Fund what was perhaps its greatest challenge to that date.

In addition, the massive transfer of wealth from oil importing to oil exporting countries that followed posed another very grave problem for the international economy, as it was recognized at an early stage, that very poor countries would not be able to borrow from the markets to pay for the increased cost of oil imports and there were doubts as to the ability of the banks to recycle the large sums involved. The Fund's M.D. Johannes Witteveen, a man of vision and a outstanding economist, understood the challenge and proposed the establishment of an Oil Facility to recycle the surplus from oil exporting to oil importing countries in order to help countries finance the ensuing external imbalances without further restricting economic activity and to gain time to devise energy saving and other adjustment strategies to reduce their external imbalances. The proposal, initially

[12] IMF, Articles of Agreement, Article I, Section II

resisted by the US, was put into place with the strong support of European and developing countries, several of which intended to resort to it, as well as that of oil exporting developing countries that would finance it.

The Oil Facility was established for one year in June 1974 to help oil importing countries to cope with the sharp increase in the price of oil imports and to assist members to adjust to the changed circumstances. The sole requirement for access to the Oil Facility was the existence of a balance of payments need. There was virtually no other conditionality than to refrain from imposing or intensifying restrictions on trade and payments without the approval of the Fund. As in other cases of the use of resources, the country was expected to consult with the Fund in order to give it the opportunity to determine whether the member's policies were conducive to balance of payments adjustment. The 1974 Oil Facility proved useful and was followed by another facility in 1975.

Under the 1975 Oil Facility stricter conditionality was applied. The member making the drawing was to describe to the Fund its policies to achieve medium term solutions to its balance of payments problems and to have the Fund assess the adequacy of these policies. The borrowing countries were also required to describe the measures they had adopted or proposed to adopt to conserve oil and/or develop alternative energy sources in order to reduce their oil imports.

In this manner, the Fund helped to recycle the surpluses from oil exporting countries to oil importers, many of which would not have had access to capital markets. This allowed borrowing countries to avoid deflating aggregate demand unduly, a measure which would have compounded the problems of the international economy.

In recent years, developed economies have been able to adopt counter cyclical monetary and fiscal policies to deal with recession and the risk of deflation. However, the failure of countries in large surplus to expand, coupled with the absence of a mechanism to recycle their surpluses, obliged emerging market economies and low income countries to adopt contractionary measures to protect their balance of payments and avoid crises of confidence. Given their importance in international output and trade, this has contributed

to a protracted recession in a group of developing countries, and a deeper contraction of world trade.

At a time of net negative capital flows to the developing and emerging market countries, the IMF could have recycled the large Asian surpluses to sustain higher levels of economic activity, investment and structural reform in developing and emerging market countries that could not pursue anti-cyclical policies on their own. Perhaps the main difference with the seventies was that at that time, several industrial countries wishing to resort to Fund support under the Oil Facility, supported its role in recycling, whereas their lack of interest doomed the efforts of developing countries because of their inadequate representation in Fund decision making.

Financial Crises

While capital account volatility has been increasing since the late 1980s, this has been exacerbated in the late 1990s. Since the Mexican crisis of 1995, which was followed by those of Thailand, Indonesia, and Korea in 1997, and later by those of Russia, Brazil, Venezuela, Turkey, Argentina and Uruguay, to name only the best known cases in which the loss of market confidence has given rise to massive capital outflows. Although the problems posed by the volatility of financial flows are well recognized, even countries that despite fundamentally sound economic policies experience short term pressures on their balance of payments or exchange market do not have a readily available source of emergency financing.

The international community agreed that "Measures that mitigate the impact of excessive volatility of short term capital should be considered"[13] and the IMF's own research studies have concluded that capital account liberalization does not promote growth and that market friendly capital controls have been effective in crises prevention in a number of countries[14].Nevertheless, the use of capital controls is still discouraged and there has

[13] Paragraph 25 of the Monterrey Consensus, outcome of the UN Conference on Financing for Development, Monterrey, Mexico, 18-22 March, 2002

[14] See: 2003 "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence" by E.Prasad, K.Rogoff, S.Wei and M.A.Kose

been little by way of Fund policy reaction to unilateral US efforts to decry the use of controls in the conduct of bilateral trade agreements(i.e. Chile and Singapore).

The Contingent Credit Line was established in 1999 to give emerging market countries with sound policies and good fundamentals, the assurance of IMF support to discourage and protect countries from speculative attacks. But it was designed in such a restrictive manner that, despite the high costs of self-insurance and the many difficulties they have encountered, no country resorted to it in its five years in existence. Although most Executive Directors, particularly those representing potential users, supported the continuation of a reformed CCL that would fulfill the original purpose of discouraging speculative attacks, they did not achieve the qualified majority (of 85 percent) of the vote required to keep it in existence. So, on November 30, 2003, the IMF terminated the CCL. The official statement said many emerging markets had reduced vulnerability by building up their reserves,(!) creating flexible exchange rates and adopting other reforms.

The risks posed by capital market volatility remain high and new financial crises are likely to recur as financial flows return to emerging markets. Following the cancellation of the CCL, Tim Geithner, President of the Federal Reserve Bank of New York, -and until very recently, the Director of the Policy Development and Review Dept. of the IMF- criticized the Fund's economic review and lending policies toward emerging market nations and advocated an alternative policy aimed at crisis prevention. He said the Fund's current policy of monitoring the performance of countries and then lending after a crisis develops is not well suited for emerging markets. He argued these nations would be better served through an insurance fund that could be "mobilized quickly and on a sufficiently large scale". A similar criticism had been made several years earlier by this writer.[15]

If market confidence cannot be maintained, and no financing is available there are essentially two ways-other than default- of dealing with crises arising from the volatility of capital: the temporary suspension of debt service payments, i.e. through the declaration

[15] See: Buira,Ariel (1999) "An Alternative Approach to Financial Crises", Essays in International Finance No. 212, International Finance Section, Dept. of Economics,Princeton University, Princeton, N.J.

of a “standstill” leading to a debt restructuring, and the use of capital controls to prevent excessive inflows of short term money. To deal with this issue the IMF had proposed a Sovereign Debt Restructure Mechanism. This called for a “standstill” on payments that would give countries in crisis legal protection against creditor suits for a limited time to allow them to negotiate the restructuring of their debt in an orderly manner. After initially giving support to the SDRM, the US withdrew support for the standstill proviso that was essential to make it operational, thus making the mechanism unviable. Most emerging market countries had reservations regarding the SDRM fearing that their support would be read by markets as indicating intent to restructure, which would raise the cost of borrowing and hinder their access to markets instead of providing an insurance mechanism, as it was meant to be.

Recent months have seen a sharp fall in the spreads for emerging market borrowers-a sharp rise in their asset prices- that responds to the Federal Reserve’s policy of monetary easing that has pumped large amounts of liquidity into financial markets. As a result, after years of withdrawal, investors in search of improving their returns are again attracted to emerging markets offering higher yields than investment opportunities available in developed countries.

If the global economy continues to gain strength and the US interest rates remain low, this will allow these countries to borrow with little risk; however, when these conditions change, as they will in time, the risk of financial crises will again loom large particularly for those countries whose borrowing is sustained by market momentum rather than by careful analysis of fundamentals. In that event, the recurrence of financial crisis will simply be a matter of time. Because the countries that are potentially at risk, the emerging markets, did not command sufficient votes to retain a modified and effective precautionary facility, and controls on short term capital flows are discouraged, the international community has no mechanism to prevent the devastation wrought by financial crises to emerging market countries. The alternative of collective action clauses in bond contracts Hill take a long time to become effective- only alter existing contracts expire.

Negative Net Capital Flows to Developing Countries

Since 1997, the developing countries, which are expected to be capital importers in order to finance investment and development, have been faced with large net negative capital flows or as a minimum large net resource transfers abroad. These countries have become net exporters of capital to the developed countries, a situation that placed a heavy burden on most of them, through the accumulation of international reserves, which at the end of 2002, stood at some $1.5 trillion.

Developing countries have resorted to reserve accumulation despite the prevailing difficult international economic conditions for two reasons. First, some among the handful of countries that continued to receive private capital inflows, mostly in Asia, wished to protect competitiveness and prevent the overvaluation of their currency and sterilized the inflows. The second reason, and this applied to a much larger number of countries, was the desire to protect themselves against the devastating financial crises to which the volatility of capital flows had subjected numerous countries since the eighties. In fact, reserve accumulation was a form of self-insurance against financial crises.

However, self-insurance is the most primitive form of insurance and it is very costly. From self insurance you move to group insurance, and then to broad collective insurance provided by a much wider insurance scheme, such as the IMF. But countries did not feel they could rely on IMF support to prevent crises.

Capital flows from developing to developed countries constitute a misallocation of resources, an anomaly to be corrected exacerbated by the rapid growth of the twin (external and fiscal) deficits in the US. Net negative capital flows mean that countries with per capita incomes of a few dollars a day are exporting capital to the largest and richest economy, a country with a per capita income of over $34,000. The fact that the world's richest economy has become the largest borrower in order to sustain large fiscal and current account deficits is a massive misallocation of world savings; it indicates that something is very wrong in the management of the world economy.

The issue of negative flows has been recognized as a problem to be addressed for some time. In the Monterrey Consensus, the international community recognized that"Private

international capital flows, particularly foreign direct investment, along with international financial stability, are vital components to national and international development efforts. Foreign direct investment contributes toward financing sustained economic growth over the long term. It is especially important for its potential to transfer knowledge and technology, create jobs, boost overall productivity, enhance competitiveness and entrepreneurship, and ultimately eradicate poverty through economic growth and development…"[16]

"To complement national efforts there is the need for the relevant international and regional institutions as well as appropriate institutions in the source countries to increase their support for private foreign investment… To this end, it is important to provide export credits, co-financing, venture capital and other lending instruments, risk guarantees,…"[17] Unfortunately, little has been done to promote increased flows of capital to developing countries; no new instruments have been designed to increase private capital flows nor to diminish the risks of capital account volatility for investors or countries associated with borrowing in a foreign currency. The development finance institutions that have the capacity to pool risks and develop derivatives for their management have not been creative, nor have they expanded their lending operations to take up the slack. In fact during the period 1997-2003 the World Bank lending remained at some 54 percent of its statutory lending capacity and net flows from the World Bank to the developing countries became negative. It is reasonable to assume that the lending policies of the Bank and the Fund would be different if the developing countries had a greater say in their design.

The **Creation** and Management of International Liquidity

International liquidity creation depends on the expansion of capital markets and in today's US dollar based payments system, the balance of payments deficit of the US.

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[16] Outcome of the UN International Conference on Financing for Development, March 2002 (Monterrey Consensus) paragraph 20

[17] op.cit. paragraph 22

Concern that global liquidity would not expand in step with the needs of the world economy, thereby creating a deflationary bias, led the international community in 1969 to the creation of the SDR as a reserve asset. The subsequent rapid expansion of financial markets, starting in the late seventies, led the major countries to believe that it was not necessary to expand liquidity through the creation of SDRs, since credit worthy countries could resort to market borrowing. Since at best, access to financial markets was limited to the industrial countries and a few emerging market economies, this was always a questionable argument.

In recent years, the volatility of capital flows and the contraction of access to financial markets have resulted in net negative capital flows for the developing countries as a group and aggravated the difficulties faced by most developing and emerging market countries in meeting their liquidity needs.

As noted, the access to financial markets for a number of emerging market countries is improving currently, as a result of increased market confidence and the low demand for credit in industrial countries, but more than 150 developing countries still have virtually no access to international financial markets. Consequently for these countries, the accumulation of international reserves (a form of export of capital) comes at the cost of reducing imports of consumer and investment goods, i.e. of reducing consumption and investment levels.

Arguing that an SDR allocation would give rise to inflationary pressures, several major industrial countries have opposed even modest SDR allocations and as a result, no SDRs have been allocated since 1981.This argument could not be made in the recessionary circumstances prevailing in the world economy after 2000; in fact, an SDR allocation would have contributed to economic recovery.

Should the international community leave the creation of liquidity to market forces? This was not the view of the founding fathers of the IMF nor is it the view implicit in Article XVIII which empowers the IMF to create international liquidity to promote its purposes.

The international community can counter contractionary forces by expanding international liquidity. The IMF has the capacity to create international reserve assets

through SDR allocations and could come to the assistance of countries that have difficulties in building up their international reserves.

At a time of recession and an incipient international economic recovery, an allocation of say, SDR 70 to 100 billion, would not only not pose any inflationary risks, it would be positively helpful not only for the recipients of SDRs, but for the recovery of the world economy. Approval of an SDR allocation requires an 85 percent majority of the Executive Board. This means that it is subject to the US veto, and may also be blocked by a grouping of industrial countries, such as the EU, voting against it. However, in the past several European countries with a strong interest in Africa, have been favorable to an SDR allocation and one could assume that in current circumstances, they would be supportive. If this were the case, a coalition of developing and EU countries might be able to persuade the US to overcome its reluctance to put the matter to Congress.

Under the Articles of Agreement, SDRs are to be allocated to Fund members in proportion to their quotas; consequently, over 60 per cent of any SDR allocation would accrue to industrial countries. However, short of an amendment of the Articles, industrial country recipients could donate the SDRs they are allocated to developing countries at no cost to them, on condition that the recipients meet the low interest due on the SDRs received.

Since the SDR interest rate is the average of the short term interest rates on the basket of currencies that compose the SDR, it is market determined, and although it would be below the developing country cost of borrowing, it would not impose any resource transfers or costs on other countries. Nevertheless, the liquidity provided as a result of SDR transfers would be on terms much more attractive to recipients than market borrowing, even for those few countries that have access to financial markets, as these countries normally pay a significant spread or premium over interest rates on developed country Treasury papers. Moreover, the cost of holding international reserves for recipients of SDRs would decline, since the return they can obtain on the investment of their international reserves would be similar to the SDR interest rate (with no quasi – fiscal costs). For those countries that can not borrow in financial markets, the benefits of an SDR allocation, including transfers of SDRs originally allocated to industrial

countries, are unquestionably larger, though more difficult to estimate since there is no market price with which the cost of external borrowing can be compared.

Responding to Exogenous Shocks

The poorest countries with less diversified economies, are the ones that are most affected by commodity shocks. More than 50 developing countries depend on three or fewer commodities for most of their merchandise export earnings. Whether they are the result of price shocks or those arising from droughts, floods or other natural disasters, developing countries with incomes per capita of $1,000 or less are those that suffer the most. Developing ccountries with incomes of $2,000 per capita or higher are less seriously affected in relative terms. This is because of the greater diversification of their productive structure and exports make them better placed to absorb commodity shocks.

The cost of the average commodity shock has been estimated as equivalent to some 2.5%[18] and by another estimate to 7% of GDP and if indirect costs are considered, as much as 20% of GDP.[19] On average, shocks occur every two to three years, and there is reason to believe that natural disasters, particularly those related to extreme weather, are on the rise.

The IMF has a facility to assist countries to cope with commodity shocks and excess costs of cereal imports. The Compensatory Financing Facility was introduced in the IMF in 1963 and liberalized in 1966 and 1975[20], and its purpose was to provide financing to countries for export revenue shortfalls in relation to a medium term trend. In principle, access to the Compensatory Financing Facility was virtually unconditional, because exogenous shocks, whether due to a fall in the price of commodity exports or to natural disasters, say a drought, are not the result of government policies. Therefore countries suffering from a shortfall in their export earnings as a result of such shocks could have access to the CFF provided there is assurance of repayment and the commodity problem is not the result of a secular deterioration in the terms of trade. Drawings on Fund resources however, are limited to 45 percent of a member's quota for commodity shocks

[18] IMF, "Fund Assistance for Countries Facing Exogenous Shocks", Prepared by PDR, August 8 2003
[19] Paul Collier, "Primary Commodity Dependence and Africa's Future" World Bank, April 2002, pp 3
[20] Executive Board Decision No.4912 (75/207) Dec. 24, 1975

and 45 percent for excess import costs in any twelve month period, with a cumulative total of no more than 55 percent of quota. Given the small size of IMF quotas and the high dependency of some countries on exports of a single commodity, this limit is by itself very restrictive.

The CFF was much used by low income countries in the seventies and early eighties. However, industrial country directors, wishing to limit its use, argued that drawings on the facility allowed countries to postpone adjustments and therefore imposed heavy conditionality on its use in 1983[21]. As a result, the conditionality that was introduced has greatly discouraged use of the CFF and for practical purposes the facility has virtually ceased to exist. A more representative governance structure would be more sympathetic to the needs of countries affected by exogenous shocks.

The Problems of the Poorest Countries

The Poverty Reduction Strategy Papers (PRSP) are meant to assist low income countries to achieve sustainable development and emerge from their poverty. In recent years great emphasis was placed on country ownership of the programs. However, reality is somewhat discouraging. Take a very low income country, like Malawi, and look at the IMF report's policy recommendations: (You can find it on the web) The Report centers on macroeconomics and the pursuit of financial stability. The report notes that under the program inflation fell from an average rate of 30 percent in 2000 to less than 10 per cent in June 2003. The program aimed at a strong fiscal adjustment while channeling an increasing share of budgetary resources to pro-poor activities. It notes that although many of the reforms have been initiated, the pace of implementation has been slower than envisaged in implementing the privatization agenda and various public expenditure management initiatives. While recognizing the importance and relevance of macroeconomic policy recommendations to attain stability and improve fiscal administration and attract official development assistance, questions may still arise as to the relative priorities to attain a sustainable economic position in face of the urgent problems of a population ravaged by lack of food and diseases.

[21] Exec.Board Decision No. 7528 (83/140) Sept. 14, 1983

Unfortunately, the IMF report fails to mention that Malawi is a country ravaged by both HIV/AIDs and Malaria pandemics, that has a population with a life expectancy of 38.5 years and an infant mortality rate of 185 per thousand for children under 5. That it is a largely subsistence agriculture economy, with little irrigation or fertilizers, on a soil largely depleted of nutrients. It is a country suffering from food shortages; with no public health system to speak of, severely lacking in infrastructure, with very limited resources to provide basic education to its population.

Among those questions that might receive a different answer from a more representative governance structure are the following: Is across the board trade liberalization the best development policy to diversify output and reduce poverty in low income countries? [22] Do governments have the fiscal and administrative capacity to establish a safety net to assist displaced workers? Industrial countries liberalized trade only after they had achieved a substantial level of development.[23]Perhaps an appropriate real exchange rate and other export support measures would be more effective. [24]

Most economists would not regard total opening of the capital account as a wise policy for very poor countries at low levels of financial development. Nor would immediate adherence to WTO rules regarding intellectual property, investment measures or subsidies be likely to assist poverty reduction or unleash a flood of investment flows.[25] Similar questions may be asked with regard to the timeliness of the recommended early adoption of the over 60 standards and codes. Would this be the best use of scarce qualified human resources? Did today's developed countries comply with such policies and standards at early stages of their development? Did the newly industrial countries in Asia? Are China, India, Vietnam and other low-income countries experiencing high rates of growth in compliance with the recommendations on trade and capital account liberalization and with most other policies listed above? Do these recommendations

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[23] See Ha-Joon Chang "Kicking Away the Ladder"……………..
[24] See G.Helleiner"Marginalization and /or Participation: Africa in Today's Global Economy", Lecture to CASS Conference, published in Canadian Journal of African Studies,Vol.36 No.3, 2002
[25] See G.Helleiner op.cit.

reflect historical experiences of development? Are the recommended policies and standards at the root, or are they the fruit, of development?

A low-income country must have a PRSP to qualify for debt relief. The objective of the HIPC initiative, launched in 1996, was to reduce the debt burden and help countries to attain debt sustainability. Unfortunately, this is not assured even for the few countries that have met all the criteria. As a recent IMF working paper concludes, programs to relieve some of Africa's poorest countries of their debt burden may not produce a sustainable fiscal situation. The study[26], which reviews the situation prevailing in 12 member countries concludes that these may not be able to raise sufficient revenues to pay for the pro-poor spending programs that the IMF has envisaged without falling back into unsustainable debt levels. As is often the case, the export revenue and fiscal projections on which the program was based proved too optimistic and the debt relief granted was found insufficient[27]. If the countries are to escape from the cycle of poverty and high debt, the answer would appear to be substantially higher levels of debt relief and of ODA provided as a grant.

Conclusion

The review of seven major problems confronting the world economy suggests that existing monetary and financial arrangements are not conducive to providing an enabling environment for financial stability and development. In that sense they are dysfunctional. Since the issues are well understood, and the technical possibilities for improvement exist, this must be seen as a political problem, largely a failure of the prevailing governance structure in the international monetary and financial system to address the issues. This failure results from an excessive concentration of power in a small group of industrial countries that while shareholders no longer feel the need to take account of Fund policies and requirements and are no longer genuine partners in a cooperative enterprise. The major countries address their economic problems and imbalances

[26] "Fiscal Sustainability in African HIPC Countries: A Policy Dilemma?" IMF, WP/03/187 by Annalis Fedelino and Alina Kudina
[27] For a fuller discusión of the HIPC Initiative see B.G. Gunter "Achieving Long –Term Debt Sustainability in Heavily Indebted Poor Countries" in "Challenges to the World Bank and the IMF" edited by Ariel Buira , 2003

directly, acting outside the Bretton Woods system. This combination of concentration of power and working outside the system has lead to a decision making process that gives insufficient consideration to the problems and interests of developing countries and emerging market countries.

A more inclusive and participatory governance structure, giving appropriate consideration to the needs and interests of non-industrial countries, could result in substantial improvements in the management of financial risks, of international liquidity, more stable growth and a fuller utilization of resources of the global economy as well as increase the legitimacy of the international financial institutions.

An open and constructive discussion of these and other issues with an increased participation of developing countries in decision making would not only lead to a better understanding of problems but to better outcomes, as a result of accommodation to developing country needs and interests. Commensurate with their greater responsibility, they would be expected to increase their financial contributions to the international financial institutions very substantially, which they are fully able to do. However, for the reformed governance to be representative, low income countries should not be excluded lest their interests not be represented. This would require a substantial increase in basic votes.

With higher levels of international reserves than industrial countries and a proportion of world output similar to that of the G7 countries, measured in terms of purchasing power parity, the developing and emerging market countries, including the more dynamic members of the international community, are major players whose participation is needed for providing adequate resources to the institutions, in making surveillance effective, for the adoption of counter-cyclical policies, and for dealing with the problems of financial crises prevention and resolution, financial intermediation and negative capital flows to developing countries, the creation and management of international liquidity, dealing with commodity shocks and for producing more viable HIPC and PRSP strategies.

Until now, the changes required to make governance more representative have been resisted by those countries, mainly in Europe, that are substantially over represented in the BWIs and wish to maintain the privileges they derive from an outdated status quo. In so doing they are hindering the workings of the international monetary system.