THE FUTURE OF THE BRETTON WOODS INSTITUTIONS

Conférence prononcée par M. Jacques de Larosière
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Introduction

The world has changed since the Bretton Woods Conference :

Any discussion on the future of the Bretton Woods institutions is bound to start from recognizing the profound changes that have taken place over the last thirty years and which have significantly altered the post war world economic foundations.

Basically, two major factors have been at work :

- on the one hand, the international monetary system is no more one of fixed exchange rates and capital controls. Since 1971/73, we live in a world of floating exchange rates and free capital movements, and this has substantially transformed the environment in which the IMF was created :

- on the other hand, the development model has completely changed. In the post-ward period and until the 70', the name of the game was to transfer public funds to governments or state-owned institutions of developing countries in order to finance projects. But this situation has been superseded by the enormous development of private capital flows over the last ten to fifteen years. Last year, for instance, the private sector transferred approximately twenty times more resources to the developing countries than the World Bank and the other multilateral development banks (MDBs). With globalization and privatization, the traditional rule whereby the World Bank may only lend to governments is obviously put in question.

Critics argue that, in the face of these changes, the international financial institutions (IFIs) have not adapted enough :

As far as the IMF is concerned, critics ask whether this institution is sufficiently taking into account the reality of the floating rate system and if it is not delaying market oriented reforms by propping up unsuitable pegs in a number of countries. Critics are also questioning the long term nature of Fund's lending through strings of programs negotiated with countries that too often show their inability or unwillingness to adjust.

As far as MDBs are concerned, critics argue that these institutions lend large amounts to governments that either don't need them or misuse them. They consider that the cost of MDBs and especially of the World Bank are high, indeed excessively high in relation to the efficiency of their lending operations.

Although IFIs have changed to adapt to the new circumstances, the fact of the matter is that the level of concern and the loudness of criticism have increased over the recent years. The strategic and philosophical foundations of those attacks are very diverse :

- some, from the left side of the political spectrum, denounce IFI conditionality as being exclusively free market inspired for the benefit of “corporate capitalism” and not sufficiently focused on the fight against poverty ;

- some, from conservative circles, like the majority of the authors of the Meltzer Report commissioned by the U.S. Congress in 1998, argue that the IFIs have to be completely overhauled in order to make them more efficient and accountable. They underline that MDBs have in general failed to foster growth and reduce poverty.

But, whatever the inspiration, the intensity of criticism is increasing.

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I shall try, in my following remarks, to analyze the main objections raised by those who are attacking the Bretton Woods institutions and to give you my own assessment of what should be the direction for the future of the IFIs.

I shall draw on my own experience at the head of the IMF and of the European Bank for Reconstruction and Development (EBRD). I shall also draw on the report released on April 26, 2001, on “The Role of MDBs in Emerging Market Economies” by a commission chaired by Angel Gurria and Paul Volcker and sponsored in particular by the Carnegie Endowment for International Peace.

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I. THE IMF

If there is unanimous agreement on the need to improve its “preventive” role, there are major divergences on the future role of the Fund.

A. Agreement is unanimous on the need to improve on preventive mechanisms :

Many analysts have argued that some of the recent financial crises - especially the 1997 South-East Asian crisis- could have been prevented -or at least mitigated- if the proper warning signals had been provided early enough by the IMF and by those who are in charge of assessing the economic performance of emerging countries. In particular, it can be observed that not enough attention

had been focused at the time on the indebtedness of the private sector, on its maturity and currency structure.

But for such early warning indications to be provided in time, there is a need in the emerging countries for reliable, timely and transparent data. Hence the efforts by the IFIs to provide assistance to countries on data collection and reporting. Hence the encouragement provided by the IMF to member countries to publish article IV reports on their economies. Hence the incentives provided to emerging countries to adhere to the Fund's program of "special data dissemination standards" that is intended to provide the market timely and homogeneous economic and financial data. Hence the regular quarterly publication by the IMF of the "Emerging Market Financing" reports. Hence the encouragement to emerging markets to engage in regular meetings and "road shows" with private investors. Hence the collaboration between the IMF and the World Bank to strengthen banking systems, risk management and surveillance functions in LDC's. And I could go on and on….

B. But disagreements persist on the future role of the IMF :

Here we need to recall the essence of the Meltzer Report.

1. The Meltzer Report :

Basically, the Report recommends :

a) eliminating IMF lending to countries affected by long term problems. The IMF should not be involved in long-term development assistance (as in Africa) nor in structural transformation (as in the post-communist transition economies). Therefore the enhanced structural adjustment facility and the poverty reduction and growth facility should be eliminated ;

b) limiting IMF's lending operations to the provision of short term liquidity to solvent member governments when financial markets close. The IMF would therefore play a role of "quasi-lender of last resort" for solvent emerging economies in crisis situations. Liquidity provided by the IMF would be short term, carry a penalty rate (i.e. above the borrowers recent market rate) and be secured by a clear priority claim on the borrower's assets. There would be no need for detailed conditionality since countries eligible to the short term lending would have to be "financially sound".

2. Reactions to the Meltzer Report and recommendations for the future:

I think one should distinguish two types of situations : helping countries on the road to balance of payments viability and handling financial crises.

a) The Fund should continue to provide assistance to countries as long as they demonstrate that they are committed to adjustment :

There is obviously here a major weakness in the Meltzer Report. It is not because a country is facing structural problems (development wise or transition wise) that it should not be eligible to IMF balance of payment support.

Helping a developing -or emerging- country to reach balance of payments viability over the medium term is, on the contrary, one of the most important functions of the Brettons Woods institutions. There are, in the history of the IMF, a host of examples that show how the Fund can be effective in it's role of providing policy advice and helping the adjustment. Let me mention, in this respect, the remarkable achievements in terms of fiscal discipline and monetary stability that have been obtained in Latin American, North African or Eastern European countries over the last two or three decades or so.

Of course, there have been relapses and slippages. But if you look at the overall picture on the long term horizon, there is no doubt that the macroeconomic setting of the developing world has become less chaotic, less inflationary, and more conducive to private investment than would have been the case had we not benefited from such an institution.

This process can, in the event, lead to a string of Fund supported programs. The important criterion, here, is to avoid situations where things continue to deteriorate and where IFIs only continue lending to recoup what the countries owe them. But as long as commitments and tangible results are there, the role of the Fund (be it as a "precautionary" standstill provider) can be easily justified.

b) In cases of financial crisis, the IMF should enhance its catalytic role vis a vis the private sector :

I must admit that I do not comprehend the logic of the Meltzer Report recommendations for the Fund's role in crises management.

Making the Fund the "quasi lender of last resort" seems to me a solution fraught with danger. The "moral hazard" objection should be taken seriously all the more so because it is often difficult to distinguish a liquidity crisis from a solvency one. Besides, the Fund has only limited resources and, by contrast to a "normal" lender of last resort (i.e. a Central Bank), has no ability to issue money.

And if one assumes that a solvent country loses market access (the only case where the Meltzer Report envisages a lending role by the IMF), one fails to understand how a "penalty" rate applied by the Fund so as to make its assistance more expensive than the most recent market rate obtained by the country in question (by definition, already significantly dissuasive since it would be a "pre-seizure" rate) could help the interested debtor when one thinks of the potential magnitude of present spreads in crises situations.

The fact of the matter is that, in a crisis situation, regaining market access requires the combination of several "reassurance factors" :

- a program negotiated by the Fund with the debtor country (macroeconomic discipline is always at the heart of the process allowing a country to regain market access). Here, the Fund has a unique role to play, one that no other institution can taker over ;

- some financing provided by the IMF, but not necessarily in very large amounts (much depends on the balance of payments requirements, on market sentiment, and on the degree of involvement of the private sector in the problem).

Indeed it seems logical that the IMF should devote more attention and efforts to the private sector involvement (PSI) in debt crises management. In a world where most of the debt is incurred by and owed to the private sector, it is normal and healthy that private creditors be called upon at an early stage to discuss debt reschedulings, standstills…. I know that the problem is more complex than it was in the 80's (when banks were the main actors) but it remains that private creditors (be they banks or bondholders) can and should be involved in orderly solutions whenever that appears possible. I am not advocating a systematic set of rules leading to compulsory mechanisms. That is not what is required. But I have argued that the Fund should call on the private sector early in the day and share with its representatives (through the IIF for instance) the rationale behind a Fund program for a particular country, the concept governing its balance of payments viability and the financial requirements that are needed. If such a framework was truly discussed between the IMF and the creditors (as it was 20 years ago), it would be easier to address in an orderly fashion the issue of private sector involvement and to address it with a "voluntary" approach and with market related solutions (ex: incentives to participate could take the form of limited guarantees or credit enhancements).

The art is to combine an agreed framework with practical, case by case solutions. Hopefully there are signs that suggest that the new IMF management is moving in that direction.

I will leave aside the discussion of the "contingent credit lines (C.C.L.)" designed by the IMF two years ago and that has not yet been utilized. The idea is to offer countries very large[1] short term precautionary facilities that would be drawable in cases of crises. If the facility has not been used up to now it is probably because of its status : neither automatic nor completely conditional. Some countries may consider that the conditionality procedures are too complex for large emergency drawings, whilst the mere initial application to become eligible to the facility might be seen as carrying a "stigma".

c) As far as the functioning of the international monetary system is concerned, I have no time to dwell on the issue :

[1] In the order of 300 to 500 percent of quota (i.e. 12-20 billion dollars for a country like Brazil or 4-7 billion for a country like Thaïland).

Let me just say that, aside form multilateral surveillance -which has its limits- and barring any revival of the SDR (international liquidity creation in cases of global need) -which I presently see as very remote-, the Fund could play a major role in the functioning of the exchange rate system if the main players (G 3) decided to coordinate their policies in a way conducive to more stability. But that is another story…

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II. The MDBs

A. The Meltzer Report criticism and recommendations :

1. The criticism :

The Meltzer Report underlines what it calls the inefficiency of the MDBs : collectively they employ 17.000 people in 170 offices and have obtained 500 Billion dollars from governments, with the main objective of fighting poverty. But the authors remark that “there is a wide gap between the bank’s rhetorical promises and their performance and achievements”.

They stress :

- bureaucratic inefficiency ;
- poor evaluation process : “wrong criteria combined with poor timing” ;
- costly expansion ;
- insufficient cooperation between overlapping institutions ;
- and, most important, excessive concentration (70 %) of non aid-resources to 11 countries that enjoy substantial access to private resource flows (like Argentina, Brazil, China…).

2. The recommendations are twofold :

a) MDBs should abandon lending to countries that enjoy capital market access (as denoted by an investment grade rating) or with a per capita income in excess of 4.000 dollars. This should take place over the next five years. Starting at 2.500 dollars per capita income, official assistance would be scaled back.

MDBs should not engage in any emergency lending.

b) the World Bank and the regional institutions should focus on poverty reduction. In poor countries without market access, poverty alleviation grants to subsidize user fees should be paid directly to the suppliers upon verified delivery of service. In addition, MDBs could lend to poor countries governments with subsidized interest rates on the basis of institutional and

policy conditionality. The World Bank would become the "World Development Agency".

B. Looking to the future of MDBs :

1. The objectives :

A number of the criticisms made in the Report are well taken and are actually shared by many officials and economists inside the MDBs. But the most radical measures recommended by the Meltzer Report seem to miss the very essence of the criticism.

I would put my views as follows :

- fighting against poverty should indeed the basic aim of MDBs,
- but facilitating the investment climate in poor and middle income countries alike is key to the success of poverty alleviation,
- the present globalized world is dominated by private capital flows : this should have significant implications for the strategies, policies and methods of MDBs.

2. The ways to go forward :

a) Graduation should not be automatic :

Even if one agrees with the idea that, over time, less MDB resources should go to middle income countries, one should avoid the type of automatic and simplistic graduation approach recommended by the Meltzer Report. The reasons why I believe the report misses the point are the following :

- a middle income country that has today easy access to the financial market can be closed off suddenly and loose its rating as we have seen in the aftermath of the Russian crisis in 1998 and even today in some Latin American countries that have nevertheless a sound macroeconomic track record ;

- furthermore, as Nancy Birdsall, of Carnegie Endowment for International Peace, observes [2] : "Many middle income countries cannot issue debt for terms beyond five years. Yet development investments -in schools and infrastructure- have much longer gestation periods";

- "moreover, when global market turmoil requires these countries to reduce government spending to rebuild credibility with private lenders,

[2] Carnegie Endowment – Policy Outlook : « The World Bank of the Future : Victim, Villain, Global Credit Union ? », April 2001.

it is the MDBs that provide credits to sustain their education and health programs".

All this is not to say that nothing should change. For instance, one could well imagine that the World Bank should apply different rates of interest to its borrowers. Those that are better able to access private markets should face higher interest rates. This would undo the argument that the bank is crowding out the private sector.

But as Nancy Birdsall observes : "flexible and competitive pricing implies changes in cost-sharing and ultimately in the balance of power among shareholders". This would be indeed a step towards enhancing the sense of ownership in MDBs.

b) Getting MDBs out of borrowing (and lending) is not a good idea :

The "Club idea" conceived by Keynes in 1944 was and is still brilliant. It goes on the following lines : a club with big depositors and guarantors can borrow cheep and therefore reduce the costs for the poorer borrowing members, and this at very little risk for the depositors as long as the bank is well run.

If all education, health, environment… investments were to be financed by each middle income country at market rates, the cost of those investments would raise exponentially (given their limited access to the market).

c) catalyzing private sector investment is a must :

Private financing (notably in the form of FDI) is a feature of today's world.

In my view, MDBs should not compete with capital flows that are available to finance investment in emerging countries.

They should, on the contrary, demonstrate that they are truly "additional". There are many cases where such complementarity exists and is essential :

- there are projects that private investors would judge too "risky" if there was not the presence of an MDB (leaving commercial risk to the private investors and sharing "political risk " with an IFI makes sense in some cases) ;

- there are projects where private financiers would not be ready to take on the longer maturities (which can be taken by the MDB) ;

- there are projects where MDB conditionality is crucial to trigger private financing (this is the case, in particular, in private energy or water projects in countries where the "fee and tariff culture" is still embryonic and where the presence of an IFI is of the essence).

Modalities of such a collaboration between MDBs and the private sector are diverse (co-lending, B loans, equity participations…) and have been successfully practiced over the last years notably by the IFC and the EBRD.

The EBRD -that carries out 2/3 of its activity in the private sector in transition countries- is an illustration of what I have just said. It can be seen as a model of collaboration with the private sector although it is not even mentionned in the Meltzer Report. This collaboration is founded on the basic concepts of additionality, sound banking and transition impact.

As Nick Stern, who is the Chief Economist at the World Bank, after having held the same position at the EBRD, wrote in a recent illuminating paper [3] : "The Role of the IFIs is to help finance the costs of change rather than to cover the costs of not changing".

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Conclusion

To conclude, I should like to stress three brief points.

1. In the immediate future, I don't see much in terms of revolutionary changes. The new U.S. administration made a few noises in its initial weeks of office that suggested that they were uneasy with the type of large "financial packages" by the IMF and MDBs in crises situations. But a few days ago, we could hear Mr. Colin Powell, Secretary of State, express the Bush Administration's support to the Bretton Woods institutions and praise the success of big international financial rescue packages. The Secretary of the US Treasury has himself just endorsed a new 10 billion dollars of extra funding for Turkey from the IMF and the World Bank. Mr. Powell went as far as saying : "The Bretton Woods institutions are doing wonderful work today building on the legacies of 57 years". So, business as usual….

2. My second remark is to say that we should precisely <u>not</u> be content and stay where we are. The world <u>has</u> changed and so have the IFIs. But not enough. I have tried to show in my brief presentation what should be, in my view, the main directions of that indispensable transformation. IFIs continue to have a role in a world of globalization. But this is a changed role. As Nick Stern recently stated [4] : "The IFIs now start unavoidably from the premise that the private sector is the engine or locomotive of growth and development ; surely the failures of developmental "dirigisme" and the collapse of command economies have taught us that lesson. It is central to the role of the IFIs,

[3] « Investment and Poverty : the role of the IFIs », April 22, 2001, London.
[4] See above.

therefore, to promote and foster private-sector-driven growth- and to do so in ways that are pro-poor ".

3. But this is a fundamental change, one much more complex and far reaching than the simplistic rules for graduation recommended by the Meltzer Report. It is a change that requires leadership from the heads of IFIs, political support from the shareholders and a capacity to adapt, to move from quantity to quality and to get rid of the unbearably heavy bureaucracy that still besieges too many of those institutions.

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