Bretton Woods Institutions in 2000*

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Bretton Woods, a place in New Hampshire in the U.S.A. became famous soon after the Second World War when a Conference was held there. As a result of the deliberations in 1944, the International Monetary Fund (IMF or Fund) and International Bank for Reconstruction and Development (IBRD or World Bank Group) came into existence, usually described as Bretton Woods Institutions (BWIs) or Bretton Woods Twins. There have been significant changes in their role and functioning. In fact, fifteen years after this suggestion, a comprehensive review of these institutions is taking place. I will briefly explain the origin and adaptation of these institutions to the changing times and share with you the current debate on the future of these institutions. Being a central banker, I will focus more on the role of the Fund.

Origin and Adaptation

In the Bretton Woods Conference that took place towards the end of World War II, 44 countries were represented, and most of the Africa and much of Asia went unrepresented though India was an active participant. Substantive negotiations were essentially between the U.K. and the U.S.A., and thus between their spokesmen, *viz.,* Lord Keynes and Mr. Harry Dexter White, respectively. The problems and perspectives were thus of the post-war era, and the painful memories of the Great Depression. The major contribution of the Conference was the acceptance of the idea that the international monetary system has to operate with a framework of cooperation and consultation among governments. It also accepted the idea of provision of resources to a country from a general pool to get over its temporary balance of payments problems, and this became the basis for the creation of the International Monetary Fund (IMF). It also recognized the need for transfer of resources from capital surplus to capital deficit countries through the intermediation of an official multilateral body, *viz.,* the international Bank for Reconstruction and Development (IBRD).

The basic structures of BWIs remain somewhat unchanged. Governments are political bodies, and these institutions representing the creation of national authorities are bound to be political; and, therefore, their membership and functioning in some way, and to some extent at least, reflect political realities. Their membership, open only to Governments, is naturally voluntary. They are cooperative in character, though the voting power is guided by 'quota' in the IMF and shares in IBRD, reflecting uneven strength partly due to historical reasons and partly due to emerging economic and trading strengths. So, they are akin to cooperatives whose members have unequal strength. They are also like clubs, where members are expected to observe certain rules regarding conduct of economic policy, within a mutually acceptable framework which allows for some degree of flexibility.

Members are permitted to draw resources from each of the institutions, subject to eligibility criteria and all such drawals, except some technical assistance grants, in the form of a loan repayable along with some interest or fees. The institutions prescribe conditions or covenants for drawing such resources, and thus those who draw resources are subjected to some severe obligations to the institutions than others. These basic features of BWIs remain more or less unchanged until now.

The membership, however, has been increasing from less than fifty when they commenced operations, to over a hundred and eighty now. Most of newly independent countries naturally became members during the 'fifties, and 'sixties. Initially, the Americas and Europe dominated, which continues even today in a significant way. However, when the institutions started their operations, the then U.S.S.R did not formally join Bretton Woods, while many of the socialist

economies withdrew their membership. But, a few like the erstwhile Yugoslavia continued as members for a long time. During the initial three decades, China was represented by Taiwan. The Bretton Woods twins were thus functioning for over thirty years claiming to be world bodies without membership of the large socialist bloc. The 'eighties, however, saw active participation of China which got its rightful place, while the 'nineties brought Russia into its membership and it includes now almost every economy of the world. There are only a few exceptions: Cuba, North Korea and Taiwan. In brief, these institutions are more representative of the world economy now than ever before in their history.

The International Bank for Reconstruction and Development (IBRD) or commonly referred to as the World Bank (WB) was the other international financial institution established in 1944, apart from the IMF. The WB was founded with the aim of providing developmental assistance to the war-devastated countries of Europe and Asia. During their history of over fifty years, there have been both institutional innovations and a changing focus to meet the dynamics of global economy. Thus, IBRD which initially assisted war-torn economies, such as Japan and France soon left this task to the U.S.A. under the Marshall Plan and concentrated on developing countries. Originally envisaged to provide only project-specific loans, IBRD shifted its focus to programme-lending, structural adjustment, and more recently, to policy lending and covered areas such as irrigation systems, power, highway and port development and communications. From commercially viable projects, the focus shifted to social sectors, then to poverty-related issues and more recently to governance issues as well as to institutional development.

One of the major issues connected with lending was the relationship between World Bank and private sector. World Bank lending required a guarantee from the government receiving the funds and this acted as a constraint to direct lending to the private sector. To enable lending directly to the private sector, the International Finance Corporation (IFC) was established in 1956. Besides the issue of lending directly to the private sector, it was increasingly felt that there were a number of very poor countries for which possibilities of borrowing at WB's near commercial rates were limited. Consequently, the International Development Association (IDA) was created in 1960 to cater to the development needs of poor countries. Resources for IDA was to come from the rich countries and these resources were to be 'replenished' every three years through a new round of negotiations among the IDA donors as to the total IDA availability and share of each country. Later, the International Centre for the Settlement of Investment Disputes (ICSID) to arbitrate private investment disputes and Multilateral Investment Guarantee Agency (MIGA) to guarantee investments were also added. These efforts of IBRD were supplemented by Regional Banks (like Asian Development Bank, African Development Bank).

In IBRD, the shareholding of member-countries broadly reflects economic importance and is somewhat akin to that of IMF. The voting rights do reflect the shareholding. Only a part of the subscribed capital of IBRD is paid-in by member countries and the rest is callable. The paid-in capital is the financial basis of WB's activities and the members do not claim dividends on profits. The bulk of lendable resources of IBRD are, however, mobilised by borrowings from capital markets and hence, IBRD can, in turn, lend only to those countries, which are considered creditworthy. This implied that many poorer countries were not eligible, in the sense that any loan to them from the IBRD would have adversely affected the quantum and rate at which the IBRD could raise its lendable resources from the capital markets. In these circumstances, International Development Association (IDA), an affiliate of the IBRD, was established, with contributions in the form of grants from the Governments of developed countries providing resources on soft terms to low income countries. The repayments of such loans are recycled

through the IDA. A part of the profits of the IBRD are also made available to the IDA. Another body, the International Finance Corporation (IFC) was also sponsored as an affiliate of the World Bank, specialising in providing finance to the private sector. Membership of the affiliates is, by and large, common to that of the IBRD and these institutions together constitute the World Bank Group. A more recent (1988) addition to the family is the Multilateral Investment Guarantee Authority (MIGA), which contributes to boosting foreign direct investment in developing countries by covering non-commercial risks.

Since 1999, the emphasis of the World Bank group is on the Comprehensive Development Framework (CDF). The CDF aims at suggesting a holistic approach to development that recognises the importance of macroeconomic fundamentals and yet assigns equal weight to the institutional, structural and social underpinnings of a robust market economy. Strong participation of Governments, donors, civil societies, the private sector and other developmental actors is emphasised in the CDF. The Bank also reaffirmed its commitment to fight poverty and renamed the new objective as "to fight poverty with passion and professionalism, for lasting results". The multipronged approach now encompasses Country Assistance Strategies (CAS), new lending and non-lending services, higher IDA replenishment, and debt relief. It is evident that the World Bank has been attempting to adapt itself to emerging needs.

The IMF can be characterised as a financial club. Its functioning is guided by its Executive Board and the representation in it is decided on the basis of voting rights which in turn is determined by each country's quota. The Executive Board meets at least three times per week. The Executive Board has 24 seats, where all countries are represented, most of them in geographical groupings. The present membership of the Fund is 182 countries which in effect means that there are very few countries that do not take part in the IMF.

The IMF has also been attempting to adapt itself to changing needs. Under the original Bretton Woods exchange rate regime, each country would set a fixed value – called par value of its currency in terms of gold or the U.S. Dollar. The par values of two currencies determined the official exchange rate (also called parity) between them. Exchange rate fluctuations were to be limited to a narrow band around the official exchange rate. While temporary balance of payments deficits were to be covered from a country's own reserves and if necessary by loans (technically termed as purchases) from the IMF, any fundamental balance of payments problems were to be corrected by exchange rate changes. This system ran into problems in the 'sixties, since fixed exchange rate regime constrained the conduct of independent monetary policy in most developed countries. Due to difficulties faced in gold supplies and doubts about the role of U.S. dollar as a reserve asset, the IMF agreed to create Special Drawing Rights (SDR). Due to several reasons, however, the SDR did not take the central place of the principal reserve currency as envisaged during its creation. In 1971, USA closed its gold window and this led to the emergence of floating rate regimes in many countries, replacing gold and par value systems that were bedrocks of the original IMF. The Second Amendment of the IMF Articles of Agreement, which became operational in 1978, formally recognised the reality of the heterogeneous exchange rate policies.

The IMF responded to several challenges to international monetary order with addition of a series of facilities such as Compensatory Financing Facility (1963) later (in 1988) renamed as Compensatory and Contingency Financing Facility, Extended Fund Facility (1974), Supplementary Financing Facility (1977), Supplemental Reserve Facility (1997), and Contingency Credit Line (1999). Besides, there are concessional facilities for poor countries. These funds are not from Fund's General Resource Account but within the framework of a

specific trust fund and then under Structural Adjustment Facility (SAF) established in 1986, which, in 1993, was incorporated into the Enhanced Structural Adjustment Facility created in 1987. In 1999, the ESAF was assigned the additional task of fighting poverty and was renamed as Poverty Reduction and Growth Facility. The amount that a member country can borrow from the Fund from the various facilities with the exception of Supplemental Reserve Facility (SRF) and Contingent Credit Lines (CCL) are set in proportion to a member's quota.

In the 'seventies, IMF's financing activities mainly reflected massive balance of payments imbalances arising out of the two oil crises. In the 'eighties, the major requirements of Fund assistance came from debt crises. In the context of debt crises of Latin America in the early 'eighties, IMF emerged as a major actor in both "bailing-in" the banks to agree to debt restructuring programmes and 'bailing-out' the banks that had lent heavily to these countries through additional financing against greater adjustment. But in the early 'nineties, Fund assistance was more concentrated on needs of its new members, particularly those which had formerly been centrally planned economies.

The IMF's break with the principle of catalytic financing came in 1995, when it arranged a US $40 billion rescue package for Mexico at the initiative of the USA. The IMF's role and capacities were severely tested in the most recent crisis-episodes, *viz.,* East Asian, Russian and Brazilian crisis and in the face of increasing evidence of its deficiencies to deal with such global disruptions, there has been a general emphasis on the need for a thorough review of Bretton Woods Institutions.

It is worth noting here that until the 'nineties problems in a country's balance of payments were, barring shocks, essentially a consequence of what could be termed as inappropriate policies of the Governments in the countries concerned. The Asian crisis, however, highlighted a new dimension to the problem. The Asian crisis was largely attributable to failures in the private sector – both in the recipient as well as lending countries. This new dimension is an important element in the set of factors that have urged a fresh look at the role of BWIs and of the international financial architecture.

It would be inappropriate to conclude that the BWIs have been successful in all their endeavours or that they have been totally adequate or objective in all their responses to the global challenges or to the problems of individual countries. Yet, they do represent significant mechanisms for multilateral cooperation and have to be continuously assessed in that light without prejudice to improving their functioning or even evolving parallel or supplementary organisation, if considered worthwhile. The current debate is, in fact, on just such lines.

India and Bretton Woods

India was a founder member, along with 38 countries and has been an active member of the Fund right from its inception. India obtained a quota, which ranked her among the five largest stake holding members of the Fund and the World Bank. India's fifth place assumes significance as each of the five largest stake holding is entitled to a 'permanent' chair in the Executive Board and appoint its own Executive Director. India, thus enjoyed a permanent seat in the Fund at the time of its inception. However, in the early 'seventies, Japan improved its quota and share-holding to rank amongst the five largest stake-holding members, with the result that India moved to an 'elected' status.

India's recourse to the IMF was limited during the period 1945 to the 1980s. Before the First Five-Year Plan, India borrowed a moderate amount of SDR 100 million under the lower tranche (generally up to 50 per cent of the quota). During the Second Five-Year Plan period, to cope up with the problem of balance of payments, an amount equivalent of SDR 200 million was

borrowed from the IMF. During the Third Plan period, India encountered severe balance of payments problem and hence borrowed a higher amount of SDR 375 million from the Fund. During 1965 and 1968, the balance of payments situation worsened and India devalued its currency and sought IMF assistance to the tune of SDR 415 million, including SDR 90 million under the Compensatory Financing Facility.

The next availment of the IMF facility was during 1973-74, when India was affected by the first oil shock and hence borrowed SDR 775 million, including SDR 200 million under the Oil Facility. Then again during July 1978 and December 1980, India made use of Trust Fund amounting to SDR 529 million.

In the early 1980s, to finance the huge current account deficits, India entered into three year Extended Arrangements with the IMF for SDR 5 billion in November 1981. But, India availed of only SDR 3.9 billion and the balance of SDR 1.1 billion was surrendered.

The oil price hike in 1989 and the Gulf war widened India's current account deficit forcing India to borrow SDR 2,208 million under Stand-by arrangements and SDR 1,352 million under CCFF. These loans are repaid.

As a founding member and main borrower, India has had major influence on WB's lending policy. WB's cumulative lending since 1950 to India comes to US $45 billion for 405 projects; the annual commitments to India averaged about US $1.6 billion recently. Outstanding liabilities to the IBRD as at the end of March 1999 was about US $ 8.1 billion, of which about US $ 2.1 billion was to the non-Government sectors. Taken together, liabilities to IBRD and IDA stood at about US $ 26.4 billion as at the end of March 1999. India experienced a negative transfer of resources to the World Bank group during 1993-98. As against gross disbursements of about US $ 9.7 billion by both IDA and IBRD, repayments of principal and interest amounted to US $ 6.2 billion and US $ 4.9 billion, respectively. As a result, there was a negative resource transfer of about US $ 1.4 billion during 1993-98.

Some general observations on the relationship between India and BWIs may be in order.

First, India has always been represented by an Executive Director on the Boards of each of these institutions (even after losing its 5th place) and its contribution in their conduct of business is generally valued.

Second, India has been a responsible and prudent borrower of resources from both these institutions. This includes quality of policy-making and project implementation, which is considered high relative to other countries.

Third, in times of crises, these institutions extended support to India in a timely manner.

Fourth, both the institutions do acknowledge the valuable contribution that Indian policy-makers made to their policies and procedures - though there are many differences.

Fifth, there have been a few instances, such as the recent sanctions by USA, when there have been some disruptions in their smooth conduct of business with India and such instances are attributable to political factors governing select members rather than to the membership as a whole or to the management.

Sixth, the professional talent and technical expertise of economic policy makers in India is acknowledged to be, at the very least, on par with those in the BWI. For example, the contribution of Dr. Rangarajan as Governor, RBI in designing external-sector liberalisation is universally acknowledged and many observers feel that East Asia could have avoided the crisis if they had benefit of such advice. Similarly, the monetary policy initiatives taken by Governor Jalan in steering the economy successfully through domestic and international uncertainties in the recent past are widely appreciated.

To sum up, the relationship between India and Bretton Woods is one of mutual respect for mutual benefit, though not necessarily one of full agreement on many matters. On the whole, India commands greater respect in the BWIs than any time before, for charting its own path towards growth with stability, and that too very successfully, so far.

What is New in 2000?

The international monetary system in 2000 is vastly different from what it was, say when the Bretton Woods Conference was held and indeed dramatic changes have taken place in the last two decades.

First, and perhaps the most important change, is end of ideological differences among nations. This has paved the way for the emergence of a common approach to solving economic and financial problems. For example, on the role of the *State versus the market* there are less differences among members now than before.

Second, the convergence in economic ideology also meant greater integration among the economies leading to greater compulsions to find common solutions.

Third, there is a relatively greater convergence in economic thinking between people, governments and multilateral institutions than before, resulting in a focus on transparency and accountability of all concerned.

Fourth, the developments mentioned have changed the relevance of the Fund in particular, in the sense that BWIs, which were mainly the concern of borrowing countries primarily in the non-socialist part of the world, have now become relevant to the totality of international and financial system.

More specially, the international monetary and financial system has undergone dramatic change.

First, the magnitude of capital flows has grown by leaps and bounds.

Second, the private component of such capital flows has grown exponentially faster than the Government account.

Third, the sheer variety of flows, the instruments and the participants have all grown so rapidly that the share of Governments and banks- the traditional sources – has become relatively less important.

Fourth, technological advances have made such flows highly cost-effective, remarkably fast and immensely mobile-warranting a constant trade-off between efficiency and stability in the financial sector.

Fifth, these developments, affecting both domestic and off-shore financial centres have made the tasks of domestic regulators highly complex.

Finally, the role of Governments in domestic economic management has been, relative to the past, different, yielding greater initiatives to markets and this finds its echo in the role of multilateral institutions, which are creatures of Governments. Further, due to interdependence of economies, conditionalities and covenants addressed to an individual borrower may often give only half solutions, and the realisation of this implies that, the Fund especially, has to go beyond what happens in a borrowing country. Like Governments now, these multilateral institutions derive their influence, not so much on account of the quantum of resources that they allocate, as from the working rules that they may prescribe and the safeguards that they may emanate to influence the markets. It is in this context that BWIs are able to command importance in the international financial system, an importance that is disproportionate to the resource transfer that they are able to deliver.

In regard to the changes in the status of developing countries as a group in this changed current monetary and financial environment where BWIs have such a disproportionate influence, the

following generalisations could be made:
(a) There is greater realization about the diversity among the developing countries, though the overall trend is global economic integration.
(b) It is also recognised that merely removing Governmental restrictions does not automatically ensure the integration of the economies.
(c) In the process of globalisation, some developing economies are more broadly integrated than others, and there can be different depths of integration between developing countries and industrialised countries.
(d) The transfer of resources from BWIs to erstwhile socialist economies, especially Russia, brings a new dimension to the division of the world into the developed and the developing.
(e) The large flow of private capital flows to developing countries is concentrated among few economies – often described as emerging economies. There is a substantial increase in savings available in some economies which are in search of investment opportunities and these go to developing economies where the risk weighted returns to capital appear higher. Thus, the concentration of investments is among a few economies.
(f) Modern technology has enabled not only massive easy and low cost inflow of capital but also equally large, volatile outflow of capital, and these flows invariably have an impact on currency and trade. In the process, the economies of developed countries have become an integral part of large capital flows and hence are affected by crises and contagion from some developing countries as well.

These features of the 'nineties meant that the country-specific solutions, usually through conditionalities or covenants of the BWIs, were tending to be not even half solutions. The search for alternatives or supplements to the BWIs and/or a thorough revamp of these should be viewed in this light.

In recent years, the BWIs had to workout "Reserve Packages" involving the private sector and Governments. Thus, the IMF arranged a US $ 40 billion reserve package in 1995 to meet the Mexican crisis. The total package for Indonesia, Korea and Thailand was over a hundred billion U.S. dollars of which only a third was from the Fund, and about half from bilateral sources. While the IMF's prescriptions in respect of East Asia were subjected to severe criticisms, especially at the time of launching of the package, the Russian crises brought into limelight some of the weaknesses of IMF's surveillance.

Alternative or Supplementary Arrangements

While the changing realities mentioned above necessitate a reform of the international financial system, the recurrent crisis in the recent past triggered a serious debate on a new international financial architecture, inevitably affecting the future shape of BWIs. To date one comes across a number of proposals and the formation of a number of new forums, and I will refer only to a few interesting ones here.

International Credit Insurance

According to Mr. Soros, a private investor, the efforts to stabilise the global economy should focus on two goals. Firstly, to arrest the reverse flow of capital from the periphery of the global capitalist system to the centre and to revive and stabilise the flow of capital from the centre to the periphery and secondly to ensure the political allegiance of the peripheral country to the global capitalist system and provide for an environment were they to opt out of the global system. To achieve this objective, Mr. Soros proposed the formation of a credit insurance mechanism as a permanent part of the IMF. This institution would explicitly guarantee, up to defined limits, the loans that private lenders make to a country. Countries would pay a fee while floating loans, in

order to finance the cost of insurance.

However, Mr. Soros's proposal for an International Credit Guarantee Corporation raises one serious question, *i.e.,* how would the credit guarantee awarded to an individual country be allocated among the country's borrowers. Secondly, the recent experience has shown that insurance –explicit or implicit- have limited utility when a country is confronted with systemic crises.

International Regulator and Rating Agency

Henry Kaufman, President of the Henry Kaufman and Co., Inc., proposed the formation of a new international institution manned by investment professionals drawn from private sector. The Agency will have supervisory and regulatory responsibilities over financial markets and institutions. It would supervise the investment and position taking activities not just of traditional financial intermediaries but of non-bank financial market participants such as hedge funds as well. It would be empowered to harmonise minimum capital requirements, establish uniform accounting and disclosure standards and monitor the performance of financial institutions and markets of its members.

One issue here is how a global financial regulator, quite far off from the national markets, would be able to enforce regulations it prescribes. Regulation and supervision is basically a "hand-on" affair and it is more effective when it is close to the market. Secondly, the idea of a global financial regulator can be feasible only if there is some degree of political integration. Thirdly, the question of who will rate the rating agency is a big question mark or to put differently, how would one ensure accountability of rating agencies.

International Bankruptcy Court

Jeffrey Sachs of Harvard University proposed the formation of an international bankruptcy court. The basic idea is to give debtors some "breathing space" in the event of default and facilitate orderly restructuring of debt. The proposal of international bankruptcy court can be as effective as having a lender of last resort.

The major issue here is an enforceable international legal framework. For example, will international bankruptcy court have the right to enter a debtor country and seize physical assets and remove the board of directors? To be effective, international courts may need requisite powers to supersede national courts.

International Central Bank

Jeffrey Garten of the Yale School of Management proposed the formation of an international central bank to serve as an international Lender of Last Resort (LOLR). The global central bank would provide liquidity to ailing nations by purchasing bonds from national central banks. Its operations would be financed by credit lines from national central banks or by a tax on international merchandise transactions and certain global transactions.

The major issue here is obtaining consensus on additional liquidity and compliance of national authorities.

World Financial Authority

The increasing global character of financial markets and its growing links between the different segments of the financial sector has motivated some to propose a global agency for financial regulation and supervision or World Financial Authority (WFA). The second argument for WFA is that the financial sector in many countries involves cross-border transactions and transmission of instability across borders and hence their regulation and supervision should be carried out on a unified and global basis.

There are different models of WFA and these vary from improvement over existing

arrangements to the ones that are more comprehensive in terms of responsibilities. One such proposal was by John Eatwell and Lance Taylor, who called for the establishment of a body with the responsibility for setting regulatory standards for all financial enterprises –banks, insurance funds, companies – both on-shore and off-shore. The standards promulgated by WFA are generally sought to be implemented by the national regulators. Another responsibility of the WFA is expected to be to develop innovative means for directing capital flows towards long-term needs.

An important, somewhat open issue, relates to the WFA's relationship with national regulatory regimes and existing multilateral bodies. Existing multilateral bodies are based on links with regulators and supervisors at national level. It is not self-evident how WFA would improve the functioning and cooperation of national regulators. For WFA to become effective, there has to be some degree of harmonization of depositor and investor protection and insolvency regimes of different countries. A proposal which is far less ambitious than WFA but which has taken a definite shape is the proposal for Financial Stability Forum .

Financial Stability Forum (FSF)

The proposal for the establishment of the Financial Stability Forum (FSF) was made by Hans Tietmeyer, President of the German Bundesbank in the platform of Group of Seven major economies of the world. The FSF was conceived in April 1999 to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. The institutional vehicle of the forum is a committee consisting of representatives from the finance ministries, central banks and senior regulatory authorities of the G-7 countries as well as from the IMF, the World Bank, the Basle Committee on Banking Supervision, International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Bank for International Settlements (BIS), Organisation for Economic Cooperation and the Development (OECD), etc.

Financial Stability Forum has since been set up with membership basically on the above lines, serviced by a secretariat from the BIS of which India is a member. Though India is not a member of Financial Stability Forum, India is invited to contribute to many of its Working Groups reflecting our standing in the world intellectual and financial community.

G-22 Reports on International Financial Architecture

G-22 was put together as an *ad-hoc* body of the Finance Ministers and the central bank chief of twenty-two countries at the initiative of President Clinton, immediately after the Asian crisis and this action itself is considered by some observers to be an admission of inadequate response from BWIs. The Reports of October 1998 in which India was represented recognizes that the present system of supervision of the global financial system is fragmented both functionally and geographically. The Group agreed that it would not be feasible to completely overhaul the BWIs, or set up a new large international financial institution. The Report proposed a number of innovations. Among these are: The formation of a Financial Sector Policy Forum with representation from the finance ministry, the central bank, and regulatory and IFIs, and systemically important emerging economies; formulation of system for the exchange of information on financial sector regulatory and supervisory methods; and formulation of a process of coordination or a clearing house to match demands from individual countries for technical assistance in financial regulation.

Group of Twenty (G-20)

G-20 was set up last year with G-7 countries as also with India as one of the 11 major emerging market members. Its objective is to encourage informal exchange of views leading to

mobilisation of consensus on international issues. G-20 offers a much desired bridge between the G-7, *i.e.,* large industrialised economies and the systemically important emerging market economies. The inaugural meeting of G-20 Finance Ministers and central bank Governors was held in Berlin on December 15-16, 1999 with three important issues for discussion, namely, avoiding financial crisis and promoting sustainable growth in the global economy; role of domestic policy in this; and the extent to which implementation of common standards and codes and enhanced transparency practices could strengthen the international financial system.

The Indian position on each of these three issues largely voices the concerns of the developing world at large. India favours a flexible adaptation of transparency practices, core principles, and codes consistent with the differences in the institutional mechanisms across the G-20. India is also of the view that with regard to "approach to capital account and exchange rate regimes" there cannot be a "one size fits all" approach. India considers that crises prevention measures include resolving the impossible trinity (*i.e.,* the incompatibility between independent monetary policy, an open capital account, and a rigidly managed exchange rate regime), timely identification of macro-imbalances and appropriate financial sector reforms. Finally, India views that a country must have the appropriate institutional, technological and legal infrastructure to help in adopting the best practices and codes.

Reforms in Operational Framework of the Fund

There have been several suggestions from time to time, to reform the operational framework of the Fund. These gained added momentum in the current context and a brief recall is appropriate.

Lender of Last Resort

One of the main criticisms against the Fund has been regarding "inadequate availability of resources" to combat the crises of the magnitude that happened in East Asia. This raises the question of the need for International Lender Of Last Resort (ILOLR) and whether IMF can fulfill that role. It is argued that it cannot act as a lender of last resort because it is not an international central bank and therefore, cannot create international reserves; it does not have enough resources and IMF is particularly low on resources during emergencies. The defense has been that although it cannot create liquidity and may not be able to provide necessary financing from its own resources, the IMF can perform its role as "crisis manager" by arranging resources from other sources.

To enhance the resources available, India had argued for issuance of SDR by Fund to itself for use in ILOLR operation subject to pre-determined cumulative limit and other appropriate safeguards. Such a mechanism would not result in any permanent increase in unconditional liquidity (as such newly created SDRs would be exhumed when it is repurchased by the borrowing country) while providing for temporary additional liquidity which can be used to deal with crises.

Contingency Credit Line (CCL)

Many supporters of the IMF see CCL as the first step towards making the IMF a true lender of last resort. CCL enables a country to negotiate advance access in the range of 300-500 per cent of quota and possibly more in exceptional circumstances to meet a 'short-term financing need' arising form a sudden and disruptive loss of market confidence consequent upon developments in other countries. There are some pre-qualifying conditions that have to be met by countries seeking access to the CCL.

India's position has been that the conditions of use of CCL are unduly restrictive. For instance, the possibility of contagion, systemic instability can be due to unexpected changes in the world economic conditions that adversely affect a group of countries. There are also concerns that the

application for CCL could trigger "panics" and "run" on the country and could undermine the market confidence in the country.

Resources

The ability of the IMF to provide "international liquidity" can be analysed in terms of its ability to provide "conditional" liquidity (Quota allocation) and "unconditional liquidity" (SDR allocation). The IMF has been unable to muster the requisite 85 per cent of voting power to make additional allocations on the basis of "global need". Developing countries including India have consistently supported general allocations of SDR.

The access to most of Fund's resources by member countries are set in relation to the quota. There is increasing concern that quota shares of many developing countries, which have grown faster in both GDP and trade than in industrial countries, have not been given adequate quota increases.

India has been in the forefront to advocate a larger quota for developing countries and has made strong presentations to the Fund Board on various occasions on the need to include "need based" variables in the quota formula and to use more widely accepted PPP-based GDP in quota calculation.

The recent Report of the Quota Formula Review Group (QFRG) (Chairman: Prof. Richard Cooper) has rejected the Bretton Woods and derivative formulas and has come out with a simple formula consisting of two variables – GDP and variability in receipts (current receipts plus net long term capital inflows). This new quota formula has not accepted the theoretically sound criterion of PPP-based GDP.

Review of Fund Facilities

The revision of IMF facilities has become one of the main areas of envisaged reform of the Fund. The main argument for review of Fund facilities is that in the present scenario, private capital markets have become more important and hence there should be curtailment of IMF lending. Secondly, it has also been argued that the present set of Fund facilities encourages use of Fund resources for unduly long periods or in unduly large amounts. Hence there was suggestion from the industrialised countries that Fund finances should be pre-dominantly short-term and should be priced in such a way to discourage its excessive use and should be accompanied by incentives to repay as quickly as possible.

As part of the initial measures to simplify its facility structure, IMF at the beginning of 2000 has abolished four facilities: (i) Buffer Stock Financing Facility (BSFF), (ii.) Currency Stabilisation Fund (CSF), (iii) the contingency element of Compensatory and Contingency Financing Facility (CCFF) and (iv) financial assistance to measures of Debt and Debt Service Reduction (DDSR).

Although India has generally supported the need for some housekeeping, it has argued for the need for a spectrum of Fund facilities rather than a single facility in order to meet diverse requirements. At the same time, there is a need to periodically review each existing facility in terms of its operational relevance and to eliminate those facilities that have outlived their utility as has been done for example, in the case of the Buffer Stock Financing Facility (BSFF) and the contingency element of the Compensatory and Contingency Financing Facility (CCFF). It may also be necessary to suitably modify certain facilities so as to meet the overall objectives of the Fund in a more efficient manner.

Private Sector Involvement

In recent times, there has been much debate about the role of private sector in forestalling and resolving financial crises. This issue has become important due to two reasons. First, in the recent East Asian financial crisis, majority of funds involved related to private capital. Second,

given the limited size of the Fund resources in relation to its demand, an effective restructuring process involve voluntary 'burden sharing' between the debtors and creditors. The issue involves the framework to facilitate standstill agreements to provide breathing space to debtors, renegotiation of debt/bond contracts and possibility of new financing. The renegotiation of debt/bond contracts involve issues like protection of rights of creditors, collective representation clauses, clauses on qualified majority voting, etc.

India's basic stance has been that the key issue is whether by involving the private sector the overall costs associated with the foreign exchange crises can be reduced, either by smoothing out the crises resolution process, or by reshaping the incentives under which the private institutions operate. On the issue of having an overall 'framework' for involving the private sector, India has taken a general stand that efforts to "bail-in" the private sector should be framed on a "case-by-case" basis keeping in light the wide diversity of the country situations, their institutional capabilities and other objective factors. The moral hazard issues involving imprudent lending practices can be mitigated only if such investors are concerted to bear the burden of adjustment under crises. In the context of the specific instruments suggested to extend maturities under crises, India has opined that the advantages of the proposed contingent credit lines from private financial institutions as well as concerted rollover of short-term inter-bank lines has not been clearly evident. On the other hand, though India has generally supported the introduction of collective action clauses in sovereign bond issues, the formation of creditors' committee and 'standstill agreements', it has been opined that concrete operationalisation of such ideas should ensure that obligations of the private sector of the industrial countries do not involve sacrifices by the developing country official creditors.

Surveillance

Surveillance is one of the mechanisms through which the IMF promotes good macroeconomic and financial sector policies among the member countries. The surveillance of the global economy is conducted either bilaterally (through Article IV consultations) and multilaterally (through publication of reports such as World Economic Outlook and International Capital Markets). The surveillance mechanism of the Fund was subjected to wide criticism world-wide for its failure to predict and detect the East Asian financial crises.

In June 1998, the Fund had commissioned an external evaluation by an expert panel headed by Mr. John Crow (former Governor, Bank of Canada) on Fund surveillance over members' policies under Article IV of the Articles of Agreement. The Crow Committee in its report last year recommended that the Article IV consultation process is "too bilateral" and therefore should have an "international focus". Besides, it recommended that the Fund surveillance devotes substantially larger attention to the "vulnerabilities" of member countries and devotes more resources to the "spill-over issues".

India's position is that Fund surveillance programmes should be "country friendly" rather than "market disturbing". At present, there is an "asymmetry" in the treatment of countries in terms of surveillance – developing countries are subject to more frequent and intense surveillance while developed countries are subject to less frequent and less intense surveillance. But, recent experience has shown that the sources of instability could arise in developed countries as well. Hence it is important that advanced countries are also subject to "enough" surveillance along with developing countries.

International Financial Standards and Codes

Under the aegis of G-20, the issue of codes and standards has become an important area. Adoption of codes and standards are important for increasing transparency and for facilitating

favourable market perceptions. A Code of Good practices on Fiscal Transparency was approved by the Fund in 1998. Similarly, a Code of Good Practices on Transparency in Monetary and Financial policies has also been approved by the Interim Committee (presently known as the International Monetary and Financial Committee) in September 1999. Similarly, OECD has brought out guidelines on "Corporate Governance" and the World Bank on "Social Sector Policies". The Financial Stability Forum (FSF) has identified 12 key standards for implementation by various agencies.

Indian view has been that the compliance with standards, important as it is, does not by itself provide a solution to the problems of financial stability. Further, the extent and depth of integration of each country would vary. Hence all codes may not be equally relevant for a country, warranting country specific prioritisation in the extent and pace of compliance. In fact, international standards themselves keep evolving. Under the circumstances, each country should have the necessary flexibility to move towards broad consistency with freedom to deviate depending on the unique circumstances.

India has called for an "inclusive process" in the implementation of standards and codes. Today, the plethora of standards and codes are overwhelming and highly demanding of manpower and financial resources of developing countries. The implementation of these codes and standards involve micromanagement of sovereign national economies and therefore may be overly intrusive. Hence a pragmatic approach to the issue has been advocated by India.

A Standing Committee on International Financial Standards and Codes has been constituted in India with the joint membership of Government and the RBI. The main task of this Committee is to identify and monitor developments in global standards and codes and consider its applicability to the Indian financial system. The Committee would also help align, to the extent necessary, India's practices to international best practices.

Considering that there are a number of codes in a wide variety of areas, the Committee has identified 10 different subjects, based on their criticality and importance and constituted an Advisory Group under the chairmanship of eminent personalities. These Advisory Groups have been constituted in the areas of fiscal transparency, transparency of monetary and financial policies, banking supervision, securities market regulation, insurance regulation, accounting and auditing, bankruptcy, corporate governance, payments and settlement system and data dissemination.

The Advisory Groups will study the present status, the applicability and relevance and compliance in India of the relevant standards and codes, given the prevailing legal and institutional framework. The Advisory Groups will also compare the levels of adherence in India *vis-à-vis* industrialised countries as also emerging economies with a view to understanding India's position and prioritising actions on some of the more important codes and standards. The Advisory Groups would chalk out a course of action for achieving the best practices.

Some Reports of the Advisory Groups are now publicly available and the remaining as and when submitted will be made available to all concerned in public and private sectors.

Moral Hazard

There is a strong argument that today's financial woes are the result of bail-outs of both recipients and investors by the Fund. This criticism has been levelled against the backdrop of "bail-out" of Mexico and Russia. The issue of moral hazard arises when investors and borrowers behave recklessly because they believe that they will be "bailed-out" when there is trouble. The real challenge before IMF is to avoid moral hazard and at the same time provide means of not only avoiding financial crisis but also minimising their adverse impact when such crises occur.

India recognizes the issue of moral hazard, but has been focusing on the fact that countries such as India which internalised the burden of crisis in 1991-92, should be recognised and rewarded.

Approaches to the Reform of the IMF

There have been several suggestions for reform of IMF, and a few of the more serious ones deserve to be mentioned here.

Eichengreen's Proposal

Eichengreen has argued for making the IMF more independent. According to Eichengreen, "international standards" must form the basis for future IMF multilateral surveillance. He believes that IMF policies often serve the political agendas for its dominant members. Hence, he recommends giving IMF more independence by prohibiting its Executive Director from taking instructions from national Governments and by giving them an explicit mandate to foster policies that "maximise stability, prosperity and growth".

Lawrence Summers

Mr. Summers, currently Treasury Secretary in the USA, argued that the IMF needs to be more transparent and open in its agreements with countries. Further, the IMF needs to be more accountable to its members; work harder in designing the terms of financial support to make it more market-based and more "acceptable" to its recipients. In designing its programmes, he indicated that the IMF needs to take better account of the broader structural and institutional environment with which they are to be implemented and needs to work with others in the international community to ensure greater private sector burden sharing in the event of any crisis.

Transforming the Interim Committee

The objective of this exercise is essentially to bestow decision-making powers to the Interim Committee (IC) as well as to enhance its political accountability. Among the many proposals considered in this connection, one relates to the formation of a Council which would be a political and decision-making body, comprising persons with political responsibility. Yet another proposal relates to converting the Interim Committee into a permanent International Financial and Monetary Committee. The proposal has since been implemented.

A number of measures have already been initiated in order to make the meetings of the IC 'more efficient, productive and participatory', and India had supported these initiatives.

Meltzer Commission Report

International Financial Institution Advisory Commission (also called the Meltzer Commission) was established last year by the U.S. Congress to report on the workings of the international financial institutions. The Commission submitted its Report to the Congress on March 9, 2000.

Some of the major recommendations of the Meltzer Commission are -

(i) The IMF should pull out of all medium and long-term lending. Its role should be a quasi-lender of last resort to emerging economies with short maturity loans, collect and publish financial data from members and provide advice (but not impose condition) relating to economic policy.

(ii) More than 70 per cent of the World Bank's money was lend to 11 countries that already had access to the international capital markets. Consequently, World Bank lending to these countries are "irrelevant".

(iii) The regional development banks should take over the primary role of promoting development in Latin America and Asia and the World Bank should take lead in Africa until the African Development Bank was ready to assume responsibility.

(iv) The Commission recommends that currencies should be divided into G-5 currencies, other currencies considered useful for intervention, and non-usable currencies. IMF is sought to be a

stand-by lender and in a crisis the Fund should borrow convertible currencies as needed to finance short-term liquidity loans, rather than maintain significant amount of paid in capital.

The Meltzer Commission report did not find universal support even in United States. One of important recommendations of the Meltzer Commission is that the Fund should lend only for short-term purposes. But the past experience has shown that a turnaround in balance of payments crises takes more than "short-term" and if the Fund restricts its lending to short-term (maximum of 120 days), borrowing countries may be forced to approach the Fund, time and again.

One of the controversial prescription of the Meltzer Commission is that World Bank lending is "irrelevant" to poorer countries which had access to private sector lending. But it must be noted that normally private sector lending is not available for provision of public sector goods like basic health, education and social services .

Conclusion

It is clear that the international financial architecture is being revisited on several fronts and the role of the BWIs as well as the framework of the functioning of the BWIs are integral to this process of review. There is clearly a consensus, as of now, that no new bureaucracies or international financial institutions be set up. There is also a consensus that multiple consultation and cooperation are desirable and, Financial Stability Forum and G-20 are prime examples. The process of international cooperation is no longer confined to those where only national Governments are involved though they continue to be critical. The operational framework of BWIs is under review and as to what shape this would take, it is difficult to speculate, but the BWIs will continue to be in the centre stage.

India is closely involved in these processes as one of the key systemically important and fast growing large emerging economies, with a significant interface now with the global financial system.

On the limited issue of utilisation of resources of BWIs, India will be repaying the last instalment amount of about US $ 25 million to the Fund in June, 2000. In fact, by pursuing appropriate policies, we have been able to repurchase almost all our obligations in the last seven years. Besides, during this period, we have built up over US $36 billion of foreign exchange reserves while maintaining the external debt almost constant. If the macro policies continue to be sound to ensure progress in desirable directions of efficiency and stability, I believe there will be no need for us to approach the Fund for any assistance. With a comfortable external sector position, significant reduction in the Government's fiscal deficit should help the Government to phase out its dependence on IDA. Over the medium-term, it should also be possible to earmark all loans from IBRD for utilisation in long gestation but commercially viable projects such as those in infrastructure, perhaps in quasi-Government sector. In this background, I could envisage a more active role for India in future in the BWIs, including governing the international financial architecture.

The major thrust of policy for the government in the near future would, therefore, be three-fold. The first major thrust would be to ensure the continued implementation of appropriate macro policies; the second key thrust would be to address satisfactorily social issues, such as poverty, primary education, primary health, environmental protection, governance, etc. The third area of attention would be to benchmark our institutional and procedural frameworks governing the fiscal, monetary, accounting and regulatory areas with international best practices and aligning ourselves with them. The recently established Standing Committee on Codes and the eminent persons associated with Advisory Groups should help us in the third thrust area but this will be of help only if there is matching progress in areas relating to macro policies and social issues.

To conclude, the BWIs role, in an environment of high proportion of private capital flows, is likely to be one of catalyst, whereby it renders support and advice to outside bodies such as G-20 and BIS in respect of evolution of standards and codes, that do not fall within BWIs core competence. In this context, the need to clarify the respective roles of the BWIs in particular and international financial institutions in general becomes essential. One can envisage a situation where the BWIs reform internally not merely through change in voting rights but also in the manner of its functioning, by exhibiting greater willingness to coordinate more effectively with developing countries.

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* **Dr. V.S. Krishna Memorial Lecture delivered by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India, on March 18, 2000 at the Andhra University, Waltair.**
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