International Monetary and Financial System: Some Perspectives*

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Let me at the outset express my high appreciation of the efforts being made by the National Defence College to include in the training programme themes of global importance and to give the participants wider perspectives on both national and international issues. Such a treatment is necessary, since no person who is interested in development can think of national economic issues in isolation. Indeed, the world economy is the canvas against which countries operate, interact and further their mutual interests.

In my presentation today, I shall briefly touch upon the major events that shaped international finance to the present position and raise some of the issues that are presently being discussed by most academic specialists, policy thinkers and serious financiers as part of the strengthening of the international financial architecture.

International finance has developed into a separate subject of inquiry from the broad area of international economics. Trade in goods among nations provided the focal point of attention in most theoretical constructs and applied international economics. Although foreign capital flows and cross border lending were in evidence even in the early part of the twentieth century, there was very little of emphasis on this aspect in the thinking on balance of payments adjustment at that period of time. Gold - the metal which was used as a base for expressing the exchange relationships and for settlement of international transactions - flowed among countries, in an almost automatic way, in line with the cycles of economic activity. By the 'twenties of this century, gold standard initially gave way to gold exchange standard, and finally to paper standard wherein paper currencies with backing of gold became predominant means of payments and settlements. However, the need for adequate gold reserves was a major consideration for protecting the economies from fluctuations in economic activity. In fact, economies competed for building up of reserves by adopting `beggar my neighbour' policies, and through exchange rate manipulation, in the 'thirties and 'forties, given the uncertainties introduced by such circumstances as the Great Depression and the Second World War. With export pessimism dominating in the environment of the 'thirties and early 'forties, there was no option but to build the edifice of international finance on the principle of 'international co-operation'. The Bretton Woods Conference of 1944 provided an opportunity to put to test this principle and to address the problem of international payments among countries.

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This Conference, historically speaking, occupies an important watershed in the history of

international finance. It led to proposals for setting up of three institutions under the framework of the United Nations - the International Monetary Fund (referred to as IMF or the Fund henceforth), the International Bank for Reconstruction and Development (referred to, for purposes of convenience, as the IBRD or the World Bank henceforth), and the International Trade Organisation (ITO). Of the three, the Fund and the IBRD were set up, while the ITO did not take-off. The main underlying rationale behind these institutional arrangements was to make provision for short-term external financing (through IMF), for financing reconstruction of war-ravaged economies and development of war-affected as well as other developing economies (through the World Bank), and for laying down a code of conduct for countries regarding commodity agreements, export subsidies, quotas, tariffs and other subjects of relevance in international trade (through the ITO). In the place of ITO, what emerged ultimately was a General Agreement on Tariffs and Trade (GATT). By January 1, 1948, GATT came into being to set out rules for international trade relations and a forum for multilateral negotiations on these issues. This lasted till the World Trade Organisation (WTO) was set up in January 1995 with much broader agenda covering trade in goods and services and trade-related issues.

The institutional arrangements proposed in the 'forties were at the instance of the Governments, in particular of the United States and Great Britain. India was one of the founding fathers of the Bretton Woods institutions. In a sense, the arrangements were intended to provide for State, or rather official intervention for the purposes for which the institutions were set up. In this scheme of things, there was very little recognition for private market financing.

Surprisingly enough, the beginnings of international co-operation soon after the end of World War II were uneventful in that the business of IMF and IBRD was so limited that these institutions earned less than the costs of their operations. The reconstruction and rehabilitation of war-torn economies in Europe were facilitated by massive amounts of Marshall aid provided by the United States.

Development financing in a significant manner for developing countries was most in evidence since the 'fifties. In the 'fifties and the 'sixties this was made possible by the World Bank mainly in the form of project assistance. This assistance was assumed to give rise to economic rates of return, enabling countries to repay the loans taken from the World Bank. Development financing was also provided by developed countries in the form of foreign aid. As it turned out, foreign aid during these decades and to some extent grants and concessional aid, which were initially considered as promoting development as well as humanitarian values was also utilised as a means of furthering the foreign policy interests of developed countries. This element of foreign aid, however, needs to be seen in the context of the ideological frame of the cold war politics at the global level. As the effectiveness of foreign aid began to wane towards the end of the 'sixties, its role in development financing has slipped despite efforts at the high international diplomatic level to have an agenda for aid to be a substantial part -1 per cent and later 0.7 per cent - of the lending countries' GNP.

One of the remarkable features of the 'fifties in so far as the IMF is concerned was the

major decision taken to highlight the monetary character of the institution. This decision even today is considered as providing the very life-blood of the IMF and of all the processes that the countries in need of short-term financing to meet external imbalances, would have to undergo, to bring about a turnaround and have an appropriate macroeconomic balance. This pertains to conditionality, which is nothing but a framework that requires borrowing countries to undertake macroeconomic policies that help to realise external adjustment and to repay the IMF the funds utilised for the purpose within the stipulated time schedule. Conceived and developed by Harry White of the United States, conditionality helps not only to safeguard the integrity of the Fund but also to ensure that needy countries adopt appropriate policies. It is not really a set of conditions as many tend to believe, but a policy framework that has economic reasoning to support it. As policy framework would differ from country to country depending upon the economic circumstances, conditionality may at times be regarded as asymmetrical in application. Where the framework requires hard economic decisions to be taken, conditionality often gets to be treated as impractical and harsh.

Conditionality as a concept received most attention in the literature. It arouses emotions partly because the policy framework itself can be manipulated. But, as history shows, it did not have importance in the 'fifties and almost till about the end of the 'sixties.

Apart from conditionality, two other important developments that took place during these two decades need to be mentioned. One is the emergence of the euro-dollar market, with the US investors placing the US dollars outside the country for earning higher rates of return. The capital movements that occurred as a result and the growing international trade facilitated by the rapid and high performance of a number of European economies, triggered fears of shortage of international liquidity and the ability of the US to meet the dollar liabilities that were outside the country and were in excess of the stock of gold reserves with the US. The convertibility clause under which an ounce of gold could be obtained in the US for US $ 35 came under serious cloud. The large expenditures incurred by the US in connection with the Vietnam War and the slackening economic momentum in the US had increased uncertainties about the role of the US dollar as the reserve currency and the sustainability of fixed exchange rates.

Very early in the 'seventies, the US had to take the decision to make the dollar

inconvertible, and move towards the regime of floating exchange rates under the weight of the burdens created by the large dollar balances outside the US. By 1973, the switch over to the floating rate regime by the rest of the world was complete. The Fund membership on its part ensured that the international liquidity problem is addressed by creating through the First Amendment to the Fund's Articles, the Special Drawing Rights (SDRs) by January 1, 1970. The Fund also put in motion processes to have a major transformation in the form of Second Amendment to the Articles to be consistent with the turn of events. Besides, the Fund established medium term financing facilities and the World Bank gave more pointed attention to structural and sectoral lending than ever before. These decisions were momentous. But a historic decision of the oil producing countries in late 1973 to hike the prices of oil affected the whole economic edifice of the world economy. It affected the cost structures and the budgets of developed countries adversely and made inflation inevitable in almost all developed countries. The sharp increase in the prices of other primary commodities in the mid'seventies further aggravated pressures on inflation, requiring cutbacks in expenditures and activities in developed countries. Producers of oil and primary goods improved their incomes, enabling them to invest abroad as well as to undertake large scale investments within the economies. The former type of investments was mostly in the nature of petro dollars parked with international banks. The latter type of investments created additional employment of both skilled and unskilled labourers from within and outside the originating countries. In good many cases, the large expansion of incomes in developing economies which benefitted from increases in the prices of oil and other primary goods led to extravagant expenditures and borrowings from abroad. Given the large resources on hand, international banks extended loans to all the countries which were high gainers of incomes and were considered as carrying minimal potential repayment risks. In the event, a number of oil and primary commodity producers became major borrowers. For example, Zambia and Nigeria in Africa and Mexico in Latin America which benefitted from the price boom of the 'seventies had by the early 'eighties incurred large unsustainable levels of external debt, so much so that Mexico defaulted on principal repayment by late 1982.

The 'seventies changed the entire fabric of international finance. Developed countries faced with the problem of stagflation had to undertake strict macroeconomic policies and work out strategies to economise on the use of oil and to introduce new technologies to improve their productivity and cut costs. Their ability to provide enough resources for international adjustment was constrained. This explains why the countries in need of funds used the available official resources through IMF and World Bank, and bilateral mechanisms, alongwith the relatively easily available private sector financing. On their part, the international institutions had to strike a balance between their resources and the demands made on them by adjusting conditionality rather than the 'price'. As the poor countries with no access to private markets suffered in the process, the IMF created a separate fund out of sale of a portion of its gold. The World Bank on its part began to enter the market for raising resources to meet demands for project assistance.

The turn of events during the 'seventies was such that it would have been well-nigh

impossible for the international monetary system (IMS) to have provided for sharp increase in international liquidity beyond what was the case, without aggravating global inflation. Given the supply of funds in the private markets and budget constraints, official financing became the adjusting variable in striking a balance with the international demand for funds. In reality this meant that market financing being large and available relatively easily, official financing was constrained, adversely impacting in the process the poorer countries. In some cases, countries seem to have preferred to borrowing from the market place in view of the absence of conditionality to availing of facilities from the conditionality-based Fund.

The contours of the international monetary system changed with the introduction of the floating rate, the presence of SDRs as an international unit of account, the use of multiple currencies (besides the US dollar, the pound sterling, DM and Yen) as reserve currencies, and the setting of processes of adjustments in detail with conditionality as an important element. The theoretical rationale for countries with external surpluses (exports of goods and services in excess of imports of goods and services) to support deficit countries in terms of international cooperation was under some doubt in view of the rapid growth of private market financing. Countries in financing-need, approached private markets or official sources, or both the sources. But private markets which are supposed to provide finances only if the countries in need give evidence of their ability to service their debt did not always follow this rule. The interest rate on private loans also differed from country to country and in certain cases was left 'floating' in line with some reference variable.

The 'seventies also witnessed the developing countries grouping together to formulate positions to safeguard their interests in the international bodies. The relative deterioration in the economic power of the developed countries, the oil and primary commodity boom and the need for reform of the Bretton Woods-based international monetary system had all played a role in the emergence of developing countries as a group in international economic affairs. The Group of Twenty Four, carved out of the political Group of Seventy Seven, exclusively to devote attention to matters relating to IMS, had become the important spokesperson of developing countries just as the Group of Ten represents the interests of industrialised countries.

In the 'eighties and the 'nineties so far, private capital flows were dominant -as much dominant as official financing in some cases. Private capital often flowed into non-tradable sectors (for example, real estate) and added to the debt stock of recipient countries. In many instances, such flows were of short-term nature. They increased expenditures via money supply expansion and shot up asset prices. The impact on prices and exchange rates in recipient countries of such flows was very substantial. However, the flows lasted so long as the confidence of the viability and sustainability of the system of the recipient country was in place. Once a doubt arose, capital flight had followed, reminding one of the herd behaviour of markets. At times, the contagion effect based on the regional location of the country in question also operated, ignoring in the process the economic fundamentals of the relevant country. Work-outs of private debt posed serious problems and often official intervention at the global level was rendered necessary due to growing integration of markets.

The experience of the 'eighties and that of the 'nineties so far provides some extraordinary

perspectives on the challenges and opportunities that the international monetary system was faced with. Among these, the important ones are the severity of the external debt problem, the volatility in exchange rates in contrast to the expectation that floating exchange rates will be market-determined, sustainable, and less fluctuating, the sharp turnaround in terms of trade against agriculture, and other primary commodities, the deterioration in the economic performance of poorer countries particularly of Africa, the stricter designing and implementation of conditionality in the adjustment programmes supported by the Fund and World Bank, the growing acceptance of external current account convertibility among many countries and increased relaxations on capital account, the growing cross border flows of capital, the sharp expansion of international financial markets in particular the capital and bond markets, the increasing role of private sector financing of activities in many parts of the world, the shrinkage in the Government's role in economic activity with consequential awareness of the potential dangers of large public sector deficit, and the need for undertaking not only stabilisation policies but also institutional or structural reforms for realising sustainable growth with stability. The opening up of the economies and sharp technological changes especially in the payment and settlements area, facilitated the integration of financial markets in an increasing manner. Imbalances in the developments of sectors and in the macroeconomic and structural reforms spelled serious economic problems.

The recent examples of economic crises in Mexico, Thailand, Korea, Indonesia, Russia and Brazil, to name a few, show how important it is to follow credible macroeconomic and structural policies, so that there are no speculative or panicky capital flows. Given the nature and size of the problems faced by these countries and the vulnerability of the banking sector in Japan and of the unregulated segments of the financial system in other parts of the developed world (e.g., hedge funds in the US), it is clear that the world financial system will need to be strengthened by definitive actions to promote prudential norms and standards. It is also clear that international institutions like the Fund and World Bank cannot, with their limited resources provide support to stem capital outflows from any country. Developed countries' governments too, on their own, do not seem to possess adequate resources to address such problems. Private creditor involvement in resolving the crisis situations which has typically be conspicious by its absence till recently, has also *not* been forthcoming in an open manner. And needy countries, particularly, the emerging market economies, do not seem to have enough reservoir of inner economic strength to undertake harsh adjustment at the cost of growth and price stability. The need of the hour is to promote genuine international cooperation not only between Governments but also between all the participants of economic life.

It is against this background, the international attention has been focussed in the last two to three years on the need for building up a robust and efficient international financial architecture. The literature in this area, built around the Latin American, East Asian and Russian crises, is vast and filled with insights about the causes, consequences and lessons of the crises. In general, most arguments revolve around a few themes, which seem to be familiar but carry nuances that are not as widely recognised as they should be. It is not possible to deal with all of them here but we need to place some of the issues involved in a proper perspective.

Take the case of exchange rate pegs. Fixed exchange rates did not work in the past and

exchange rate expectations in the market place are known to be governed by a number of factors, both economic and political, including confidence in the credibility and sustainability of macroeconomic positions and policies. Undoubtedly, floating rates too exhibited volatility but authorities can intervene either by direct presence in the market or through regulations that have a bearing on foreign exchange trade. One of the important lessons of the recent crises is that exchange rate flexibility is vital but that alone is not enough. The authorities will need to ensure that markets accept the exchange rate policy that is being pursued as credible.

Fiscal deficits have always been treated as the villain of the piece in the literature on adjustment. While this is well recognised, it is also important to ensure, in the given environment of the capital flows, that the saving-investment balance of the private sector does not, as the experience of the recent crises showed, become unsustainable. Firms borrowed freely from abroad in some of the crisis-hit countries, taking advantage of the absence of controls on taking loans and on the terms and conditions associated with such borrowings. Banks and financial institutions too borrowed from abroad without giving adequate regard to their exposures to different sectors and to the probability of build up of non-performing assets as a result of strengthened cash base. Free foreign capital flows into domestic capital markets also seem to have taken place in some of the crisis-hit countries. These types of flows - particularly those of short-term nature-have been found to be volatile and move out very quickly and destabilise the economies. Some of the countries did not monitor the size of such flows, with the result the short-term indebtedness and volatile flows became a major area of concern for the authorities.

When capital outflows occur in large amounts, countries' foreign exchange reserves dwindle to such a low level that it becomes difficult for countries to manage their day-to-day existence without outside financing. Banks and financial institutions are the conduit through which such outflows occur and when the banks themselves find it difficult to service their own debt obligations, the failure of the financial system would be inevitable. It is for this reason surveillance and supervision of banks and other financial entities is essential.

It is in this context, a number of proposals have recently been made to prevent and to stem

crisis situations. Some argued in favour of target zones; some favoured capital controls, at least on short term flows, or levy of a tax on such flows such as the one proposed by Professor James Tobin or the one adopted by Chile. Some argued for larger IMF-World Bank financing and for the Fund to act, like a central bank of a country, as a lender of the last resort. There was also a proposal for setting up of a global central bank. There are also proposals for collaborative efforts wherein the needy countries will undertake adjustment with some modest financing on the basis of a Fund-designed arrangement, together with donor government support. Yet another proposal is to create a separate fund in some international organisation such as the Bank for International Settlements in which there will be broader participation of countries with capital placed at the disposal of the organisation, so that the Fund-World Bank or the country in question could draw on these funds, under certain conditions, when need arises. Some proposals call for establishment of separate agencies such as an international insurance authority, or an international supervisory, regulatory and rating agency. Some others call for (a) strengthening of the existing international institutions such as the Fund and World Bank and operative mechanisms such as the Interim Committee of Finance Ministers; (b) setting up of contingency lines of credit at the Fund with definite eligibility criteria and conditionality; (c) 'standstill' agreements with private sector on capital flows; (d) private sector contingency credit lines; and (e) private sector involvement in renegotiations and orderly debt work-outs. Underneath most of these proposals is a clear recognition that countries which have weak financial structures and inefficient financial supervisory systems are likely to be most vulnerable to crisis of confidence. Calls are also made for building up of investor confidence through data dissemination on most critical areas, and through adoption of transparency in monetary, financial and fiscal policies and procedures.

There are problems in implementing some of these proposals, apart from issues of moral hazard, explicit or implicit in them. Nonetheless there seems to be an implicit acceptance on the part of most countries of the general principle that there should not be too many rules and restrictions without setting in place transparency and regulatory framework. The degree of capital controls to be exercised is, for the present, left to countries themselves, giving up in the process, the catholicism of free capital account convertibility. Discussions are going on about the standards for transparency and the extent of Fund Surveillance as also on the extent of private sector involvement. The various proposals are being discussed at different international organisations and official meetings and judgements are yet to be delivered. Efforts are being made by the Fund and World Bank as also by some countries to ensure that there is participation of as many countries as possible in the ongoing discussions on the strengthening of the international financial architecture so that there is universal acceptance of the proposals that are to be put into effect. The year ahead has exciting prospects and the 21st Century is likely to begin its innings with a major development which, one hopes, will be good for the entire mankind.