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THE US AND INTERNATIONAL FINANCIAL REFORM

Pressures for the strengthening of the international financial system have been building up for some time. It now appears that the appointment of James Baker as US Secretary of the Treasury — and the different perception of US national interests he brings to the job — have increased the prospects for reform. How the present system works and the ways in which it may be changed have major implications for developing countries and the purpose of this Briefing Paper is to describe the background to the Baker initiatives and to analyse these, with particular reference to their implications for the International Monetary Fund (IMF) and World Bank (IBRD).

The Pressures for Change

At the heart of the matter is a mis-match between the present-day realities of the global economy and the institutions set up at Bretton Woods in 1944 to ensure that the financial system promoted economic prosperity. To the IMF was allotted the tasks of promoting exchange rate stability; an adequate volume of international liquidity; a free, balanced and multilateral payments system; and the provision of 'temporary' assistance to member states in balance of payments (BoP) difficulties. The complementary role of the IBRD was to encourage investment in the re-building of war-devastated economies and in the development of low-income countries.

Since World War II the world economy — and its problems — have been transformed and the Bretton Woods arrangements have come under stress, particularly since the 'debt crisis' of 1982. Consider the following illustrations:

Exchange rate instability. The attempt to maintain stable exchange rates through the IMF was abandoned in the early 1970s in the face of the growing scale of private currency transactions and diverging inflation rates. Since then each major currency has floated. But instead of smooth adjustments to equilibrium values, the freeing of the currency markets has been accompanied by instability, over-shooting and persistent major misalignments. This has increased the uncertainties and costs of trade, and there is a presumption that it has held back the growth of trade — although most econometric attempts to capture this negative correlation have found it elusive.

Pro-cyclical and unequal creation of liquidity. The objective of maintaining an adequate and orderly supply of international liquidity appears to have been defeated by the explosion in the 1970s of international banking. Liquidity creation has been largely privatised and a distinction now has to be drawn between 'owned' and 'borrowed' reserves. Countries considered creditworthy may acquire liquidity by borrowing it. Others — including most of the poorest ldcs — have fewer options. The IMF's 'Special Drawing Right' (SDR) has remained the small change of the system. This results in an uneven supply of liquidity that exacerbates both inequalities and instability in the world economy — for banks lend most in expansionary times and cut when trouble looms.

Persistent debt problems. A combination of worsening world trading conditions, steeply rising interest rates, an unsustainably rapid expansion of bank lending concentrated on a few ldcs and irresponsible economic policies in several of these led to the debt crisis of 1982. The response — of short-term stabilisation programmes in most of the major debtors, backed by IMF credits; some new money from the banks; and a series of short-term debt reschedulings — bought a breathing space but no lasting solution. It did not reduce debt servicing burdens, which were higher in 1985 than in 1982. It necessitated such severe cuts in debtors' imports as to reduce the investment and capacity utilisation necessary for BoP adjustment. The policy conditions attached to IMF credits have remained highly controversial. The post-1982 cuts in real wages and living standards are proving politically unpalatable. Debtors' incentives to continue servicing their debts — and their vulnerability to retaliatory measures — have been eroded by their success in strengthening their trade balances, by the failure of promises of continuing access to capital markets (there was a net resource flow *from* the debtor countries of $22bn in 1985), and as domestic pressures increase for more expansionary policies.

Deflationary bias. It has long been complained that the Bretton Woods system is biased against most deficit countries by placing the bulk of the onus of 'adjustment' on them without similar pressures on countries persistently in surplus. IMF 'surveillance' of all members' policies is supposed to take care of that but is largely ignored in practice. Moreover, in recent years the weight placed on adjustment policies within deficit ldcs has increased as supporting finance has dwindled. IMF resources relative to world trade and BoP imbalances have declined sharply. Access to its Compensatory Financing Facility — intended chiefly to recompense ldcs for unexpected export shortfalls — has been made less automatic. Efforts by the IBRD to fill the gap, particularly in the poorer ldcs, have themselves been restricted by shortages of money (see Box 1). These factors and the continuing emphasis in Fund programmes on demand restraint have contributed to the economic downturn of recent years.

Solution of these problems has been made all the more difficult by a retreat by some major industrial countries from the machinery of global economic co-operation and their undermining of the Bretton Woods institutions. They have preferred instead the 'coordination' achieved through the workings of world capital markets and have placed priority on 'putting our own house in order'. It is because they signal a desire to return to internationally co-operative solutions that the Baker initiatives are of particular interest.

Box 1

IDA 8: Still lean and getting meaner?

Background and Trends

The International Development Association is called the World Bank's 'soft aid window'. It is financed by *grants* from the donor countries and these resources are subject to three-year 'replenishments'. The 7th replenishment ("IDA 7") covered 1985-87; IDA 8 is being negotiated now for disbursement in 1988-90. Poverty and lack of creditworthiness govern eligibility for IDA resources. To be eligible, countries must have had 1983 per capita incomes of no more than $790 and the bulk of lending has been to countries with income averages of below $400. Countries satisfying the poverty criterion but judged to have creditworthiness receive a 'blend' of IDA and IBRD loans, with the latter on much harder terms. China and India are the two chief 'blend' countries. Since IDA was established in 1960 all IDA credits have been on the same terms: a 50-year maturity with a 10-year grace period and 'interest' (actually a service charge) of just 0.75% p.a.

The 1983 negotiations over IDA 7 were particularly tough.[4] The Bank staff asked for $15bn, most of the major donors thought $12bn was a minimum but the Reagan Administration, then in a choleric anti-Bank phase, was adamant that it could not go above $9bn. To retrieve some of the damage, the Bank mobilised a Special Facility for Africa (SFA) on the basis of voluntary donations, which eventually came to about $1.5bn. However, the SFA was set up on the conditions that it would not be repeated and that its usage would be confined to support of policy-reform programmes.

Even adding the SFA and IDA 7 together did not prevent a 4% decline in real terms over IDA 6; and commitments under IDA 6 were, in turn, 18% below IDA 5. Faced with this decline the Bank sought to protect its allocations to Africa as well as accommodating China (the People's Republic became a member in 1980) by cutting massively in its allocations to India, whose share fell from about a third of IDA 6 to less than a quarter of IDA 7. There has also been some trend within IDA towards more policy conditionality, although the bulk of its loans are still for projects or specific sectors.

The IDA 8 Negotiations

Discussions have already begun about IDA 8 with the intention of having an agreement ready for the October 1986 Annual Meeting of the Bank. The negotiations hinge on three interlinked issues: (a) the size of the replenishment; (b) the terms on which IDA loans should be made in future; and (c) the allocation of the money. The outlines of an agreement are already emerging.

On *size*, the Bank staff argued for an IDA 8 of $15bn on the grounds of IDA-country need and the Bank's own lending strategies. That figure received little support, however. The US announced that it was looking for a figure in the range of $9-12bn. Most other donors were willing to go rather higher. All parties have now agreed to work for a replenishment of $12bn.

On *terms*, the US has been arguing for a hardening, on the grounds that, with the rise in world interest rates, the degree of concessionality now — and the spread between IDA and IBRD terms — is greater than it was in 1960 and that harder terms would give IDA more of the character of a revolving fund. Others point out that the trend in bilateral aid to low-income ldcs is towards more grant aid and argue that it is inappropriate to harden terms when so many of these countries are facing major debt problems. Nevertheless, in return for a $12bn replenishment it seems likely that there will be agreement on reducing loan maturities to 40 or even 35 years, perhaps with a reduction in the grace period to 8 years. However, attempts to raise the interest rate will be resisted.

On *allocations*, there is already agreement that a larger proportion will go to sub-Saharan Africa, primarily in support of policy reforms. In the context of a $12bn IDA 8, this inevitably means a further real reduction for India and a cut for China too. There is a danger that because the US is being less intransigent on IDA 8 the outcome will be regarded as satisfactory. That would be a misjudgement. *A $12bn IDA 8 is in real terms no bigger than IDA 7 plus the SFA.* The toughening of terms will reduce the 'grant element' in IDA loans (and any major increase in interest charges would have a particularly negative effect). And the legitimate claims of India, China and other 'blend' countries will be further abandoned. Above all, the scale of IDA 8 will be entirely inadequate relative to the needs of the countries it serves.

The Baker Initiatives

Baker I: Realignment of Exchange Rates.

The first of his three initiatives was to call a meeting in September 1985 of finance ministers from the Group of Five (G5) major industrial countries (France, Japan, UK, US, West Germany) to persuade them to undertake collective action to reduce the over-valuation of the US dollar. Failing such action, he argued that it would be politically impossible to head off the plethora of protectionist legislation then before Congress, with all the damage that could do to trade and the economic recovery. A lower dollar could also reduce the debt problem, for most debts are dollar-denominated.

The G5 needed little convincing of the need for a lower dollar but were unsure whether they could deliver. The resources held by their central bankers were dwarfed by the scale of private currency transactions; the markets could 'make monkeys' of the authorities. But their interventions worked. The trade-weighted value of the dollar fell by 10% between September 1985 and February 1986, and by much more against such currencies as the Yen and Deutsche Mark. Perhaps by good fortune, the markets were ready for an over-due realignment. Encouraged by this success, the Americans are now studying more systematic ways of reducing exchange rate fluctuations and misalignments; and support for the idea of establishing 'target zones' for major currency values (of which the European Monetary System provides a working example) appears to be increasing.

Baker II: A Deal for Fifteen Debtors.

Next, at the October 1985 annual meeting of the Fund and Bank came Secretary Baker's proposals for dealing with the debt problem and its continuing threat to the solvency of banks in the US and elsewhere. His suggestions contained two key elements: (a) recognition that growth must be resumed in the debtor countries; and (b) the provision over three years of $29 billion of new money for 15 debtor countries.[1] Of this, $20bn should be new lending by commercial banks. The balance of $9bn would come from the IBRD and Inter-American Development Bank (IDB). The World Bank would thus move towards centre stage, although the IMF would continue to play a 'critical role' (see Box 2). To earn access to this new money, debtor governments would have to adopt 'comprehensive macroeconomic and structural policies, supported by international financial institutions ...' but these should be

1. Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia.

growth-oriented. IMF programmes should thus place more importance on supply-side measures. So far this 'plan' has got off to a slow start, chiefly because, when announced, the ideas had not been fully thought through.

Baker III: More Money for 'Policy Reform' in Africa

The October 1985 proposal also contained crumbs of comfort for some ldcs not included in 'the Baker 15'. The initial reactions of some of the other G5 countries was frosty and the details are still being negotiated. What looks likely, however, is a package that will result in more money from both the Bank and Fund directed towards the poorer ldcs with chronic BoP difficulties — particularly in sub-Saharan Africa — in support of 'comprehensive, growth-oriented' programmes of policy reform.

More specifically, it seems likely that the US administration will support a $12bn replenishment of IDA, the IBRD's soft loan window, with an increased proportion of this sum earmarked for Africa (Box 1). For its part, the IMF is due to receive repayments during 1985-91 of Trust Fund[2] credits lent in the mid-1970s and the plan is that $2.7bn of this should be re-lent to low-income ldcs through a newly-created Structural Adjustment Facility, again with special concentration on Africa. These two items are seen as a package and the intention was that they should be deployed together in support of 'cooperative' programmes — the meaning of which is taken up in Box 2.

Unanswered Questions

We turn next to consider some of the unresolved issues concerning the Baker II and III proposals.

Question: How much support for Baker II?

This question can be asked of several constituencies. Will the bankers support it with $20bn-worth of new lending? They have so far sent out a variety of signals, none of them rapturous. It is an idea that runs counter to their objective of reducing exposures in the major debtor ldcs and to the wishes of their central bank regulators. As the price for their co-operation, they are trying to negotiate a shifting of risk to the IBRD by way of repayment guarantees.

Will the IBRD and IDB play their parts? They are both willing but the plan poses them with some tricky issues (for example, about possible adverse effects on their credit ratings) and they may have difficulty in negotiating enough programmes to be able to deliver new disbursements at the intended level. Already there is some concern about the IBRD's apparent slowness to respond.

How do the 15 debtors feel about it? They welcome the promise of new money but they are chary of the policy strings that will go along with it and no-one wants to be the 'guinea pig'. None of the largest debtor countries has yet negotiated an adjustment programme cast in the Baker mould. Lastly, most of the other major creditor-country governments have been noticeably quiet on the scheme. Although they convey the impression of being willing to go along with it, it remains to be seen whether this will be translated into actions to make it easier for the banks to lend more to debtor ldcs and to make Fund programmes more growth-oriented.

2. The Trust Fund was set up in 1975 from the profits of selling one-sixth of the IMF's gold stock. It made credits available on soft terms and without rigorous policy strings to low-income ldc members experiencing BoP difficulties because of the end-1973 quadrupling of oil prices.

Box 2
The Fund and The Bank: an unhappy couple?

The Baker initiatives have thrown Fund-Bank relations into some turmoil, not the least because they have raised questions about the Fund's previous hegemony in matters of BoP adjustment. Baker's 1985 speech, while saying that the Fund should continue to play a 'critical role', could nevertheless be read as being rather disparaging of it. It envisaged an enhanced role for the IBRD and called for 'more intensive IMF and World Bank collaboration'. In the context of Baker III, he has since urged the need for 'co-operative' Fund-Bank country programmes.

Heads of the two institutions have been meeting to operationalise these ideas but there are tensions. The Fund emphasises its continuing 'central role' in these matters while the Bank is promoting itself as the appropriate 'lead institution'. The US idea of joint programmes has apparently been dropped, to be replaced merely by joint 'medium-term policy frameworks'.

The difficulties are not just those of inter-agency rivalry, although there is plenty of that. The differences in style, procedures and pace are major ones. The Fund is more hierarchical than the Bank, more closely controlled from the top, more secretive. The IBRD has much the larger staff and is accustomed to negotiations that stretch over months. There is usually greater pressure to agree new credits on the Bank staff than in the Fund. For these reasons past pressures for closer co-operation have come to little. It has now become common for a Bank official to accompany a Fund mission, usually to advise on the government's investment programme. But the Bank complains that its person is usually excluded from the Fund's decision-making while the Fund complains that the Bank's routines are too leisurely to fit in with its own tight timetabling.

More fundamentally, there are tensions between the 'stabilisation' goal of the Fund and the 'adjustment and development' objectives of the Bank, and the Fund is uncertain how to make its programmes comply with Baker's emphasis on growth-oriented programmes. Collaborative programmes can scarcely contain conflicting policy recommendations, so one or both of the institutions will have to give on this issue. Also unresolved is the thorny problem of 'cross-conditionality' between the Fund and Bank, whereby access to credits from both would be curtailed by failure to comply with the conditions of either. Developing country representatives are particularly opposed to such a provision.

Question: What sorts of policy strings?

Both Baker II and III envisage more policy-related lending by the IBRD in addition to high-conditionality credits from the IMF (rigorous conditionality is likely to be applied to the re-lent Trust Fund money, in contrast with the original credits). But is this conditionality likely to be regarded by the intended recipients as a price worth paying? Controversies about the appropriateness of Fund conditionality in ldc circumstances are sufficiently venerable to need no rehearsing here.[3] What is interesting is that US Treasury officials are now publicly saying that Fund programmes have been too deflationary and should be made more growth-oriented — a view shared by commercial bankers. However, it is doubtful whether the Fund is equipped for this change and whether the other G5 governments will support any major re-design of Fund conditionality. Indeed, this aspect of the Baker proposals appears to be quickly slipping out of sight.

The IBRD is already moving quite rapidly in the

3. See Tony Killick (ed.), The Quest for Economic Stabilisation (ODI and Gower, 1984) for a review of these controversies.

direction of 'policy-related' (as distinct from project-related) lending, particularly in Africa. About 40% of Bank lending to Africa in 1985-87 is expected to be of this type. Baker II and III will push it further in that direction. Moreover, the Americans have been quite frank about the types of policy reform they are looking for. They say these should include: increased reliance on the private sector; tax and labour-market reforms to encourage domestic saving; measures to encourage foreign direct investment and liberalise trade.

Moves in such directions may well be overdue in some ldcs but an aggressive and exclusive insistence on such policies would raise major questions. It appears to place excessive faith not only on the restorative powers of private markets but also on a single-solution approach to an enormously wide range of ldc circumstances — from Guinea to Mexico. More generally, it raises questions about how much 'the men from Washington' can actually know and about what conditionality can actually hope to achieve in the face of scepticism by the recipient government. It is an approach likely to create more points of friction between the Bank and borrowing governments. Finally, the thrust of Baker II and III raises the spectre of impossibly proliferating conditionality by the Fund, the IBRD, the IDB and bilateral donors.

Question: Is the money enough?

Baker II offers nearly $10bn a year to the 15 debtors; Baker III promises perhaps an extra $2bn a year for low-income ldcs, with rather more than $1bn extra a year for Africa. These are modest sums when compared with estimates of need. It was quickly pointed out that the prospective financing gaps of the 15 debtors were far in excess of $10bn p.a. Following the recent fall in oil prices, Mexico's needs in 1986 alone are put in the range of $4-6bn (but see below). As regards Africa, the IBRD estimates that excluding Nigeria, it will need an extra $6-7bn p.a. to the end of the decade.

Indeed, the Bank is extremely concerned about the failure of donors to provide adequate supporting finance to African governments, like Kaunda's in Zambia, undertaking precisely the type of painful policy reform constantly urged upon them. It is also important to distinguish between gross and net flows, *for both Baker II and III are about helping ldcs to repay their debts*. At the heart of Baker III, for example, is the desire to ensure that countries can afford the substantial repayments to the Fund coming due from this year, and to extricate those already in arrears. But if the amounts are too small or the conditionality too fierce governments may prefer to slip quietly into arrears.

Question: Will world economic conditions allow the initiatives to succeed?

There is a limit to what can be achieved by policy improvements backed by modest amounts of new finance. For example, many IMF programmes have been knocked off course by the combined effects of oil shocks and the recession in OECD countries. Will similar shocks undo the Baker initiatives?

The key variables are the growth rates of the chief OECD economies, the value of the US dollar, the course of trade and protectionism in the US and elsewhere, world interest rates (in the determination of which the size of the US budget deficit is a major factor) and the price of oil. The prospects for these are mixed. The fall in the oil price by close to 50% since Baker's initiative is unambiguously good news for oil-importing ldcs who will be thrice-blessed. They will pay less for their oil (about a quarter of their imports in 1983). They will benefit from the expected boost to OECD growth rates: immediately prior to the oil price fall, forecasts of OECD growth were still being revised down but now the major uncertainty centres on how far they should be revised up. Ldcs will also gain from the likely falls in interest rates and the lower dollar. The conventional wisdom is that the dollar is unlikely to return to its 1985 peak and may fall further. Following the Gramm-Rudman legislation there is probably a greater prospect of action to reduce the US budget deficit, even though that legislation may not take effect and American fiscal policy remains in a mess.

These gains for ldcs are dependent on, and will follow, those for the industrial countries. On the other hand, heavily indebted oil exporters like Mexico, Venezuela, Nigeria and Algeria are in big trouble. The 'third oil shock' has dramatically redistributed burdens, but not removed those at which the Baker initiatives are aimed. Other commodity prices remain generally depressed.

Conclusion

It is clear, then, that the success of the Baker initiatives is far from assured. The bankers may not chip in; the conditionality may appear to the ldcs to be disproportionate to the money on offer; the third oil shock may require a re-design; and the markets could decide to mark the dollar up again.

It is clear also that some issues remain largely untouched by the US proposals. The highly unequal distribution of world liquidity is one, and the related ldc demands for a new SDR allocation is another. The future of the Compensatory Financing Facility remains in question and, underlying that, the whole question of the extent to which it makes economic sense to require deficit countries to adjust to temporary disturbances. Above all, the issue of asymmetrical adjustment — the disproportionate adjustment burden on ldc deficit countries — is not on the agenda at all.

Nevertheless, the Baker initiatives are important. They mark a break with the laissez faire approach to international policy co-ordination which has dominated since 1978. They assign greater importance to, and support for, the Bretton Woods institutions. They recognise the need for a fresh approach to the debt problem.

The US dominates decision-making in the IMF and, to a lesser extent, the World Bank, and Europe has acquiesced in this situation. The US now shows signs of moving from a negative stance to a more constructive leadership and the possibilities for change appear greater. It would, on the other hand, be naive to believe that the Reagan administration has been converted to the cause of reducing international inequalities. The most realistic hope is in a somewhat more enlightened view of where US interests lie, and acceptance that these are not consistent with indefinite economic depression in ldcs.

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