Felix I. Lessambo

INTERNATIONAL FINANCIAL INSTITUTIONS AND THEIR CHALLENGES

A Global Guide for Future Methods

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Abbreviations

ADB	Asian Development Bank
AfDB	African Development Bank
AMC	Asset Management Company
AS	Advisory Services
BED	Board of Executive Directors
BMC	Borrowing Member Country
BIS	Bank for International Settlements
BIT	Bilateral Investment Ttreaty
BoP	Balance of Payment
CAF	Corporación Andina de Fomento
CAO	Office of the Compliance Advisor Ombudsman
CAS	Country Assistance Strategy
CCL	Contingent Credit Lines
CDB	Caribbean Development Bank
CEB	Council of Europe Development Bank
CFF	Compensatory Financing Facility
CLEERE	Climate Change, and Energy Efficiency and Renewable Energy Facility
CODE	Committee on Operations and Development Effectiveness
CPIA	Country Policy and Institutional Assessment
CPR	Country Performance Rating
CSF	Countercyclical Support Facility
DEM	Deutsche Mark
DMCs	Developing Member Countries
DRC	Democratic Republic of Congo
EA	Emergency Assistance
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECF	Extended Credit Facility
ED	Executive Directors
EIB	European Investment Bank
ESAP	Enhanced Structural Adjustment Facility
EP	European Parliament
ETF	Extended Fund Facility
EU	European Union
EVP	Executive Vice President

FCL	Flexible Credit Line
FDI	foreign direct investment
FSI	Financial Soundness Indicators
FSO	Fund for Special Operations
GAB	General Arrangements to Borrow
GBS	Global Broadband Solution Inc
GNI	Gross Net Income
GPG	Global Public Goods
GRA	General Resource Account
HIPC	Heavily Indebted Poor Countries
IADB	Inter-American Development Bank
IBRD	International Bank of Reconstruction and Development
ICD	Islamic Cooperation for the Development
ICSID	International Center for the Settlement of Investment Disputes
ICIEC	Islamic Corporation for the Insurance of Investment and Export Credit
ID	Islamic Dinars
IDA	International Development Association
IDB	Inter-American Development Bank
IEO	Independent Evaluation Office
IFC	International Finance Corporation
IFIs	International Financial Institutions
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
IPRSP	Interim Poverty Reduction Strategy Paper
IRTI	Islamic Research and Training Institute
IsDB	Islamic Development Bank
ITFC	International Islamic Trade Finance Corporation
JASPERS	Joint Assistance to Support Projects in European Regions
LADB	Latin America Development Bank
LICs	Low-income countries
MCE	Microfinance Centre of Expertise
MCI	Mid-Cap Initiative
MD	Managing Director
MDB	Multilateral Development Bank
MDG	Millennium Development Goal
MDRI	Multilateral Debt Relief Initiative
MED	Monetary and Economic Department
MENA	Middle-East and North Africa
MIC	Middle-Income Countries
MIL	Environmental Investment Loans
MIFs	Microfinance Institutions
MIGA	Multilateral Investment Guarantee Agency
MSMEs	Micro-, Small-, and Middle-Size Enterprises
NAB	New Arrangements to Borrow

NDB	New Development Bank
NEPAD	New Partnership for Africa's Development
NIB	Nordic Investment Bank
NTF	Nigeria Trust Fund
ODA	Official development Assistance
OECD	Organization for Economic Cooperation and Development
OED	Operation Evaluation Department
OIC	Organization of Islamic Cooperation
OIE	Office of Independent Evaluation
OPCS	Operations Policy and Country Services
OPEV	Operations Evaluation Department
OPIC	Overseas Private Investment Corporation
PC	Performance Criteria
PCDR	Post-Catastrophe Debt Relief
PCG	Partial Credit Guaranty
PCL	Precautionary Credit Line
PLL	Precautionary and Liquidity Line
PIL	Project Investment Loans
PPPs	Public-Private Partnerships
PRAP	Poverty Reduction Action Plan
PRGF	Poverty Reduction and Growth Facility
PRI	Political Risk Insurance
PRSP	Poverty Reduction Strategy Paper
PSES	Policy on Social and Environmental Sustainability
PSI	Policy Support Instrument
PSP	Private Sector Participation
RCF	Rapid Credit Facility
RFI	Rapid Financing Instrument
ROSC	Report on the Observance of Standards and Codes
RSFF	Risk-Sharing Finance Facility
SAPRI	Structural Adjustment Participatory Review Initiative
SBA	Stand-By Arrangement
SCF	Standby Credit Facility
SDD	Sustainable Development Department
SDR	Special Drawing Rights
SMEs	Small and Medium-Sized Enterprises
SOEs	Sstate owned enterprises
SRF	Supplemental Reserve Facility
TCP	Technical Cooperation Program
UNCITRAL	United Nations Commission on International Trade Law
UNDP	United Nations Development Program
WB	World Bank

Disclaimer

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Contents

Part I

The Bretton Woods and Affiliates Institutions

The International Financial Institutions' framework has become inefficient. The equilibrium reached in the aftermath of World War II—the Bretton Woods Institutions—is outdated and can no longer face the challenges of the twenty-first century. While many have argued for a major governance reform of the Bretton Woods institutions whose representation structures are dominated by the West and fail to accurately reflect the distribution of power in the global economy, such reform alone would not or is far not responding to our world's stringent challenges. More is needed. The modus operandi needs to be revisited to attract the best policy thinkers imbued with a sense of mission and understanding of the multiple-faceted challenges. No institution standing alone has the answers to all the problems, and thus, cooperation becomes the mantra.

Chapter 1

International Financial Institutions: Architecture, Flaws, and Legitimacy

General

International financial institutions need to be adjusted to the needs and challenges of the twenty-first century. Today's economy differs significantly from the world status of economy of the 1940s, which led to the creation of the Bretton Woods System and most of the existing international financial institutions. The globalization of financial markets, the debt crisis, cross-border flows of capital, and the rise of new economic powers have weakened the current system.

As Solimano stated, "The dividing lines between the balance of payments financing (the realm of the IMF) and development lending (the scope of multilateral development banks) have become less clear."[1] In the same vein, the *Report of the High-Level Commission on Modernization of World Bank Group Governance* pointed out:

> Regional institutions have become increasingly important in the economic and political life of the Bretton-Woods institutions, serving as catalysts for regional integration, cooperation, and development assistance.[2]

Thus, time has caused the reevaluation of an adequate balance of power between the Bretton Woods institutions, the regional development banks, and even the international investment banks, as many countries seem to prefer their regional development banks to the distant global Bretton Woods institutions. As Jose Antonio Ocampo has said:

> The current system will only be workable if it is based on stronger regionalism. A stronger regionalism is the only way to balance the huge asymmetries in power that we have in the system that is centre-periphery.

> It is good to have competition between regional and sub-regional development banks and among the bilateral donor community. Similarly, it is good to have various regional monetary funds.[3]

Indeed, the governance within these development banks is more inclusive—relative to the corporate structure still in existence within the Bretton Woods institutions dominated by the West. There is a greater degree of representation for developing countries in the most important decision-making bodies.

THE BRETTON WOODS ARCHITECTURE

The Bretton Woods Conference, officially known as the United Nations Monetary and Financial Conference, was a gathering of delegates from 44 nations who met from July 1 to 22, 1944, in Bretton Woods, New Hampshire, to devise a new financial architecture for the post–War World II economy. The two major accomplishments of the conference were the creation of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD).[4]

Participants in the conference believed, to some extent, that free trade promoted not only international prosperity, but also international peace. The conference discussion was dominated by two rival plans developed, respectively, by Harry Dexter White, Special Assistant to the Secretary of the US Treasury, and John Maynard Keynes, an adviser to the Treasury of Great Britain.

The Keynes plan involved the creation of an International Clearing Union, which would act as an international central bank and issue its own currency (the bancor), the value of which would be determined at a relative fixed price to gold. Each member country would establish a fixed but adjustable exchange rate in relation to the bancor. International payments balances would be settled by using the bancor as a unit of account. The bancor would have very limited convertibility; countries could purchase bancors but would not be able to convert them into gold. In other words, bancor reserves would remain within the system to avoid the possibility of a drain on reserves. Each country would also be allocated a quota of bancor based upon their levels of imports and exports.

Dexter White, the "assistant secretary," pushed for the exchange rates of member-country currencies to be fixed to the dollar; and foreign governments and central banks could exchange dollars for gold at $35 per ounce. Dexter convinced other participants that the newly designed architecture would help reduce trade barriers and allow capital to flow freely between member countries.

The Broader Compromise: 1945–1971

The compromise that ultimately emerged was much closer to Dexter White's plan than to that of Keynes, reflecting the overwhelming power of the

United States as World War II drew to a close.[5] Under the new architecture, trade would be progressively liberalized, but restrictions on capital movements would remain.[6]

White and Keynes independently drafted plans for organizations that would provide financial assistance to countries experiencing short-term deficits in their balance of payments. This assistance would help ensure that such countries would not adopt protectionist or predatory trade and monetary policies to improve their balance of payment positions. Both plans envisioned a world of fixed exchange rates: the US$ was to be pegged to gold at $35 per ounce, while other countries of the world were to be pegged to the US$ or directly to gold. Thus, the US$ became the currency of international financial institutions—a role it still plays today. The fixed exchange rate regime established at Bretton Woods endured for the better part of three decades. However, in the late 1940s, the United States found it difficult to cope with the growing balance of payment deficits coupled with the pressure facing the US$ in global currency exchanges. After some failed monetary policies in the 1960s, the US Treasury took various palliative measures to fix the system. In January 1961, for instance, the Kennedy administration pledged to maintain the $35 per ounce convertibility. The United States and its European allies set up a gold pool in which their central banks would buy and sell gold to support the $35 price on the London market. The effort was not successful, until 1968, when the rush out of dollars began—capital flight. Investors and multinational companies began to flow out of dollar assets and into German mark assets.[7]

Advocates of the gold-exchange system argue that the system economizes on gold because countries can use not only gold but also foreign exchange as an international means of payment. However, the gold-exchange system, as devised, contained its own germ of failure.

Professor Robert Triffin,[8] on the other hand, predicted that the system was programmed to collapse in the long run. He pointed out that (i) to satisfy the growing need for reserves, the United States needed to run continuous balance-of-payment deficits and (ii) continuous balance-of payment deficits would impair the public confidence in the US$. Robert Triffin's prediction, known as the "Triffin Paradox," came to pass in the early 1970s.

The Floating-Rate Dollar Standard: 1973–1984

After the dollar exchange crises of August 1971 (when President Richard Nixon suspended the dollar's convertibility into gold), it was only in February/March 1973 that floating exchange rates became the norm for the currencies of the major industrialized nations. To understand the situation, it is worth bearing in mind that the United States entered a recession in 1970. The markets believed that, in order to counter the recession, the United States should devaluate its dollar currency. In 1971, President Nixon announced that the United States would no longer automatically sell gold to foreign banks in exchange for the US$, and the Nixon administration