ECLAC
Economic Commission for Latin America and the Caribbean
World Bank
Seminar on Globalization
Santiago, Chile, 6-8 March 2002

TWO ARGUMENTS FOR AN IMPROVED FINANCIAL GLOBALIZATION

Manuel Marfán

This document was prepared by Manuel Marfán, Expert in Economic Development, ECLAC. The views expressed in this document, which has been reproduced without formal editing, are those of the author and do not necessarily reflect the views of the Organization.
TWO ARGUMENTS FOR
AN IMPROVED FINANCIAL GLOBALIZATION

Manuel Marfan
ECLAC
March 2002

Presentation prepared for the Seminar on Globalization organized by ECLAC and the World Bank to be held in Santiago, March 6-8, 2002.
A. Private excess expenditure is ungovernable through conventional macroeconomic policy instruments.

B. Basic principles of corporate governance for international financial institutions (IFIs)
PRIVATE DEFICITS

MOTIVATION:

Chile 1990-97

- Strict fiscal policy, exhibiting a relevant surplus.
- Central Bank achieved its inflation targets.
- Neither economic overheating nor exchange rate misalignment fueled by excess private expenditure could be avoided.

Chile 2000-02

- Strict fiscal policy, pursuing structural balance targets.
- Central Bank achieved its inflation targets.
- Dynamic growth has not resumed as private consumption has remained stagnant, while the real exchange rate exhibits a strong depreciation.
PRIVATE DEFICITS

\[ \text{CAS} = \text{Fiscal surplus} + \text{Private surplus} \]

\[ p = \alpha e + (1 - \alpha) p^* + \beta (y - y_{pot}) \]

\[ (e - p) = \frac{\beta}{\alpha} (y_{pot} - y) \]

The real exchange rate evolves according to the output gap.
CHILE: Real Exchange Rate 1978-2000
(Annual data; indices 1986 = 100)

1/ Estimated as a function of the lagged RER and the ratio (GDP / GDP trend). See text.
PRIVATE DEFICITS

- Overheating and exchange rate misalignment may coexist as long as external funding finances the concomitant current account deficit.
- Conventional central banks may achieve one nominal target (e.g., inflation).
- Fiscal policy may achieve one real target (e.g., fiscal balance).
- Private expenditure cycles depend on private sector confidence and an interest rate dominated by an arbitrage condition. Conventional policies are ineffective to handle private sector behavior.
- Fiscal policy may compensate private sector imbalances.
CHILE: Surplus Accounting (% of GDP)

Real Exchange Rate (1995=100)

-10%  10%  15%


GDP Growth

Fiscal
Non-fiscal
Current Acc.

RER (right)
PRIVATE DEFICITS

POLICY OPTIONS:

• Compensatory fiscal policy.
• Flexible tax.
• Tax on financial flows.
  ✓ Strictly for prudential purpose.
  ✓ Only with structural fiscal surplus.
  ✓ Administered by the central bank.
  ✓ Ad-valorem toll.
  ✓ Avoid time-inconsistency.
  ✓ Avoid discrimination.
  ✓ IMF surveillance of previous features.
IFIs' GOVERNANCE

MOTIVATION:

- Global institutional building has lagged behind global financial market development.
- In the absence of a global government, IFIs are second-best substitutes. Their role in shaping institution building should be enhanced.
- LDCs are misrepresented in most IFIs (e.g., Hong-Kong meetings, HIPIC Initiative).
- And excluded from most of other relevant influential bodies (e.g., Basle, OECD, G-7, etc.).
- Many IFIs, especially Bretton Woods institutions, are moving in the right direction (streamline conditionality, "ownership", efforts for independent auditing, enhanced transparency and disclosure, etc.).
- New governance arrangements should be thought.
IFIs’ GOVERNANCE

ECLAC has advocated for:

✓ More MDB.

✓ Larger role of regional and sub-regional financial institutions.

✓ Praised most efforts of constructing codes of conduct, maintaining exchange rate and capital account regimes in the sphere of national sovereignty.
IFIs’ GOVERNANCE

- Seek for positive sum game arrangements.

- Societies organized around the rule of law and respect of civil liberties have built effective forms of governance in different areas.

- Four basic principles of good corporate governance:
  ✓ Locate management and control where executive capacity is ensured.
  ✓ Basic common rights of the governed are superior to the specific rights of the controller.
  ✓ The authority must report periodically how power is exerted (transparency, disclosure, accountability).
  ✓ Independent scrutiny and authority, reliable to the governed.

- Beyond its ethical component, these principles enhance the effectiveness of governance.
IFIs' GOVERNANCE

Most IFIs resemble the structure of a corporation:

- An executive management.
- A board composed by executive directors representing shareholders (with weighted vote representing majority and minority shareholders).
- Periodic shareholders' meetings.
- Lack of corporate governance institutions.

How would it look like if basic corporate governance principles were applied?

A case for adjustment programs.
IFI's GOVERNANCE

1. Executive capacity: OK as it is (a caveat with respect to sub-regional IFIs).

2. Basic rights of minority countries: Prevent practical abuses.
   - The right to avoid excess conditionality.
   - The right to avoid excess adjustment.
   - The right for a statement of the board on private sector involvement.

3. Accountability: The board members (and not the management or the staff) should be accountable for the respect of previous rights.

4. The right to audit:
   - Self-auditing helps but is insufficient.
   - Self-auditing of the board is better than self-auditing of the management.
   - Locate auditing of the compliance with basic rights in an external independent institution (on an ex-post basis).
   - Internal auditing committee, as in some corporations.
IFIs’ GOVERNANCE

Positive sum game:

✓ Effective governance is enhanced.
✓ Minority countries earn explicit rights and an explicit auditing role.

Still missing: Evolution of control (More flexible replenishments?).