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**TWO ARGUMENTS FOR AN IMPROVED
FINANCIAL GLOBALIZATION**

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AN IMPROVED FINANCIAL GLOBALIZATION**

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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 stagnated, while the real exchange rate exhibits a strong depreciation.

PRIVATE DEFICITS

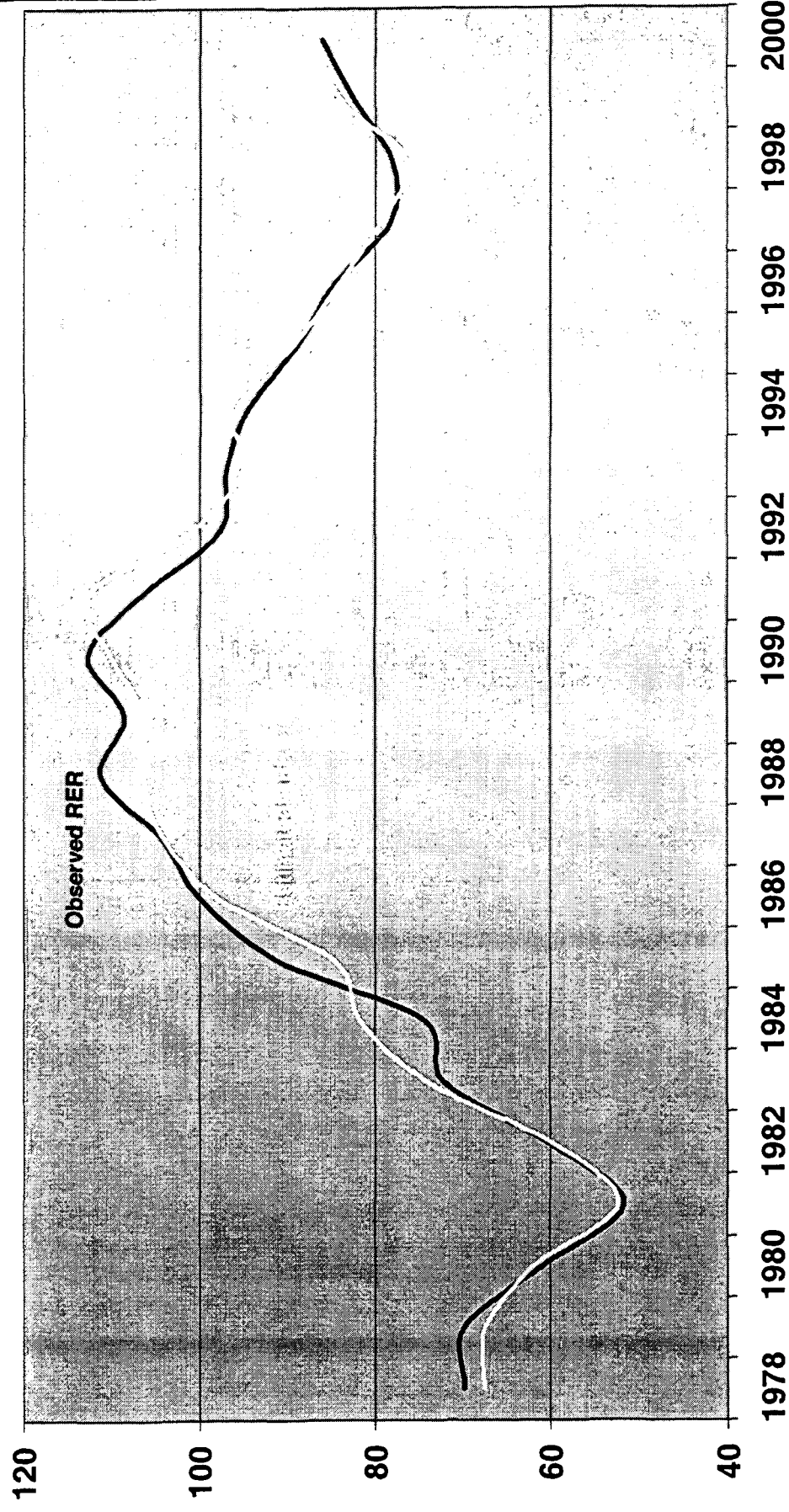
CAS = Fiscal surplus + Private surplus

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

$$(e - p) = \beta / \alpha (y_{\text{pot}} - y)$$

The real exchange rate evolves according to the output gap.

CHILE: Real Exchange Rate 1978-2000
(Annual data; indices 1986 = 100)

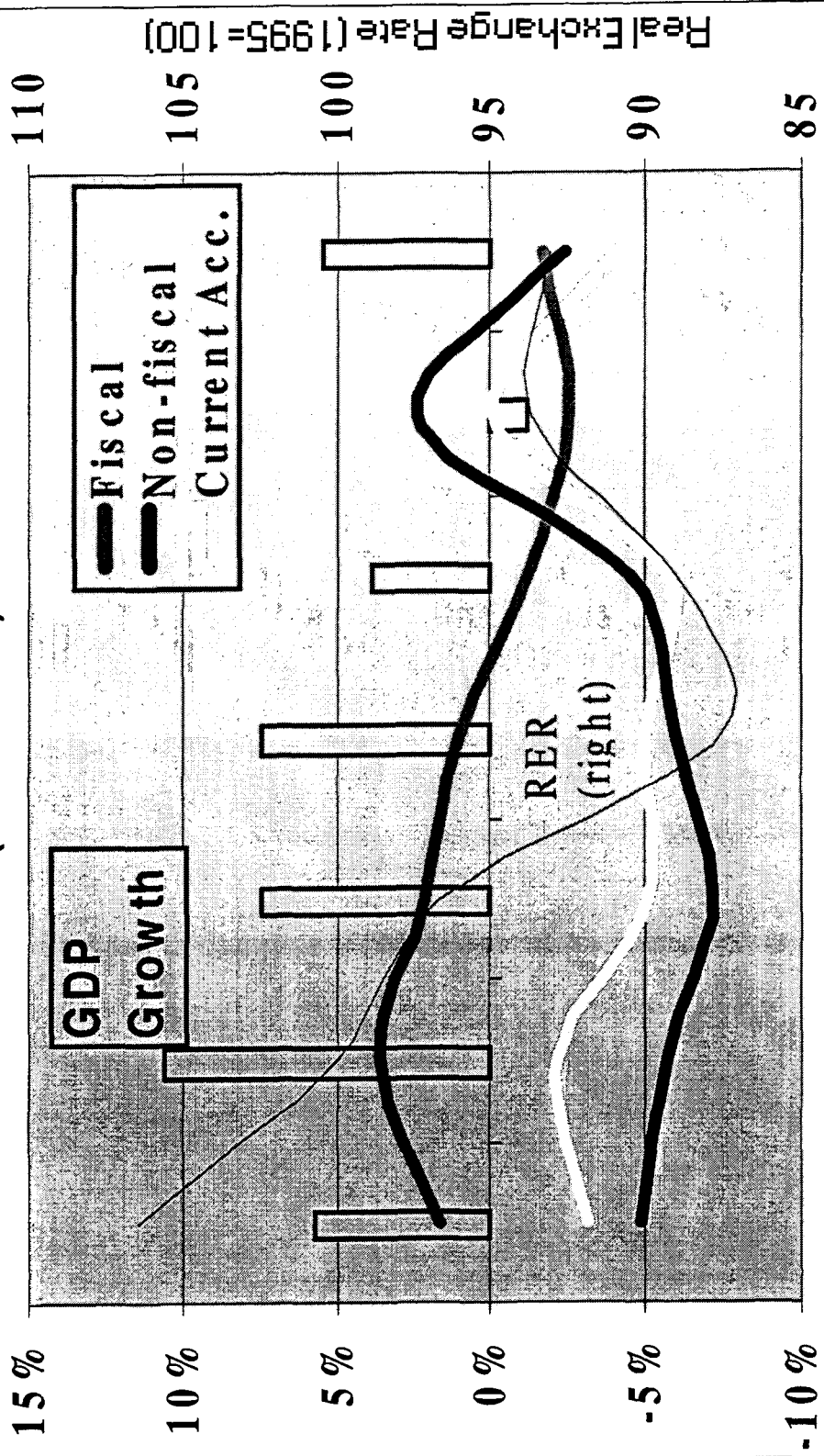


1/ Estimated as a function of the lagged RER and the ratio (GDP / GDP trend). See text.

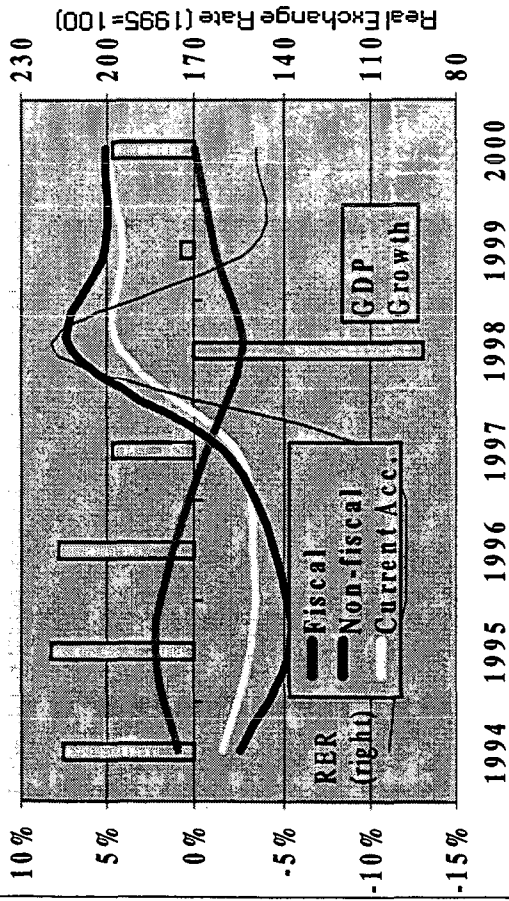
PRIVATE DEFICITS

- **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.**

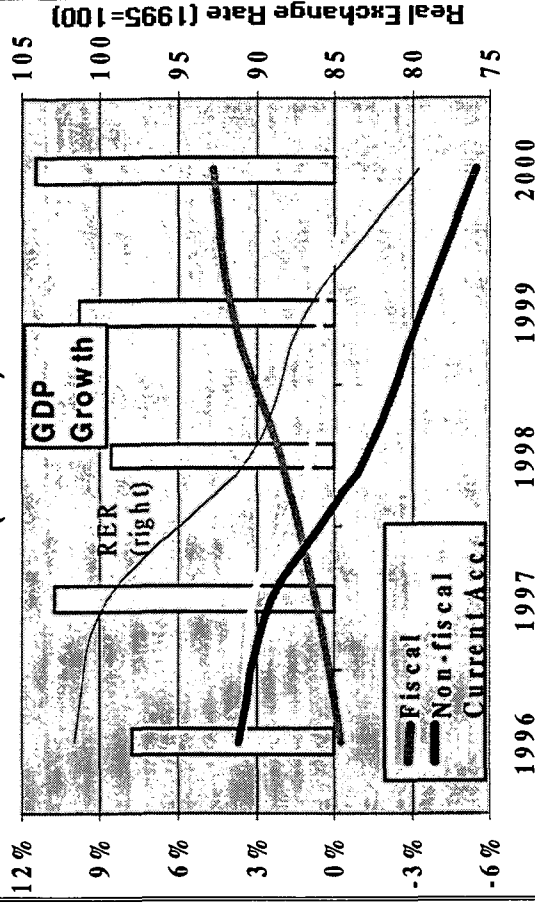
CHILE: Surplus Accounting (% of GDP)



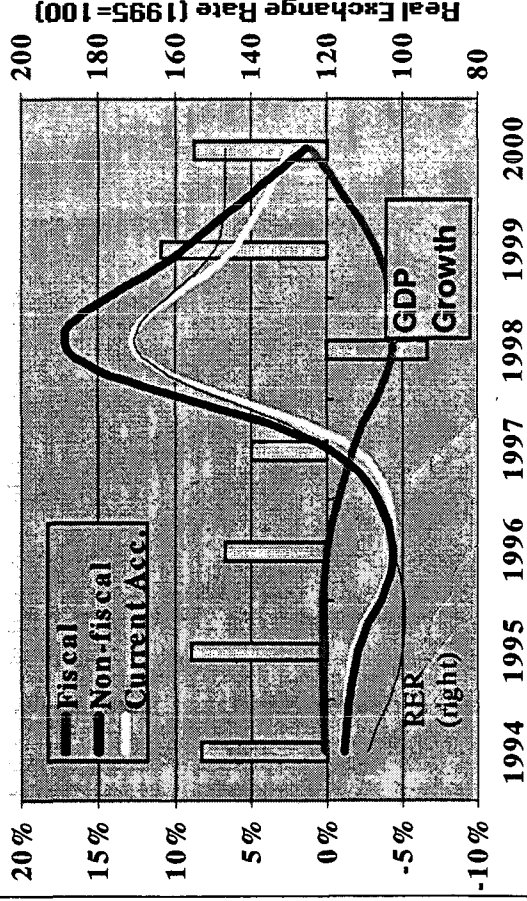
INDONESIA: Surplus Accounting (% of GDP)



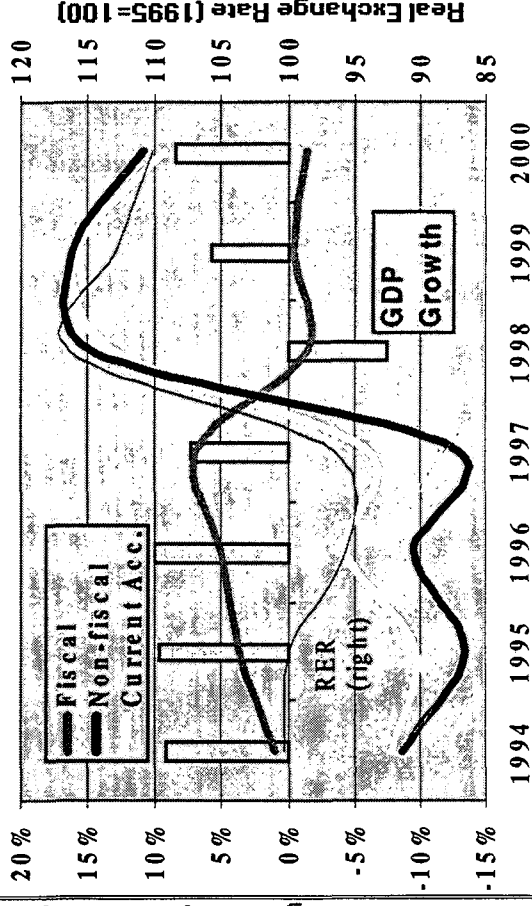
IRELAND: Surplus Accounting (% of GDP)

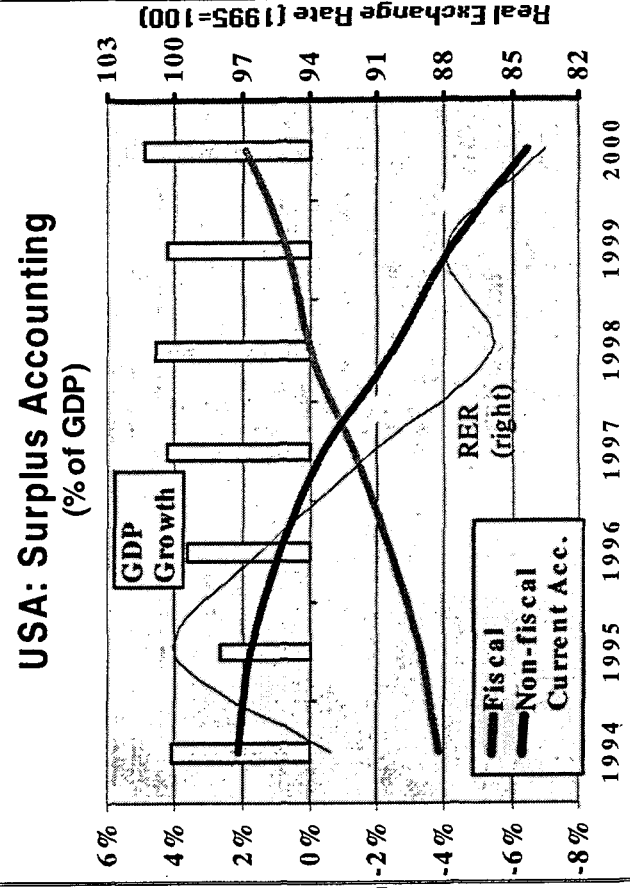
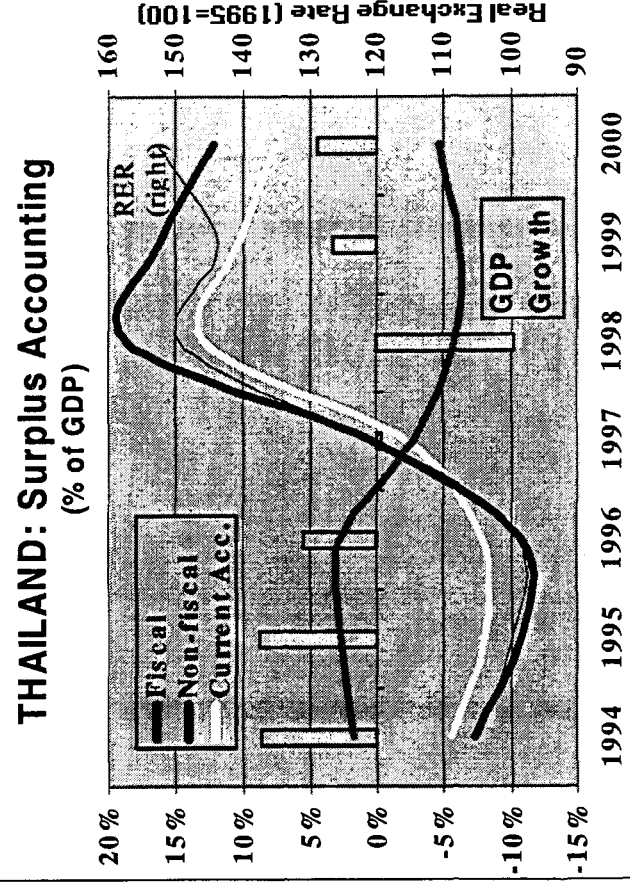
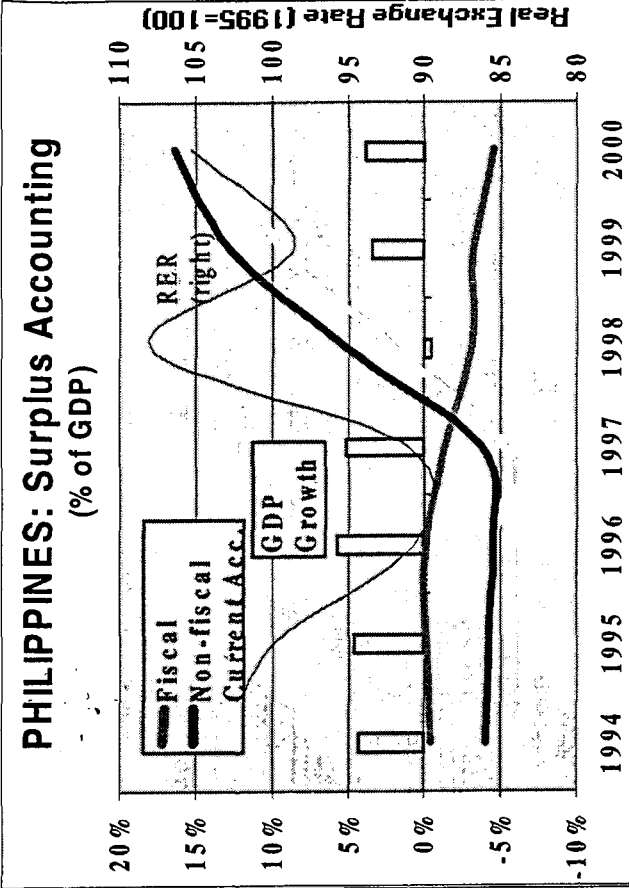
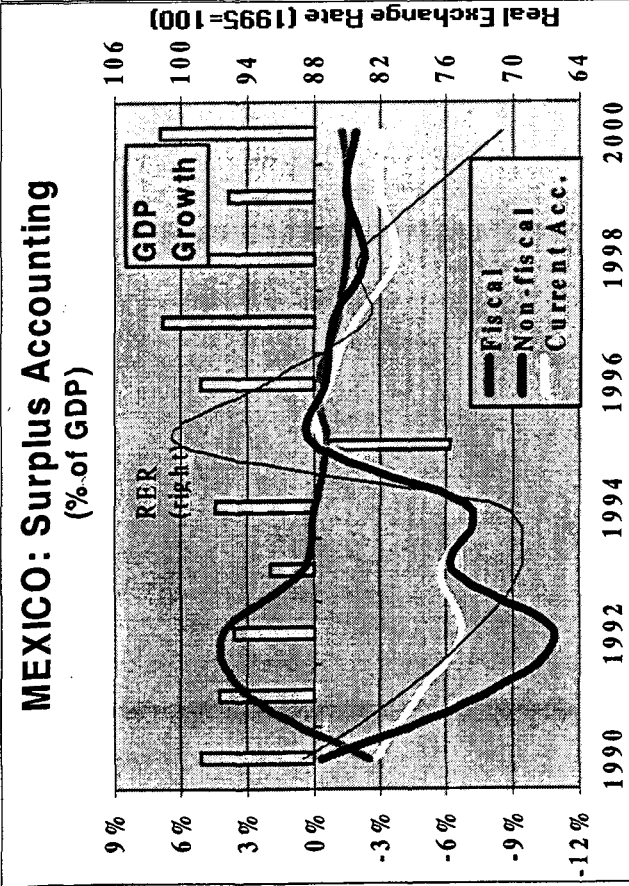


KOREA: Surplus Accounting (% of GDP)



MALAYSIA: Surplus Accounting (% of GDP)





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. There 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).
- Main 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).**
- **Periodical shareholders' meetings.**
- **Lack of corporate governance institutions.**

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

A case for adjustment programs.

IFIs' 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?).

