THE ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS IN THE PRESENT WORLD ECONOMIC CONTEXT

Notes for remarks by
John W. Crow
Governor of the Bank of Canada
at the 14th Meeting
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The current world economic environment is marked by major economic and financial imbalances within and among countries. The uncertainties created by these imbalances have focussed attention on the prospects for the growth of world demand, world trade, and the servicing of international debt. This is the background against which I will be speaking about the role of international financial institutions. Where do they fit into ongoing efforts to improve and strengthen the performance of individual countries and the world economy?

I must necessarily limit myself to a summary overview of the wide-ranging topic assigned to me. The approach I have taken is to concentrate on the International Monetary Fund and the World Bank, the two major global institutions. I will not consider other institutions, and furthermore I will not deal with the longer term structural issues of international monetary reform and international liquidity. These are not really conjunctural questions. I will focus instead on the current activities and roles of these two institutions as they relate to three broad categories of member countries: the major industrial countries; the very poor countries, mainly in Africa but including a few in Latin America; and finally, the middle-income developing countries facing debt-servicing difficulties.

Let me at the outset emphasize one very basic consideration. The role that these institutions can play, while extremely valuable, is ultimately a supporting one. The activities of the Fund and the World Bank are not the decisive element in determining how well countries perform in the economic sphere. The crucial decisions are taken domestically. What fundamentally shapes national economic performance is what is done internally to encourage the mobilization of resources and to ensure their effective use. And to the extent that we can attribute responsibility, the challenges that we are now facing among both industrial and developing countries are the result not of mistakes made by the Fund or the World Bank but of mistakes made at the national level. The Fund and Bank can offer advice with some financial support, and the Fund in particular is well equipped to place its advice in the framework of the interests of the world economic community as a whole, but in the end it is the country's home grown policies that are decisive.

I will now turn to the first of my three categories, the industrial countries.

I recognize that Fund surveillance is often viewed as relatively ineffective in influencing their policies. It is, of course, true that the

Fund tends to have a stronger influence in countries that are borrowing from it, and industrial countries have not been important clients for IMF lending in recent years. But this is only part of the picture, as I wish to show in the next part of these remarks.

From the outset the Articles of Agreement gave the Fund surveillance powers over the exchange rates of its members. But with the widespread adoption of floating exchange rates and the growth of international capital markets Fund surveillance has also evolved, so that it now encompasses a much wider range of factors influencing the behaviour of exchange rates than it used to. An example of this is the much more searching analysis found in the Fund's World Economic Outlook compared with five to ten years ago, with increased focus on the tensions and possible inconsistencies in national policies being pursued by the major industrial countries.

Behind this evolution have been a number of forces: the growing interdependence of the world economy; the continuing large imbalances; the less than satisfactory way in which the economies of individual countries have been performing. Put more directly, even the largest countries have learned that the international spillover and feedback effects of domestic economic policies cannot be ignored. This is why we have seen a move toward more explicit policy co-ordination by the major industrial countries and an increased emphasis on the need for policy consistency over the medium term.

The Fund is clearly very well placed to support this effort by providing the consistent economic framework that is needed to assess the global implications of different national policy stances. Equally importantly, it can provide the very necessary linkage to the interests of other countries not in the target group.

Without such a co-operative effort, the prospects not only of warding off increased protectionism but also of rolling it back, and for ensuring continued world expansion at an adequate rate, will be compromised. A great deal hinges on this, not least for countries with debt-servicing problems.

Turning to the second group of countries, the very poor, least developed, countries, I believe there is a strong case for special treatment. These are countries where resources are at their scarcest, that have no real means of improving their position, and no prospect in the foreseeable future of being able to service the heavy debt burden many carry. In this situation development assistance needs to be highly concessional, or indeed take the form of outright grants. In light of their poor prospects, and, I might add, the fact that in any event the loans outstanding to these countries are not very large, some debt forgiveness should perhaps also be considered. For example, Canada has recently moved to an all-grant development assistance program and has declared a five-year extendable moratorium on the repayment of development assistance loans given to some of the poorest sub-Saharan African countries. More relief of this sort needs to be provided. Initiatives along these lines were discussed at the recent Interim and Development Committee meetings in Washington, including the idea that somewhat longer rescheduling terms on official debt might be agreed upon at the Paris Club.

However, in assessing the appropriate role of international financial institutions, I see great difficulty in accepting the idea of rescheduling of debt to these institutions. To do this for a selected group of countries would go against the principle of equal treatment of all members. If done generally, it would raise questions about the continuing ability of these institutions to meet new needs, and about their financial viability. As regards the Fund, it would seriously compromise the principle of the revolving character of its resources.

This does not mean, however, that the Bank and the Fund have no financial role to play in helping the poorest countries. But by the very nature of the problems these countries face, the monies made available will have to be largely development aid on highly concessional terms. The completion of the negotiations for increasing the resources available to the International Development Association, the World Bank's concessionary financing affiliate, will help to ensure an increased flow of developmental assistance to these countries. In the case of the Fund, the amounts involved will have to be comparatively modest. The use of Fund resources can only be justified when there is a reasonable prospect that the assistance given will lead to an improvement in a country's balance of payments within the normal repurchase periods so that it will be able to repay the Fund. In many instances the underlying structural weaknesses are such that ability to repay is highly questionable. However, the recent establishment of the Structural Adjustment Facility financed with Trust Fund reflows does provide the IMF with limited resources that it can make available to these countries over a longer period than in its normal operations and at highly concessional rates. One of the challenges of the hour is to find ways of augmenting the monies made available in connection with this facility.

It should be recognized that concessional support is not costless, whether provided bilaterally or multilaterally. There is no free ride, although there is a burden shared, in intermediating through international financial institutions. The ultimate burden of concessionary financing always falls on national treasuries in one way or another and then on the taxpayers. At a time when most governments are trying desperately to reduce fiscal deficits, the increase in concessional financing is bound to be limited.

In many respects, the most significant role the international institutions can play in the very poor countries consists in providing policy advice. The Structural Adjustment Facility, for example, requires the Fund and Bank to collaborate with countries in working out a medium term policy framework or strategy for dealing with problems in their economies, thus providing a purposeful basis for financial support from these institutions and by aid donors. So even in these most concessionary cases, conditionality matters.

The third area of Fund and Bank activity to which I shall refer is their role in regard to middle income developing countries facing debt servicing difficulties. Important progress in regard to coping with debt has been made in the past five years, but at the same time quite a few questions are being asked about tactics and strategy. These include questions as to the appropriate role of international financial institutions, particularly of the Fund and World Bank.

I would like to start with some general observations.

My first is that these countries are a very heterogeneous group in terms of domestic and external situations. Institutional structures also differ greatly, as does the extent of the progress each has managed to make in adjusting and improving its economy and returning to external financial viability. In part because of this great diversity, there is no alternative to dealing with these problems and structuring solutions on an individual basis. No general cure is at hand. Nevertheless it is also true that in each case the approach taken has to fall within the broad strategic framework of domestic economic adjustment and continuity in financing that has been the hallmark of the past five years.

Secondly, it has become increasingly clear that the problems that have been categorized as the "debt situation" are not going to be solved quickly, that more than short-term adjustment is involved. Reflecting this, there has been increased emphasis on structural changes over a longer time horizon and therefore a much larger involvement by the World Bank in this process.

Thirdly, it is clear that there has been a considerable evolution at both the Fund and the Bank in recent years in line with this shift in approach. With respect to the Fund, we now see a much greater emphasis on viewing the current economic situation and policy response in a medium-term context, and greater efforts to encourage countries to undertake fundamental changes to improve the efficiency of their economies. On the World Bank side, we see increased flows of non-project assistance in support of sectoral or economy-wide reforms. The Fund and the Bank have also been making greater efforts to work directly with each other in putting their programs together.

I believe that the basic strategy of these two institutions insofar as the middle income countries are concerned is sound. This does not mean that there are not many difficult debt issues yet to be resolved. These clearly include a broad range of issues relating to commercial bank lending and other private sector flows, the role and scope for foreign private sector investment, but these are not part of my assignment today.

So let me look first at the challenges that face the Fund. In assessing them, it is important to draw a distinction between the Fund's role as an adviser and its role as a provider of financial resources. Whether or not a member is borrowing from the Fund, it is part of the Fund's function to assess the appropriateness of that member's economic policies and to offer advice through regular Article IV consultations. The Fund also stands ready to provide technical assistance within its areas of expertise. With regard to this policy role of the Fund, the important point is that for all countries, soundly conceived demand management policies are a necessary precondition for the efficient allocation of resources and sustained growth. Financial constraints will make themselves felt one way or another, and the task is to operate constructively within them. There is thus a continued role for the Fund in policy discussions in all countries.

With respect to its financial support role, it is my firm view that the Fund's resources should continue to be of a revolving character. This implies an additional reason for Fund concern about a country's policies and for the conditionality that is part of Fund programs. The Fund must be assured that a country follows policies that will enable it to repay its borrowings. This does not of course preclude the possibility that countries which are continuing to make progress may make use of Fund resources over an extended period through back-to-back standbys.

The fundamental question facing the World Bank, and indeed other institutions, is how best to assist countries which need to make major changes in their economies in order to ensure more beneficial results from their use of development funds.

One of the particular issues it has had to tackle in recent years is finding an appropriate balance between project assistance and program assistance. While much of the Bank's expertise is in helping with individual projects, what many countries need at the moment are measures directed towards improving the efficiency of certain key sectors in order to enhance the performance of the economy in general. Initiatives to liberalize trade flows, to improve the functioning of domestic financial markets, or to reassess the state's activities in the economy are examples of policy areas in which the Bank has increasingly become involved. While the World Bank has been undertaking policy-based lending for some years, it still does not have a great deal of expertise in such lending. The pressures of involvement in these areas should, however, make for a sharply rising learning curve. An important part of the learning process will be continuous and ongoing evaluation of its approaches. The World Bank must look at ways to improve its mechanisms for monitoring policy implementation and progress towards objectives in policy-based loans. Given the importance of maintaining the quality of the World Bank's portfolio, and of using well the relatively scarce resources available to it, I strongly support work in this area. A further question concerns what can be done to strengthen the World Bank's International Finance Corporation affiliate so that it can provide increased amounts of financial and technical assistance to the private sector, and perhaps help in enhancing the flow of direct investment. While the machinery needed for the World Bank to effectively perform its augmented role still needs to be worked on, there has already been a major step-up in commitments and disbursements are moving up to target rates. Existing capital resources should be adequate to support projected levels of lending in the immediate future, but the question of a further capital increase for the World Bank is clearly moving up the agenda of international financial issues.

The importance of the Fund and the World Bank working together in their country programs cannot be over-emphasized. I am not talking here about cross-conditionality. What is important is that while each institution focusses on the area in which it has expertise, at the same time they make a point of ensuring that their approaches are consistent and that the needs of the members are being met by one institution or the other. We have seen a good deal of progress in this area over the last few years, and it needs to continue.

Over the past few years, both institutions have played a catalytic role in encouraging financial flows from other sources. This role does raise a number of questions. One is the extent to which the World Bank or other official international institutions should be guaranteeing or co-financing such flows. In this regard, we should bear in mind that guarantees are not free goods -- capital has to be set aside to back them. Secondly, should we be concerned at the extent to which disbursements of bank loans are tied to disbursements of Fund and World Bank loans? It is clear that such measures are useful in the short-term when, as now, some other creditors are reluctant to make available new funds. However, I would feel that, over time, their use must be reduced and normal debtor/creditor relationships re-established. I would underline, however, that there is at present a difficult problem in channeling adequate amounts of financing to countries saddled with heavy debt-servicing obligations. Ways need to be found to make the process work more smoothly and expeditiously. All parties involved - creditors, debtors, and monetary or regulatory authorities - have an interest in seeing these difficulties resolved quickly. Some interesting possibilities for making the process work better have begun to emerge, within the essential broad framework of adjustment, structural improvement for growth and continuity in financing.

Central banks are not the principal actors in these matters. But it is incumbent upon them to use their expertise and influence to promote the cooperative approach to debt problems on which further progress depends.