

## COMMENT

### **REFLECTIONS ON 2008 AND THE GLOBAL FINANCIAL MARKETS: THE CHALLENGES FACING THE INTERNATIONAL MONETARY FUND & THE WORLD BANK**

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2008 was a surprise year for people. That was especially true of the financial crisis much greater than all experts foresaw. Many of the happenings could have been predicted though given the signals coming out of the USA in mid-2007 about the growing sub-prime lending scandal.

Started by a few greed-driven people over lending at high interest rates to people who could not afford it in the first place and then selling on the inevitable bad debts to other banks and financial institutions which, they also knew would be driven by the same greed, the sub-prime crisis quickly escalated into a tidal wave. The debts got further diluted and spread around the world as they were bought by banks and financial institutions abroad, some relying on the US rating agencies and genuinely trusting that the credibility of the US banking system was intact, some others, greed-driven - knowing that this was not true - which is why they too would sell on the debts until eventually there was no-one else to sell them to and the default domino set in following the sub-prime domino effect that had started it all.

The Western world's leaders led by the USA & European Union (EU) and their banking and financial institutions must be held accountable for what caused the current financial collapse, and be made to finally take responsibility for their actions or lack thereof. Belatedly pointing their fingers at international organizations, national institutions, and banks for their failure to monitor the financial system, political and business leaders, academics and various other stakeholders were quick to call for an overhaul of the whole financial system and for closing several important regulatory gaps. Consider the banks though; how from a purely rational standpoint, could they ever be expected to supervise themselves when their prime reason for existence was to make money and share it with their shareholders?

So who was supervising the banks? In-house risk management teams? They had a vested interest in not blowing the whistle. Ethical standards at many companies have turned out to be mere window dressing. Apart from the banks themselves, it was supposed to be the National or Central Banks of each country. Yet, they also had a vested interest in how well their banking sector was performing, for in turn this contributed to the funding of their respective governments. What about the Bank for International Settlements – the central bank for all central banks? While working there in 1997, the most talked about challenge they faced was the lack of bank supervision among their members.

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Then of course we have the International Monetary Fund (IMF) and the World Bank (WB). What were their experts doing as the financial world was falling prey to greed? They also missed the collapse of the Asian Tigers in 1997 and the collapse of the Mexican Peso among others. Why you may ask? It goes back to the old adage that ‘no-one will ever see what they don’t want to see’.

What about the financial rating firms - how did they get their ratings so very wrong for so long? This is a simple question to answer when one realizes that many of these same rating agencies were owned by the larger banks. How then could they give objective ratings and thus ‘spill the beans’ on so many? These rating agencies were merely self-serving and not credible sources of information for the markets.

It is now clear that banks and other financial institutions will never be the same again. First, some of the very large ones (e.g. Lehman Brothers) have fallen by the wayside, while others have been bought up and/or merged into larger banks. Many have also sold shares to consortia in Asia and the Middle-East, to attract global wealth funds to help them survive, thus handing some control of their destinies to these same investors. Second, many governments throughout the world have also worked to recapitalize their banks and shore them up in one way or another for fear of collapse. By committing billions to bail them out, these governments are in effect taking a stake hold in the banks. But to what avail, if the banks don’t provide credit where it’s needed to keep economies active and trading? Have the bailout funds helped the banks offer credit to consumers, SMEs, mortgage holders or to those seeking new mortgages or second mortgages – as we all thought banks were supposed to do. No, so far, they haven’t!

Who will be supervising the Banks use of these bail-out funds? Are these the same ones who failed to monitor them before and caused their collapse? It is interesting to note however, that in the US after the first payment of upwards of \$25 billion has already been made to some banks, these same banks have refused to say what they have done with the funds.

What about the experts? Where were they and how come their current silence is now speaking louder than any of their previous prognostications? Let me answer with one simple question here: how could so many ‘experts’ whether bankers, investors or the rich and powerful, have all gotten it so very wrong by investing with Madoff?

Clearly, the recent bailouts and takeovers by Western Governments and their efforts to increase banking regulations signal the end of deregulated capitalism; all the more given the G20 Heads of government’s call for a more regulated market at their April 2009 London Summit. The age of regulation and government intervention is returning to what has been a free-for-all unregulated marketplace that has run its course.

What all these points also make abundantly clear is that to resolve the current global financial crisis we need to apply a new kind of thinking. To paraphrase Einstein: *“The kind of thinking that created a problem is not the kind of thinking that will successfully resolve the problem.”* Individual countries alone cannot help to resolve this global crisis, if anything else, because of their tendencies to take care of their own interests first as can be seen from a recent WB study reporting that a number of countries, including 17 of the G20, have implemented protectionist measures even though the G20 leaders signed a pledge in November 2008 to avoid such measures.<sup>2</sup>

The world has moved on since the Breton Woods days of 1948 that led to the establishment of the WB/IMF. New economic players have emerged; most prominent among them are the so-called BRIC countries (Brazil, Russia, India and China). These emerging nations need to be better represented at the top of international organizations to replace the old Western Clubs that are relics of a bygone world and no longer have legitimacy on their power; all the more as countries like China and Saudi Arabia, among others, have been supplying cash to the West. In short, in a highly connected global economy, where nothing is more globalized than capital, that flows around the world almost unhindered, an effective response requires a shift in thinking and power at these two international organizations.

The new thinking required now must thus come from multilateral agencies such as the WB and the IMF. This will require, however, a major change in their members' power structure – especially from those currently in key power positions. Those two Washington-based institutions can no longer be dominated by the few countries who wield most of the power. But, as the adage goes, 'easier said than done'!

Indeed, old habits die hard! Witness the April 2009 G20 meeting - to address the financial crisis. Prior to that meeting, the larger EU leaders and Finance Ministers met in Berlin to plan for its agenda. G. Brown, the UK PM, then went to meet President Obama to discuss a common strategy for the G20 meeting. At the same time, ASEAN Plus Three (China, Japan & S. Korea) leaders and Finance Ministers had met in Thailand to plan their strategy to address the global crisis. The EU meeting and that between the UK and US, however, pre-empted ASEAN's inputs even though ASEAN Plus 6 account for more than half the world's population. The preparatory meetings of leaders from Latin America and Africa were also pre-empted thus perpetuating the old status quo which has failed so badly and brought the world to the brink of financial disaster.

As part of the "Washington Consensus"<sup>3</sup>, the WB and IMF are clearly very much influenced by their own key stakeholders, who carry the largest voting power on their Boards of Directors and are determined to keep it that way. Currently, the members with the five largest numbers of shares are the United States, Japan, Germany, France and the UK. Yet, if one examines the shares by global GDP for 2007, one finds that the top five countries are in fact the USA, China, Japan, India and Germany, with the UK at number 6 and France at number 8 (source IMF's WEO, April 2008).

Is there any real need in today's world to have this select group of five members at the top of these Organizations? Is this not merely perpetuating a system of 'development colonialism' which, as we are entering the 21<sup>st</sup> Century, is long past its shelf life? All members should be treated equitably and no five Board members should be able to exercise a disproportionate level of influence as is the case today. Should not China and India therefore replace France and the UK?

If the BRIC countries were to take their 'rightful' place on the respective WB and IMF Boards according to voting power allocations, it is likely that these institutions would indeed take a very different position on lending and other policy matters. Clearly, a reallocation of voting powers reflecting the current Global GDP rates would mark a major paradigm shift for these institutions.

From the time I worked at these two august institutions I never felt comfortable with the distribution of their voting rights as allocated to each of their member countries.<sup>4</sup> One interesting observation that I

made after the collapse of the Soviet Union in the early 90's when I was myself transitioning from the IMF across the street to the WB, was the 'battle' that took place within their respective Boards as to how to allocate and reassign voting rights to this large new group of former Eastern bloc members. Those with the most votes were very unwilling to part with any for fear of lessening their influence.<sup>5</sup>

The battle that raged then would be even greater today if these two institutions were to truly reform and distribute their votes according to the current size of their members, both in terms of their GDP, population, and market positions in the global economy. As contemplated in one recent WB Report, the challenge today is to "enhance the voice and participation of developing and transition countries"<sup>6</sup> This is in keeping with the 2002 Monterrey Consensus, which "encouraged the WB and IMF to continue to enhance participation of all developing countries and countries with economies in transition (DTCs) in their decision making..."<sup>7</sup> The WB and IMF differ, however, on how they define DTCs.

Whereas the WB's definition is based on the 2003 Bank's World Development Indicators (WDI), the IMF classifies countries according to its World Economic Outlook (WEO).<sup>8</sup> This complex situation regarding DTCs definitions provides ample room to procrastinate from doing anything substantive to change the current voting powers.<sup>9</sup>

This Report is also further complicated by such matters as "*Selective Capital Increases, Share Exchanges, Allocation of Unallocated Shares, Criteria for Realigning Shareholding, and IBRD Shareholding Review.*" Of particular interest is the option to strengthen Board representation for Sub-Saharan Africa (SSA) to three Executive Directors (EDs). The SSA currently has just two EDs for 47 countries. However, rather than take on the challenge and reduce the existing power from some EU members, such as France or the UK, they propose to add another CD to bring the number to 25. Yet, in paragraph 48 referring to Parity between Developed and DTC Members it states that: "*Many members have emphasized the objective to make the Bank a more equitable, representative and transparent multilateral institution, further strengthening its legitimacy, credibility and accountability. To that end, some members have proposed moving, over time, toward the concept of parity between developed and DTC members into Bank governance.*"<sup>10</sup>

The first formal summit of the four emerging BRIC powers, concluded in Russia on June 16 with calls for reform of international economic institutions and a curb on protectionism, reflects how pressing this need for a more equitable representation is. In a joint communiqué the leaders called for a stronger role in the world's shared financial institutions. The main issue is the International Monetary Fund (IMF), where BRIC countries have few votes proportional to their influence.

Is it not then timely, in the midst of a severe global financial crisis, to help bring back the WB Groups legitimacy, credibility and accountability? Still, the WB will not do so by ducking the Board representation for SSA by adding a third African ED for SSA rather than keeping the existing Board numbers at 24 and reallocating votes and ED Representations from say some European members such as France and the UK?

Would it not also be timely to see a shift in which both the WB and the IMF would work towards empowering countries to carry out their own development rather than have it 'done to them' or 'done for them,' as is so often the case (Jones, 2006).

Finally, in a bold – but economically legitimate - move, China has recently attempted to assert itself in the Global Financial Markets by proposing to abolish the US Dollar as the Global Reserve Currency and replace it with a basket of currencies to be managed by the IMF. As expected, this suggestion was immediately rejected by the USA that wished to remain in control of Global Markets. However, as Joseph Stiglitz (Nobel Winner for Economics) pointed out: *“Many critics in Asia and the Middle East, where pools of liquid capital dwarf the IMF’s own, are wondering why they should turn over their money to an institution in which the United States, the source of the problem, still has veto power, and in which they have so little voting power.”*

I believe the Chinese suggestion of a new Global Reserve Currency is a good one, but unless this is accompanied by a change in the voting powers on the WB and IMF Boards, as suggested above, it will not be enough to realize the desired outcomes. Challenges are leveled at the WB and IMF, which need to replace the old status quo and realign their respective Boards with their voting powers reallocated so as to reflect the current state of the World and not that of the 1940’s when these Breton Woods’ Institutions were first established. In short, it is high time for “parity” between developed and DTC countries.

#### Notes

2. The WB study reports that G20 officials have proposed and/or implemented roughly 78 trade measures since the beginning of the financial crisis. Of these, 66 involved trade restrictions and 47 trade-restricting measures eventually took effect. While the effects of these measures are likely minor relative to the size of unaffected markets, they have a significant negative effect on particular exporters shut out of markets. As the WB President Robert B. Zoellick said: “Leaders must not heed the siren-song of protectionist fixes, whether for trade, stimulus packages, or bailouts.
3. The term, coined by John Williamson in 1989, refers to the Chicago School’s ideological grip on the IMF and WB and their subsequent adoption of “Friedman’s neoliberal triumvirate of privatization, deregulation/free trade and drastic cuts to government spending” (Naomi Klein, *The Shock Doctrine*, 2007, p.163)
4. The WB and the IMF have adopted a weighted voting system. As provided in the Bank’s Articles, membership in the Bank is open to all members of the IMF. A country applying for membership in the Fund is required to supply data on its economy, which are compared with data from other member countries whose economies are similar in size. A quota is then assigned, equivalent to the country’s subscription to the Fund, and this determines its voting power in the Fund.
5. As stated in the WB’s website: “Before November 1, 1992, there were 22 Executive Directors, 17 of whom were elected. In 1992, in view of the large number of new members that had joined the Bank, the number of elected Executive Directors increased to 19. The two new seats, Russia and a new group around Switzerland, brought the total number of Executive Directors to its present level of 24.”
6. See the October 2008 Report on the WB’s website.
7. Ibid.
8. While the World Bank Group requires the classification of member countries as “developed”, “developing” or “in transition.” There is no uniform classification for the Bank Group, and different classifications are used for different purposes and in different contexts. IBRD and IFC members listed as middle or low-income countries in the Bank’s World Development Indicators 2003 (WDI) have been counted as DTCs, and members listed as high-income countries in the WDI have been counted as developed countries. By comparison, the Fund classifies members into ‘Advanced Economies’ and ‘Developing and Emerging Economies’. (Source : WB’s website).
9. We see for example that the current voting power at the WB Group and the IMF before Reforms is as follows: using the WDI classification, DTCs voting power is 40.0% for the IBRD compared to Developed Countries of 60.0% ; Using the WEO classification, DTCs voting power is 42.6% for the IBRD and 39.4% for the IMF, compared to developed countries of 57.4% and 60.6% respectively.
10. See WB’s website.

**References**

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