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Addressing New Global Gaps: Re-Inventing the International Financial Institutions

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Cómo afrontar los nuevos vacíos globales: Reinención de las instituciones financieras internacionales

Encarar as novas lacunas globais: Reinventar as instituições financeiras internacionais

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In this paper we discuss the critical role of International Financial Institutions (e.g., World Bank, the International Monetary Fund, Inter-American Development Bank) in light of the substantive policy and market gaps that if properly addresses would help reduce the growing income disparities and uneven access to capital markets of the world's poorest such as: access to home ownership, to growing labor markets, to credit markets by deserving NGOs and to critical information by major policy makers. These institutions need to separate financial intermediation functions from research activities to allow more efficient management of their funding sources and operational objectives. Five specific recommendations are offered.

En este artículo se discute sobre el papel crucial que desempeñan las instituciones financieras internacionales (a saber, el Banco Mundial, el Fondo Monetario Internacional, el Banco Interamericano de Desarrollo) a la luz del gran vacío legal y mercantil que, bien gestionado, podría ayudar a reducir las crecientes diferencias de ingresos y favorecer el acceso de los países más pobres del mundo a los mercados más importantes, por ejemplo, mediante el acceso a una casa en propiedad, a mercados laborales en crecimiento, a mercados de crédito por parte de ONG que lo merezcan y a información crítica de los grandes legisladores. Estas instituciones necesitan separar las funciones de intermediación financiera de las actividades de investigación para permitir un gasto más eficiente de sus fuentes de financiación y objetivos operacionales. Se ofrecen cinco recomendaciones concretas.

Discutimos neste artigo o papel decisivo das Instituições Financeiras Internacionais (p. ex., Banco Mundial, Fundo Monetário Internacional, Banco Inter-Americano para o Desenvolvimento) à luz das lacunas política e de mercado substantivas que, se convenientemente encaradas, contribuiriam para reduzir as disparidades de rendimento e as desigualdades de acesso aos mercados de capitais dos mais pobres do mundo, tais como: acesso à propriedade da casa, a mercados laborais em crescimento, a mercados de crédito por parte de ONGs meritórias e a informação crítica pelos grandes legisladores. Estas instituições precisam de separar as funções de intermediação financeira das actividades de investigação a fim de permitir uma gestão mais eficiente das suas fontes de financiamento e objectivos operacionais. São apresentadas cinco recomendações específicas.

1. The Role of International Financial Institutions

The 20th century was notable for its scientific breakthroughs in the social sciences. Economic theory evolved to a much better understanding of the relationship between monetary, trade and fiscal policies and the real economy. The laws of comparative advantage in the alignment of global competitiveness gave way to a more nuanced understanding of relative advantages created by allowing prices to fluctuate and the means of production –capital and labor, to move with global supply and demand. Through failed social

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experiments we quantified the destructive impact of regulation and price controls, and we learned that global competition may be uncomfortable for those less able to adapt in the short run, but in the long run we all benefit. We can now measure the fiscal dividend of higher, non-inflationary growth, and we have come a long way since Keynes focused on fiscal policy as the most important tool in managing economic cycles. We learned to reach moderate levels of constructive policy consensus in a multi-polar world and trade goods, services and capital with relative ease. We are now ready to tackle new challenges, but we need to build new hubs of research and thought leadership or re-tool the existing ones to meet those challenges. Someone other than any one government has to direct the global chorus to sing in reasonable harmony.

Undeniably world wealth has increased significantly over the last 20 years and the number of poor, indigent people has decreased substantially with the development of China, India, Brazil, and the former Socialist Republics along with most other emerging markets. But there are still significant knowledge and market gaps that need to be addressed. In the 20th century we saw the creation of international financial institutions (IFI), whose mission was to reduce the most critical market and knowledge gaps of the moment. After World War II, institutions like the World Bank Group, the International Monetary Fund and other multilateral regional banks were created to fill capital, trade and credit market discontinuities exacerbated by the destructive consequences of WWII. In the post-war period, member governments contributed significant funds to these institutions to help jump-start the reconstruction of Europe and Japan. At the time, international capital markets and commercial intermediaries were not sufficiently developed to clear the counterparty risks associated with the reconstruction of a world destroyed by war. When the rebuilding was under way, their mission appropriately shifted to extending credit to poor nations to help them overcome structural and cyclical gaps in their access to capital markets and global trade, foster economic growth and decrease poverty. In the process of channeling development funds to emerging countries, accompanied by and often attached to policy directives, these IFIs helped design and standardize national accounting systems and measures of creditworthiness for all nations. With standardized measurement of economic activity came improved fiscal, monetary and trade policy advice and management. The emerging theory of economic development contributed the concept of “shadow prices” to better measure the effect of infrastructure investment on economic growth. Economic theory moved from the realm of political philosophy to the field of quantitative monetary and fiscal science. With the ability to measure policy initiatives, we could now manage toward specific economic growth targets. All of these accomplishments created the basis for sustainable economic growth around the world, not just based on the unachievable promises of politicians, but on measured, soundly tested analysis of policy reforms. The hub of the scientific evolution supporting policy reforms in these institutional intermediaries was at top universities and within the economic policy research departments of newly created institutions, mostly the International Monetary Fund and the World Bank, as well as regional development banks such as the Inter American Development Bank and the Asian Development Bank. This was a remarkable achievement in a mere 50 years. No previous scientific research focused on the social sciences had achieved so much in alleviating world poverty in so little time.

Today there are over 50 IFIs (over 80 including official export finance companies) with more than \$2.6 trillion in outstanding loans. However, despite their large loan portfolios,

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their role as financial intermediaries channeling new lending and investment has been dwarfed by private sector intermediaries. Furthermore, as they increased their lending efficiencies, their research functions became secondary to their lending operations. It could be said that their success in fostering open economies, deregulation and trade, has driven them away from their initial mission: addressing intellectual and market gaps in a global cooperative economy based on fundamental research coupled with strong financial incentives.

Adoption of open economy models and price deregulation have allowed vastly expanded trade and economic growth in emerging economies, access to private capital markets and reduced dependence on IFIs. Official flows from IFIs have been (net) negative since at least 2004, as emerging countries pay more debt than they create. There could not have been a better outcome. With fairly good access to global trade and capital, emerging country borrowers, like Japan in the 1950s, have begun to repay their debts to IFIs. In 2006 the net capital flows to emerging markets were \$502 billion. IFIs net lending was negative \$26 billion in 2006 and negative \$40 billion in 2005¹. The capital market gap these institutions helped fill is no longer significant, except for a few small countries and regimes. But their mission has not ended.

Today there are new important gaps to address. There are substantive policy and market gaps that if properly addressed would help reduce growing income disparities and uneven access to capital markets of the world's poorest: Access to home ownership, to growing labor markets, to credit markets by deserving NGOs and to critical information by major policy makers. Maybe the existing institutions can address these gaps; maybe they cannot and new ones need to be created to breach current capital, labor, demographic, and information gaps. That is a relevant question, but I strongly believe the IFIs can be retooled to meet new global needs.

Despite sub-prime thunderbolts and significant losses among a few large banking groups, which have impacted the world economic growth outlook for 2008, the medium term financial outlook is still one of abundant liquidity, contained inflation, continued international trade and capital flows, relatively low risk premiums, and increased need for cross-border human capital mobility to tend to differential growth rates among countries and contrasting demographic profiles. There are, however, significant threats to human capital mobility and world prosperity: Heightened terrorism, nuclear risks, ageing populations in some of the world's growth engines, politically motivated and sometimes rogue international public lending, the emotionally charged and ubiquitous global warming/climate-change, growing concerns about water scarcity and potential pandemic challenges. Any of these threats could bring about protectionist, populist, mercantilist, feudal or outright regressive policies.

There is clearly a need to adapt the IMF, The World Bank Group, Inter-American Development Bank, Asian Development Bank, and the 50+ other IFIs to address the current capital market and knowledge gaps, if they can. They have the capital and knowledge base to do so, but they need the will and constructive leadership to re-focus their mission. These institutions need to separate financial intermediation functions from research activities, in order to offer more enlightened actions in both realms. Separation of the two functions would

1. Institute of International Finance

allow more efficient management of their funding sources and operational objectives. The following are some recommendations:

1.1. IFIs Should Become More Endowments for Research and Development and Less Financial Intermediaries

In order to fund critical areas of research on human capital flows, accurate macroeconomic accounting, post-modern fiscal and monetary policies, a portion of the IFI equity should be segregated and invested in higher return broadly diversified risk assets to finance separate research functions, much as it is done in all major universities.

University endowments know that in order to finance their research and educational functions, they cannot just invest in student loans. They know they must carve out a permanent endowment fund and invest it wisely in a diversified pool of risky assets to become a profit center from which to fund activities that do not immediately generate profits but further their intellectual development mission and increase the value and quality of the franchise. To keep IFIs excess working capital solely invested in low interest loans to the US and other developed countries (liquidity reserves in IFIs are invested in government debt of developed countries, who are in fact the largest IFI borrowers) is a waste of their resources and an unnecessary constraint on their mission. A portion of these funds, an endowment for development research, should be invested for higher total returns than that provided by US and other Euro treasury notes. More research is needed to meet current poverty and market gaps. Some research can also be outsourced to academic institutions and other think tanks if assets to support it are properly segregated and managed. The National Institutes of Health in the US is a sensible hybrid model for internal as well as outsourced research to academic institutions and other scientists.

1.2. Improve National Accounting Standards and Macro Economic Fiscal/Asset and Liability Management

Based on their substantial technical expertise and abundance of data bases and research economists, IFIs, particularly the IMF, can help improve national accounting systems to include better measures of country (public and private) assets and liabilities while producing individual country (public and private sector) balance sheets and more accurate stock and accrual accounting. A new, more comprehensive macroeconomic accounting system would help measure the appreciation and depreciation of real, financial and human capital assets and liabilities, (including environmental impact), and facilitate a more comprehensive and integrated fiscal policy. Post Keynesian fiscal policy has significantly lagged the development of monetary policy. The reasons for the arrested development of public fiscal management rest significantly with their lack of independence from the political process. By contrast, monetary policy is largely set by independent technically focused professionals in developed markets. But both fiscal and monetary policies need to be re-tooled based on an enhanced understanding of the impact a global economy has on human capital, the environment and new intermediaries that are displacing old ones. For example significant demographic and growth differences call for more enlightened migration policies, a better measurement of human capital appreciation and depreciation and its impact on fiscal policies. Commercial banks may no longer be the more efficient means to channel monetary policy. Why not allow

pension, endowment, foundation and even hedge funds (if properly supervised) to go to the Fed discount window? They are better capitalized and arguably many of them better managed than banks. Importantly they can inject liquidity into market bottlenecks more quickly and efficiently. Let's do research on this topic. Most importantly there is significant need to develop more accurate means of economic accounting. In addition to its entanglement in short term political agendas, fiscal policy development has been handicapped by lack of proper macro-economic financial accounting. Current tax policies focus mostly on "flow" accounting methods, which are overused, politically captive, and marginally ineffective. Even the most developed countries do not know the full inventory of assets (and liabilities) at their disposal for better fiscal (asset and liability) policy management. There is no yearly statement of all the public assets available to governments to fulfill their fiscal obligations. If no one knows what assets are available, or their productivity, how can we appropriately manage our liabilities and fiscal policy? Similarly there is no accounting system to measure human capital (migration) flows, human capital appreciation (through education) or depreciation (aging), to better understand the effect of spending on education, training and health, and the appropriate level of savings (reserves for depreciation) to meet post-retirement needs. Investment in the environment, pollution and CO2 emission costs can be incorporated in this exercise with a proper accounting of the real cost of water usage (the shadow price of scarce water is not known). This is a time consuming but necessary effort. It was also difficult and time consuming to develop national accounting flows, but it was facilitated by the IFIs and their influence on governments who needed their funds. If we want fiscal and macro-economic policies to be more effective in a world facing demographic gaps, economic slowdown, rogue financial actors, and significant economic and wealth distortions, we need to develop appropriate macroeconomic accounting for all assets and liabilities. Companies that face slower growth rates need to pay more attention to their balance sheet than their P & L. The same can be said for macro-economic policies. It is no wonder that so many government policies are so counter productive. We cannot make good decisions with incomplete information.

To date, only New Zealand has embarked on such a project. It is high time to look at other countries' balance sheets, before governments go "Chapter Eleven" and do not even know which assets to liquidate. Once the measurement tools are in place we also need to assure them the same independence from short term political bribery that we have granted to monetary policymakers.

Significantly, the global system of national accounts was developed by economists who believed countries (i.e. governments) could not default, since they could theoretically tax or borrow ad-indefinitum. Reality is quite different. Today we know that just as is the case of corporations, when growth stops, our only recourse is to go to the balance sheet to better manage assets and liabilities and extract the most from our "liquidation" value. If companies (and countries) do a good job of restructuring assets and liabilities, they emerge from Chapter 11. Otherwise bankruptcy is inevitable. Bankruptcy at a country level takes the form of revolution or war in the hands of radical political leaders—an unnecessarily destructive outcome for societies.

1.3. Help Clear Hurdles for Human Capital Flows

With the support of their member governments, existing or “new” IFIs can improve the global management of human capital flows by serving as an additional clearing house for global employment/migration permits. According to UN statistics, about 2.6 million people annually migrated around the world between 2000 and 2005 up from about 1.5 million/year 20 years ago². A large portion migrated illegally at high risk. Since the cost of raising and educating a human being from birth to productive capacity varies from \$250,000 to \$500,000 in the developed world, these human capital flows amount to about \$650 billion to \$1.3 trillion annually. These flows dwarf the capital transfers by all IFIs combined, clearly a market gap worth considering. These figures should be much higher in the future, given the expected demographic disparities as people age and economic growth rates in the older countries slow down. Working people who want to move from one country to another where their productivity is higher should not have to face the barriers imposed by local migration policies determined in voting booths (imagine what capital markets and trade flows would be like if they were determined in the voting booth). As is the case for trade and capital market policies, human capital should be allowed to move more freely and efficiently. It would be wonderful to get a work permit cleared through a multilateral institution rather than through local immigration and naturalization services. At the very least IFIs should be producing more policy research and capital resources to help address the need for expanded human capital flows.

1.4. New Field for Financial Intermediation: Rapid Development of Primary and Secondary Mortgage Markets in Emerging Countries

Despite dangerously relaxed mortgage lending standards, which led to the recent upheavals in the US capital markets, no one can doubt that the US has led the rest of the world in providing affordable home ownership to the majority of its population. Participatory democratic institutions owe their growth and strength in the developed world to widespread home ownership. People care more about their community when they “own” their home. While mortgage debt accounts for about 70% of US GDP, it accounts for less than 10% in most emerging countries. In developing countries like Brazil, Peru and India where it is less than 5%, lack of mortgage markets is the significant reason for lack of family wealth accumulation. IFIs can help develop primary and secondary mortgage markets to provide access to home ownership in those parts of the world where legal titles are respected. They can also help develop clearer titling processes, a pre-condition to the larger development of mortgage markets. US financial intermediaries can help the process by lending their market-making expertise and technical assistance. FNMA and Freddie Mac, recent accounting issues notwithstanding, have significant technical expertise to help improve the access to capital markets of deserving home owners around the world. The World Bank Group, Inter-American Development Bank and other regional banks can provide increased financing for loan guarantees and the initial liquidity through local intermediaries to propel profitable market making functions in emerging markets mortgages. Nothing can increase domestic demand and promote social responsibility, individual wealth building and participatory government more than widespread home ownership. Initial lending in this direction is happening at The

2. UN Department of Economic and Social Affairs, Population Division: World Population Prospects:2006 Revision.

World Bank Group, mostly by IFC, the private lending arm, but it is very small (\$250 million for all countries) relative to the importance and the potential size of these markets. In Latin America, there are only small programs in Mexico, Chile and Colombia. There are no easily accessible statistics for China and India and nearly nothing on Africa and the Middle East or Eastern Europe. Much more could be done if the sector is properly and aggressively targeted, particularly now that there is some institutional know-how and significant capital market liquidity. If necessary, there should be regional and global mortgage lending and market making agencies created for that purpose.

1.5. Leverage Economic Development by Strengthening Sources of Capital for NGOs and Help Develop NGO Credit Rating System (NGOCARTS)

This is a time to diversify global portfolio risks. Instead of struggling to compete with private capital market intermediaries, which are lending to emerging companies at a little over LIBOR, IFIs could help expand the balance sheet and activities of leading NGOs. Low cost of capital is a wonderful thing for countries and governments in the developing world. Poor countries need low cost capital to grow and meet basic human needs. But for IFIs to compete with other lenders at such low spreads may not only be unnecessary but outright bad risk management for the world at large. Instead of competing for marginal investments in an environment of excess liquidity, they could be serving other, more substantive, development functions. IFIs could make many worthy NGOs the beneficiaries of loans (with the requisite government approval) that could help them expand their reach. In the process of lending to NGOs, institutions like The World Bank Group and other regional banks could help create a “NGO Credit Rating System” (NGOCARTS) to facilitate and significantly increase NGO access to capital markets. The possibility of access to capital markets would also motivate NGOs to increase their productivity and quality of services to get an appropriate rating for their debt.

For the same yield IFIs are getting on risky loans to governments (a gap they no longer need to fill), they can lend, or supply permanent endowment and matching funds for worthy global or local NGOs. IFIs have done a bit of this through single purpose trust fund allocations of their own, but they could do much more through existing high-quality NGOs. This would significantly expand outsourcing of IFI functions (particularly in public health education and microlending) to a few NGOs and other private sector players that qualify for the job. Current total assets of NGOs are in excess of \$1 trillion. Their activities could be expanded two or three times if they had access to leverage in the capital markets. These funds would come with technical assistance where needed and matching opportunities with other cash-rich donors, loan guarantees and smoother access to credit markets. A credit rating system for NGOs would both encourage quality of management and access to credit markets.

2. Why the IFI and Not Other Institutions?

IFIs already exist, and have accumulated a significant knowledge base, reasonably well developed functional, multilateral, representative governance structures, and they have amassed a significant capital base, with unabated access to the high rated credit markets. All of their strengths can be utilized, and their weakness addressed. In fact, nothing addresses imbedded weakness more promptly than a sound redefinition of focus. Separating enhanced research capabilities from lending functions would re-energize their missions and inject intellectual leadership to the next set of objectives.

Not all IFIs should survive or engage in every one of these projects. Nor are all these needs equally pressing. The World Bank Group and Regional Banks can easily focus on enhancing their endowment-financed autonomous and outsourced research functions and developing secondary mortgage markets (with or without the help of FNMA and Freddie Mac) by creating a Mortgage Lending Bank affiliate. The IFIs can also leverage their development activities through leading NGOs, as well as help them increase their access to capital markets. The IMF and other leading research institutions can develop a balance sheet for countries and governments to better understand all the resources and tradeoffs available for growth and national wealth, asset, liability, and capital management. Maybe a new Labor Bank (or Banks) needs to be created to manage global human capital flows more efficiently. But all these institutions should use some of their capital to endow, with more appropriate and segregated investment policies, substantially enhanced research functions. To end in a light inclusive spirit, in the era of WIKIs we can all benefit by engaging the creative thought of anyone with good (or bad) ideas on any of these initiatives. Leveraging global intellectual property for global policy development should be an ongoing part of the IFI's mission.