# Improving Governance in Global Financial Institutions

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Report by Ngaire Woods, University College, Oxford
Chair of the Working Group
E-mail ngaire.woods@univ.ox.ac.uk

This was the second meeting of an ongoing project funded by the IDRC to bring together senior policy-makers and academics in order to identify and contribute ideas as to how global financial governance can be improved and made more accountable to developing countries. The agenda followed up on the first meeting (held in Oxford, December 2000), highlighting issues of both substance and process for further consideration.

The group attending the Ottawa meeting comprised past and present Finance Ministers, Central Bank governors and officials with experience in or with the IMF and World Bank from developing countries as well as scholars from both developed and developing countries. The objective was to brainstorm new ideas - to `think outside the box' - in respect of institutional arrangements and accountability to developing countries. There were six issues on which the group's brainstorming produced some constructive suggestions:

- New institutional roles in crisis management and standstills
- More focussed developing country bargaining and advocacy
- Enhancing ownership and long-term effectiveness in developing lending and emergency financing
- Applying corporate governance principles to the governance of the IMF and World Bank
- Reviewing voting rights and voice in the IMF and World Bank
- A new compact or `grand bargain' on governance

## (1) New institutional roles in crisis management and standstills

Background: The debate over crisis management has shifted dramatically in the last five years. In the 1980s it was taboo to speak of any kind of standstill on debt repayments (then referred to as a `default' or `moratorium'). Just over a decade later, as creditor governments demand that less public funds are used in crisis management, debtors and creditors alike are accepting that orderly debt workouts may have to involve standstill arrangements. This poses a number of questions, including (with particular interest to this group whose remit is institutional reform): What are the institutional consequences of this? Which institutions will be involved in orderly standstills? What kinds of institutional arrangements are most likely to be acceptable to the relevant parties, and effective in ensuring orderly workouts?

Existing arrangements are inadequate: The existing regime provides inadequate protection for good faith debtors attempting diligently to pursue appropriate adjustment measures and to manage crisis in an orderly way. A significant gap has emerged between the emerging consensus among governments in favour of standstills, and the law which still permits rogue creditors to disrupt an orderly workout through legal actions.

The problem of rogue creditors was highlighted in Ecuador when `vulture' mutual funds

bought the government's bonds (at a fraction of face value) precisely in order to hold the government to ransom by demanding 100c in the dollar and until paid, holding up the debt workout being pursued by Ecuador. Uganda provides another example where most creditors have participated in new debt relief arrangements under HIPC but where a couple of creditors are pursuing the government through courts in both London and Kampala.

Article 8 (2) (b) in the IMF's Articles of Agreement may offer some protection but this is too ambiguous for debtor governments to rely upon. In rulings on exchange contracts, EU courts have diverged in their interpretations of the Article. The US interpretation is different again. In short, new legal and institutional arrangements are necessary to ensure orderly workouts.

Contractual solutions: One kind of solution lies outside of government action. Ex ante conditions such as binding arbitration procedures (used in some joint venture agreements) or collective action clauses (in government bonds) might enhance the capacity of debtors and creditors to proceed with orderly workouts. However, many debtors are concerned that if they apply such clauses whilst other do not, their own access to international capital markets will become more expensive.

New options: At present economists and policy-makers are arguing over the costs and benefits of a clear or ex ante set of rules or framework versus a case-by-case approach, with opponents arguing that ex ante clarity enhances moral hazard and cannot possibly take account of the peculiarities of individual country situations. This group focussed on the fact that regardless of the regime, there will always be some area of discretion which requires an arbitrator of some kind. The balance between short-term adjustment and long-term capacity to sustain debt levels will require careful and independent adjudication. A number of proposals already exist for this, and these were discussed.

The most ambitious proposals call for a new international institution such as Global Financial Organization (as proposed by ECOSOC) or World Financial Authority (as proposed by Eatwell and Taylor), a new international bankruptcy or insolvency mechanism built on US Chapter 9 (proposed by Raffer), or some form of new arbitration body outside of existing institutions (proposed by Pettifor). These highlight public support for a new regime and the need for a new regime to be transparent, participatory and representative.

As regards the IMF, some in the group felt that it is the only and obvious institution to be involved in such workouts, but that it needs to reform its own governance in order to be seen as legitimate in this function. Others, however, argued that the IMF's perspective is too short-run for it to play the key role in sustainable debt workouts. A longer-run perspective is required, and for this reason the involvement of development banks should be considered.

If some kind of institution were to evolve from within the IMF, its key problem would be a conflict of interest - the IMF itself being a creditor to countries in difficulty, and insisting on being treated as a preferred creditor. For this reason, the group discussed a number of proposals which might develop an institution within the IMF which could perform a more neutral role. These proposals included:

- create an affiliate in the IMF with its own governance structure (like MIGA);

- create an ombudsman within the IMF, independent of the staff, reporting to the Executive Board, with a dispute settlement quality like the Dispute Settlement Board of the WTO;

- create a Committee within the IMF with its own decision-making rules, much in the same way as the (unused) Committee on Interpretation in the IMF with its one member, one vote procedure.

The WTO dispute settlement procedure was mentioned as an example (albeit with a very different mandate) of a new stronger institution developed within an existing organisation, which can arbitrate impartially amongst parties. The judgements of the DSB must be accepted by the WTO Council (equivalent to the IMF Board) unless there is a consensus against such acceptance. The authority of judgements is reinforced by the fact that subsequently governments are allowed to use retaliatory measures where a ruling is in their favour.

For further thought: Further thought needs to go into whether an equivalent arbitration can be envisaged within the IMF, and with what kind of capacity for enforcement (e.g. what kind of strengthening of Article 8 (2) (b)). Furthermore, how can an appropriate degree of transparency and accountability be built into this process? Alternatively, what kind of institution might be developed outside of the IMF? It was also proposed that developing countries could consider forming a Financial Stability Forum of their own in order to pursue these and the broader issues concerning debt workouts.

Follow-up: NW (to co-ordinate), DK, AG and JS to elaborate and propose.

**(2) More focussed developing country bargaining and advocacy**

Background: A very helpful briefing was given to the group by Emmanuel Tumusiime-Mutebile who highlighted the lack of developing country voice in the debate on international financial architecture. At the same time, reform in the international financial system is profoundly (and not always positively) affecting both democracy and development in the developing world. Three examples highlight this point: the lack of donor co-ordination in debt relief (HIPC/Paris Club - see more on this below) which places an enormous burden on already-over-burdened debtor governments; the lack of domestic ownership and capacity in designing policies which gain the confidence of the private and corporate sector; and the lack of response in quick-disbursing loans or research from the IFIs on the crucial issue of commodity shocks.

Azizali Mohammed subsequently presented his paper (see below) on the experience of developing country research and advocacy in the Group of Twenty-Four. Four reasons are given for the lack of success of this effort:

(1) the divergence of interests within the group;
(2) the lack of co-ordination between the G-24 and the G-11/ G-9 (i.e. developing country Executive-Directors within the IMF and World Bank);
(3) the `clientelist' nature of relations between developing country EDs and the staff and management of the institutions;
(4) the lack of outward projection and the harnessing of public support and opinion.
These problems have been further exacerbated by the lack of cohesion with other developing

country groupings, such as the G-77 and the bleeding off in influence as important G-24 members are co-opted into industrial country dominated groupings such as the G-20.

The discussion highlighted additional problems. The G-24 membership was described as `locked in' and not adequately reflecting changing relative country strengths and rankings (no new members since the Group was formed in 1972 with the solitary exception of South Africa which joined in the year 2000). The lack of direct interaction between researchers commissioned by the G-24 and Executive Directors was also highlighted as a problem. More interaction, once research has been completed, was proposed as one solution. Equally, however, there is a need for researchers to be more aware of the problems and policies facing Executive Directors and for this reason the researchers should make more effort to talk to the EDs as they undertake their research. Looking ahead, the discussion highlighted what the G-24 does not do but should. Within the IMF and World Bank, the G-24 should actively demand audits on issues such as: which countries have access to research funds? How is the research budget being spent? Any secretariat of developing countries should provide public relations support for developing countries within the IMF and World Bank, disseminating papers, press statements, and so forth. Such an office would need legitimacy (through membership, accountability, transparency etc). It was noted that this kind of activity is not being undertaken despite a plethora of developing country bodies (South Centre, the G-24 Liaison Office, the G-77 Secretariat at the United Nations ).

Gerry Helleiner's paper (see below) highlighted lessons from the experience of the G-20 process. Its small size, informality, and adaptability highlight the need for developing countries better to organise themselves to advocate policies within the international financial system. In respect of the G-20, concerns were discussed not just about the lack of representative, accountability and transparency (as addressed in the paper) but equally about the lack of clarity of the G-20 agenda and what kind of ongoing commitment can be expected from its non-Canadian G-7 `masters'. Discussion also focussed on whether some system of formal or informal constituency consultation with countries not within the G-20 could be developed to improve its representativeness and accountability.

The group took seriously the divergent interests of developing countries and what this means for input into the global financial architecture debate. In particular divisions arise such as on:
- HIPIC where middle-income countries are resisting efforts to use net income drawn from borrowing charges paid by them for loans from the IFIs' for HIPC debt relief whilst G-7 try to minimise using their own budgets;
- conditionality where middle-income countries are much less prepared to accept and much better able to resist intrusive conditions than lower income countries;
- standstills where those with access to private capital markets (and pose a systemic risk) face a very different situation to those with official debt in which cases the IMF and World Bank play both judge and jury (creditor and arbitrator).
However, on each of these issues, the significant common ground shared by developing countries was also highlighted.

As regards developing countries' advocacy and NGOs, Manuel Chiriboga introduced the need for developing countries better to ally with their own NGOs in the South since these NGOs (in Latin America at least) are increasingly focussed on auditing their own governments' policies and actions towards international organizations. A powerful developing country office would need to build upon and draw upon the energies and

popular support of NGOs both in the North and the South.

Follow-up: GH (to coordinate), AM, MC, and DK to develop a proposal for what a new office or secretariat for developing country advocacy on these issues might look like - membership, structure, process.

**(2a) Improving donor coordination in HIPC and Paris Club negotiations**

Highlighted in the discussion on developing country needs and advocacy was the "mess" which has evolved in negotiations over the HIPC, Paris Club, and PRSP. In spite of efforts to improve donor coordination, heavily indebted countries are still being required to undertake extensive bilateral negotiations with individual Paris Club debtors. This is costly and time-consuming for already over-stretched governments.

Follow-up: NB agreed to take up this issue with support from EM-T, NW and GH.

**(3) Enhancing ownership and long-term effectiveness in developing lending and emergency financing**

Background: The lack of genuine ownership and participation by developing countries in the IMF and World Bank is not just a product of unequal voting power. It is also due to the inadequate `voice' and capacity of developing countries, and their absence *from* participation in less formal parts of the research, policy-making and implementation processes. The discussion focussed on positive, constructive ways in which a greater developing country `ownership' could be secured.

Giving borrowers more voice: The lessons of the Inter-American Development Bank were discussed (Nancy Birdsall leading from her experience at both the IDB and the World Bank) with particular attention to the fact not just that borrowers have 50% of the votes in the institutions (although US controls the Treasury and Audit functions), but that equally importantly, borrowers have a majority of chairs on the Board which gives them more voice in the consensus system (than borrowers have in the IMF or World Bank). The results include: more research is commissioned from the region (than WB); more attention to local capacity and `buy-in'. For example, IDB never stopped supporting national development banks and regional banks long after the World Bank stopped.

Devolve or decentralize?: Much lip-service is paid in Washington DC to capacity-building in developing countries on issues of economic policy, yet the location of most main functions of the Fund and Bank in Washington DC runs counter to this. As Devesh Kapur noted, the literature on the IT industry notes that `clustering' occurs with knowledge even when information can be transmitted instantaneously. In the IMF and World Bank we see a `clustering effect' in seminars, workshops which comprise Washington DC staff and outside scholars and commentators drawn from the East Coast of the US, reflecting that it is more costly and time-consuming to bring people in from other countries and centres.

Although further decentralization of the international institutions might resolve some of these problems, it was not favoured by most of the group, nor indeed the more ambitious `Federal Reserve model' of organization with regional centres and divisions of labour. Some deconcentration of IFI activity is doubtless called for, but these ways forward would not adequately improve local capacity-building and attention to local knowledge. A

more promising solution would be to empower and endorse competing institutions at regional and sub-regional levels.

Devolution and more `subsidiarity' to local and regional institutions with a counterpart strengthening of regional institutions was discussed at some length. The principle of subsidiarity requires that policies be remitted to the level of governance at which they can be appropriately resolved, with a presumption against moving decisions away from local government. Although more local and regional institutions doubtless bring with them duplication and less clear governance, nevertheless, they also bring a positive and healthy dose of competition in the provision of both emergency assistance and development finance. This view of regional and sub-regional institutions contrasts to that of the IMF and World Bank who have tended to fear `forum-shopping' (or more accurately `fund-shopping'). However, what some describe as fund-shopping, others describe as healthy competition. There was wide agreement among the group that this should be further pursued, although it might be easier in the case of development banks than for a monetary institution like the IMF (cf Nancy Birdsall's forthcoming paper).

Two additional points arose: (1) it would be worth investigating the different experiences of out-sourcing research (one member gave example of `alternative' African research which was useless ; another argued out-sourced research led to yet more homogeneous research than that already produced within Washington DC). (2) It was also noted that ECLAC have been working on sub-regional arrangements, and that a previous G-24 paper (by Percy Mistry) examines issues of regional strengthening.

<u>Follow-up:</u> Nancy Birdsall to write up note on what a devolved/ MDB structure would look like for the IMF; Jomo Sundaran to prepare a note on prospects for further development towards an Asian Monetary Fund.

**(4) Applying corporate governance principles to the institutions**

<u>Background:</u> There was very powerful agreement among the group that the minority shareholders within the IMF and the World Bank should have the right to audit the performance of both institutions <u>at individual country level</u> and that such audits should be open and public. Manuel Marfan introduced the problem which arises within both the IMF and the World Bank in respect of minority shareholders' rights. By analogy, he argued, we should apply principles akin to those of corporate governance such as audit, transparency, decision-making rules and so forth that protect minority shareholders' rights. He proposed that we should conceive of a set of rights applicable to all members of both the IMF and World Bank, and a process by which minority shareholders could audit these rights. He proposed the following short list of shareholders rights:
1. no shareholder would face conditionality on issues not relevant to the immediate problem in which they have involved an international financial institution;
2. all shareholders when facing the need to adjust in a crisis, have the right to uphold some minimum standard of social protection beyond which requirements for adjustment should not be made; (additional suggestion by group member: Fund program design should also incorporate a discussion of socio-economic implications);
3. all shareholders will have the right to ask for (and obtain) a statement from the Board of the IMF (and other relevant international financial institutions) as to whether a standstill on payments is justified.

The rationale of this third point is as follows. Where the IMF (and other IFIs) run out of funds while the country in distress is at the threshold of an excessive adjustment program,

then a step towards bailing-in the international private financial sector seems necessary and unavoidable. If the (majority shareholder at the) board is accountable for introducing either excessive conditionality or excessive adjustment, it should not avoid a statement on a payments standstill. Obviously, the borrowing country should have the right for a political statement, and not a legal statement of the sort "a payments standstill is not applicable if it is against the law in the relevant jurisdiction".

The discussion (and written feedback from each member of the group) reflected widespread agreement in the group that there should be a right to an independent and public assessment or audit of IMF and World Bank performance at individual country level. Members highlighted the need for minority shareholders to be heavily involved in this process, and for the process to be open and transparent.

A couple of existing mechanisms were noted for potential development along these lines:
- the newly-formed Office of Independent Evaluation (OIE) at the IMF and the potential for it to play an auditing role;
- a sub-Committee of the Development Committee of the IMF and World Bank might make a six monthly statement to the Executive Boards;
- the provision for special majorities within the institutions already provides a veto right for groups such as developing countries e.g. in the IMF an increase in charges requires a 70% majority. For example, a super-majority could be required for all decisions having significant impact on minority shareholders or on disputes involving over-intrusiveness of the institution.
- the development of a transparent procedure for the selection of all senior management positions (since these have a particularly significant impact on minority shareholders).

There was less agreement about what a list of fundamental `rights' of shareholders might comprise, with obvious difficulties highlighted in trying to distinguish `necessary' and `unnecessary' conditionality and adjustment. It was noted that program design should be scrutinized as well as conditionality per se.

Follow-up: NW (to coordinate), MM, DK & (?there was one further volunteer - please identify yourself?) to follow up with further proposal on ways forward on this. Discussion as regard OIE to be taken up with Montek Ahluwahlia (through Devesh Kapur in Boston, and perhaps NW in London on 3 August);

**(5) Reviewing voting rights and voice in the IMF and World Bank: The 12th Quota Review in the IMF and OIE**

Background: A thorough overview of the progress (or lack thereof) on the issue of quotas within the IMF was presented by Leo Van Houtven who noted that when the Managing-Director of the Fund came into the job, he voiced sympathy with developing country claims for better representation. Since then, however, the issue has received little attention. Since the report of the Quota Formula Review Group (QFRG) in 2000, there has only be one very short discussion of the issue in the Executive Board. In 2001 a meeting is scheduled in September and an initial Executive Board meeting on reviewing quotas will be held in December 2001.
Leo Van Houtven urged us to consider four core issues:
(1) How to rekindle a sense of urgency about reviewing quotas in the IMF?
(2) What should the objectives of the developing countries be on this issue? (E.g. a 50% voting power, and/or 50% of seats on the Board?)

(3) What kind of quota formula would the group support? (What aspect of the old formula should be changed and what should the ratio of actual/calculated quotas be?)
(4) Assuming agreement on a new distribution of quotas, what strategy would best promulgate this? In particular, what should be done with the European representation and voting power? (Note the effect existing and proposed formulas would have on the European share of votes) In essence, any shift within existing parameters would have to begin with Germany and France agreeing to share a seat, thereby freeing up one seat for developing countries. Smaller European countries could then be persuaded to follow suit.

Narendra Jadhav then gave a presentation which pointed to answers in respect of each of these questions (see follow-up paper).

The discussion emphasized the issue raised at the December meeting of the Group - the urgent need for more direct African representation on the Executive Board, rather than the existing arrangement where one Executive-Director represents over 20 countries.

Follow-up: Narendra Jadhav to update paper on quotas and reform (which will then be circulated), including mention of increasing developing country seats on the Board (without any quota reform).

**(6) A new compact or Grand Bargain on governance**

Amidst the discussions above, a further idea emerged, which took the form of a new `Grand Bargain' within the Fund and Bank. The group noted the reluctance of European members of the institutions to give up their seats, and hence began to derive a list of the privileges and trade-offs which could be deployed in fashioning a new bargain. These included:
- Headships of the organizations
- senior posts in the organizations (with a possibility of rotation)
- veto rights (i.e. the nature and application of special majorities in decision-making)
- location of headquarters and of other functions of each institution
- seats on the Executive Boards (the Articles of the IMF provide for 20 seats yet already - by regular agreement - there are 24 E-Ds)
- voting rights of each member
- apportionment of net income and funding of `soft windows' in multilateral development banks

Follow-up: DK (to coordinate) LvH, NB, AM, and NJ all expressed interest in following this up with a further elaboration as to what the `basket of negotiables' comprises, and how developing countries might deploy this in forthcoming debates on quota review and senior appointments.

***Background papers (mentioned above) and report of previous meeting are posted at: http://users.ox.ac.uk/~ntwoods/wg3.htm***