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at the Joint Annual Discussion

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We have been struck by the breadth, the contagion, and the effects of the current crisis. A concerted and cooperative strategy is therefore urgently needed. Only a forceful and expeditious strategy can calm global financial markets and improve the outlook for the global economy. Moreover, we have sound reasons for seeking to introduce a number of basic improvements into the functioning of the international monetary and financial system.

What I want to do today is to discuss some essential components of the new international architecture that the world requires in order to get back on the path to sustainable growth.

However, let me begin by underscoring the urgent need to strengthen the IMF's financial resources immediately.

Recent events have belied the notion that the financial markets could readily take the IMF's place in ensuring that those countries facing a serious financial crisis can be provided with the funds necessary to support their adjustment efforts and prevent the collapse of their currencies. What the recent crises have shown is that financial markets react indiscriminately. Herding behavior in the markets and the contagion effects it produces tend to exacerbate crises rather than resolve them.

Thus we see how essential it is for the international community to have an organization—the International Monetary Fund—to provide sufficient financial assistance to countries seeking to correct their macroeconomic and structural imbalances. Only forceful intervention by the IMF can restore the confidence needed to overcome the crisis.

Our absolute priority today, therefore, is to ask member countries to ratify the New Arrangements to Borrow and the IMF's quota increase as quickly as possible. This is essential if the Fund is to fulfill its mandate in a world economy that is increasingly complex. The IMF's decision to finance part of the increase in its assistance to Russia last July with a loan from the G-10 countries under the General Arrangements to Borrow clearly illustrates the current inadequacy of the IMF's resources. By depriving the IMF of a sufficiently large increase in its own funds, the international community would be taking risks, some of which are incalculable. To paraphrase the President of the United States, when there's a fire you don't discuss the color of the fire engine or the shape of fireman's helmet; you give the fire department enough water to put out the fire.

Necessary reform of the international monetary and financial system

I would now like to make a number of suggestions concerning the direction we should take to minimize the exposure of our economies to market fluctuations and help prevent financial crises and their effects on people.

I have identified six courses of action.

1. *Strengthening national financial systems*

The strengthening of national financial systems is of vital importance. Contrary to what some people thought a few months ago, this applies both to the emerging economies and to the industrial countries, which must adopt stronger standards for the supervision of banks and nonbank financial institutions. The problem of offshore funds resides primarily with the industrial countries. Governments must seek appropriate means to promote these standards and, if necessary, to enforce them.

The international community must also cooperate in developing standards in other areas, such as accounting, advertising, asset valuation, bankruptcy, and corporate governance. Indeed, one of the lessons of the Asian crisis is that the Bretton Woods institutions underestimated the role of private financial institutions and business in general in the economy. There was insufficient awareness of the fact that the economic soundness of a country can be jeopardized by the speculative activities of its banks, the development of ill-conceived investment programs, and the spread of organized crime. Henceforth, the Bretton Woods institutions will not be able to ignore the risks of unfettered and uncontrolled capitalism. They will also have to encourage the adoption of standards aimed at undergirding sustainable economic activity.

2. *Strengthening financial market surveillance*

It is now recognized that financial markets have become a force in their own right and go their own way in reacting to economic data and, all too often, to a country's noneconomic data. Appropriate surveillance is therefore in order.

Some months ago, this view was not shared by the entire international community. Indeed, in spite of the warning that the Mexican crisis of 1995 provided, many countries continued to ignore the negative consequences of financial globalization and the growing helplessness of nation-states overtaken by an expanding, deregulated global financial market.

The Asian crisis has helped convince the international community of the need to face the challenges of financial globalization. This is a major step forward because the risks of

globalization can only be minimized in the context of a global reform strategy implemented by the organizations established for this purpose by the international community—the IMF and the World Bank.

I do not believe that we need to contemplate establishing a new institution. On the contrary, it seems to me that what we have to do is to strengthen cooperation among international financial surveillance entities, with a view to modernizing the systems established for regulating and supervising financial institutions and markets, and adapting them to market conditions. Therefore, I propose that we take a quick look at the merits of instituting a permanent standing committee for global financial regulation, within which the IMF, the World Bank, the Basle Committee, and other international regulatory authorities could focus on stability, supervision, and systemic risks. This excellent proposal, put forward by Gordon Brown, U.K. Chancellor of the Exchequer, deserves our support.

3. *Promoting orderly liberalization of capital movements*

The Asian crisis underscores the importance of orderly and well sequenced liberalization of movements of capital, and particularly short-term capital. Today, decision makers are increasingly realizing the need to act cautiously and sensibly. No country should be forced into immediate liberalization or made to abolish controls that are warranted. That is not a retrograde step but an acknowledgment of the need to take account of the economic, human, political, and cultural characteristics of each of the countries involved.

It is also my opinion that the IMF ought not to rule out, in principle, any future possibility of proposing certain forms of capital control, such as accompanying measures for its programs.

The purpose of these controls should not be to replace stabilization measures and reforms but to enhance their effectiveness by safeguarding the financial stability necessary for the success of IMF programs. They should also help to conserve the Fund's financial resources. Recent experience has shown the limits of the effectiveness of the financial assistance which the IMF can provide to countries that are completely open to capital movements: if confidence in the financial markets is not quickly restored, this assistance serves to fuel capital flight and vanishes into thin air in just a few days. This is what happened in Russia in August. The IMF does not have unlimited resources. Market confidence is not necessarily restored as soon as an arrangement is reached with the IMF. Accordingly, it would appear that under certain circumstances, some temporary capital controls, approved by the IMF as a condition for its intervention, could help to reduce the risks posed by a sudden reversal of short-term capital flows.

4. *Retooling the Fund*

The pursuit of sound monetary, fiscal, and structural policies is no longer sufficient, in and of itself, for laying the foundations of sustainable growth. The current crisis has in fact

confirmed the need for governments to be able to mobilize, at short notice, the financial resources needed to resist the contagion and withstand the pressures they may have to face in today's globalized economy.

In light of this changing environment, the international community, and the IMF in particular, must make every effort to find new instruments to provide effective assistance to countries that follow sound policies and are suddenly placed in a difficult situation because of the financial markets. The fire department needs a wide range of resources: fire engines suitable for large-scale fire fighting and all the equipment necessary to fight the blaze.

President Clinton recently pointed to one possible approach. Under this approach, the IMF would aim for greater efficiency in furnishing conditional financial assistance to countries that continue to implement sound policies as they cope with a difficult international financial situation. I welcome the Interim Committee's plans to study this proposal.

I also think it would be useful to take another look at the arguments in favor of having the IMF act as lender of last resort based on the SDR. This is an approach that would perhaps maximize the effectiveness of the mechanism proposed by President Clinton.

5. *The need for strengthened international monetary cooperation*

Even though most of us recognize how difficult it is to address the challenges posed by financial globalization, my impression is that a broad consensus is rapidly emerging as to how we should proceed in order to strengthen the architecture of the international financial system.

However, I am surprised to see that the plans for the new architecture—currently being discussed—have not carved out a role for international monetary cooperation. In my view, it is essential to ensure that the monetary union, scheduled for January 1, 1999, will strengthen mechanisms for exchange rate surveillance, multilateral consultation, and monetary cooperation at the international level. It is thanks to these methods that monetary union is now achievable. It is an important approach to a framework for world growth. For this task, we must be able to count on assistance from the IMF. As Michel Camdessus emphasized during his opening address: “[this] will be a core task for which the Fund must prepare itself.” I also hope that, once monetary union has reached cruising speed, it will be possible to begin the debate on reforming the international monetary system. In preparation for this debate, I call upon the IMF to give serious consideration to “target zones” for the dollar, euro, and yen exchange rates. I believe that an agreement on this issue would bring more stability to the system as the markets would know what is judged to be a desirable rate.

6. *Adoption of a social action strategy*

“We must go beyond financial stabilization. (...) We must focus on the social issues.” James Wolfensohn, President of the World Bank, made this appeal to us in his opening address, and rightly so, because the social impact of the crisis is much more serious than we

could ever imagine.

To prevent implosion in the most seriously affected countries, the World Bank must take the lead in proposing an action strategy designed, in the short term, to shield the poorest population groups from the repercussions of the crisis and, in the long run, to strengthen safety nets with a view to increasing the capacity of these countries to safeguard their peoples against economic shocks.

The Bank should also participate more actively in this strategy. To strengthen the impact of its own financial support, it must help crisis-stricken countries to reallocate their public expenditure in favor of programs that provide social support and generally improve economic and social productivity. To help set economies on these more stable foundations, the World Bank could also move toward the adoption of a code of conduct in the area of social policy which, once implemented, would more effectively protect the inhabitants of poor countries from the risks resulting from globalization.

Reaffirming the legitimacy of the IMF

The task of promoting economic and financial stability worldwide calls for an increase in the IMF's financial resources, a strengthening of its surveillance role, and the extension of its jurisdiction to include capital movements. If the IMF is to truly fulfill the strengthened central role it is expected to play, the principles legitimizing its actions must also be reaffirmed.

The best way to proceed here is to strengthen the role of the Interim Committee. Two proposals have been put forward recently to achieve this objective. The first, advanced by Philippe Maystadt, my predecessor and former Chairman of the Interim Committee, recommends the formation of working parties that would contribute to the deliberations of the Interim Committee, and therefore the IMF, on issues relating to the international monetary system.

In my view, this idea has two major advantages. First, it would allow for more direct involvement of national officials and experts in Fund activities. It would also relieve pressure on IMF staff, who cannot be expected to have all the answers. It would also enable the Fund's member countries to play a more meaningful role in solving difficult problems.

Second, the working parties could play a greater part in reviewing issues that cannot be easily taken up by the IMF because they go beyond the scope of its activities and responsibilities, for instance. By creating a working party to study these issues, we will ensure that they cannot be overlooked. It would then be incumbent on the Interim Committee to provide the appropriate follow-up action for the working party's proposals. This process would do much to remedy the deficiencies of the current international architecture.

A second and complementary approach would be to transform the Interim Committee into a Council with decision-making power, thereby applying a provision in the Articles of Agreement of the IMF that has never been implemented.

I am in favor of this idea, which is supported by my French colleague, Dominique Strauss-Kahn, as it can enhance the legitimacy of the IMF's decisions and, therefore, the effectiveness of its actions. One could therefore envisage the Management and Executive Board of the IMF consulting with the Council before reaching a determination about a program whose impact clearly extends beyond the economic sphere.

Here again, the experience of the euro zone and the respective roles of the Council, Commission, and ECB in Europe, are a useful example. There are situations in which management, no matter how good it may be, cannot singlehandedly be accountable for the political legitimacy of the decisions it makes. With the political influence it would carry, the Council could, under specific circumstances, enhance the political credibility of decisions, since it is true that the economic sphere is not totally separate from the affairs of state and society that politics should be primarily concerned with.

The transformation of the Interim Committee would also make it possible to strengthen the IMF's surveillance role, as its members could become more actively involved when the economic policies pursued by a member country pose a potential danger to other countries and regions in the world. In this way, the Council could play a more prominent role in the "tiered response" procedure, proposed by the Interim Committee in April 1998: in cases where the "red card" would have to be drawn on a country whose economic policy is seriously off-track, this decision could be made by the Council.

It was the prospect of nuclear power that led governments to form the UN, and the UN Security Council, in the aftermath of the war.

Any such attempt to transform the Interim Committee into a Council of world economic security, would be a momentous undertaking. However, I feel that it is important to envision this possibility, given that one of the important lessons of globalization is that only strong and concerted cooperation and intervention can stop or curb the domino effect of the current crises. This brings us to the realization that the reasons leading the UN Security Council to perform its current role in political and military affairs, are the same reasons that have led us to entrust the Interim Committee with this fundamental role in economic and monetary affairs.

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Conclusion

The uncontrolled development of financial markets—facilitated by the liberalization of capital movements and new communication technologies—is partly responsible for the magnitude of the financial crisis the world is experiencing today. However, I believe that the roots of the current crisis are not to be found solely in the financial sphere. This crisis is also a reflection of the weakness of the "political pillar" of the world economy vis-à-vis the financial markets.

The weakened decision-making capacity of some governments creates systemic risks for the world's economic fortunes. It also underscores the objective limits of IMF action. When the IMF is not dealing with governments capable of shouldering their responsibilities and tackling the deep-seated problems of their economies, its recommendations, forecasts, and assistance are less effective.

Thus, globalization does not only require that IMF policies be adapted to reflect the changing international environment, it also gives us a much keener sense of the responsibilities of governments. This realization is essential if the advantages to be gained from globalization are to be maximized and the attendant risks reduced.

The strengthening of "economic democracy" acts as a necessary counterweight to the market. It is clear today that there is no "invisible hand"—too long constrained by policy—which, if set free, would guarantee the rapid and lasting development of the world economy. The crisis bears witness to the need to "return to policy" and to the "government's regulatory role" at the national, continental, and international levels.

For it is my belief that Europe, whose characteristic emphasis on social democracy (the so-called "Rhine Model") was scoffed at for so long, ought now to play a more important role in strengthening the Bretton Woods institutions.

The "European model" that we are building, without arrogance or triumphalism, is predicated upon a common economic and social framework, cooperation among states, inclusion of the social partners in economic responsibilities, burden-sharing among all members of society, and multilateral surveillance. For a long time this had been viewed as a relic of economic history. Today, this market economy that couples freedom with a strengthened capacity to include the government as strategic planner and regulator, can serve as a model for the entire world and as a guide for the reforms that enhance the role and effectiveness of the Bretton Woods institutions. This will help us to overcome the current crisis and get firmly back on the path to world growth.