

THE INTERNATIONAL FINANCIAL INSTITUTIONS, THE UNITED NATIONS SYSTEM AND A GLOBAL CAPITAL MARKET

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1 INTRODUCTION

The combination of rapid internationalization of production, trade, capital and knowledge flows, declining US strategic hegemony and the collapse of the geopolitical certainties of the Cold War, has not surprisingly led to increased interest in the construction of appropriate institutions to regulate – or at least stabilize – the global economy. The growth of regionalism as a source of stability within geographic areas where governments can coordinate their economies to some extent has underscored this problem; as has the contrast between the steady progress towards global free trade and the chronic instability of international capital markets.

This article relates to the debate on international economic institutions in general – and those concerned with capital markets in particular – from the viewpoint of the public action required to create an 'orderly market'. It is assumed that orderly markets are of special importance to developing countries because shocks transmitted from the 'centre' have a disproportionate impact on the 'periphery', discouraging private investment in tradable production and impeding public provision of infrastructure, making structural adjustment slower and more costly for the poor.

The argument of this article is that the current proposals for institutional reform are focused on inter-governmental relationships, while the central issue is in fact the prudential regulation of **private** actors: that is, international banks and firms. Moreover, the absence of any system of international commercial law means there is no clear institutional basis for a truly global capital market. The implication – although admittedly a somewhat speculative one – is that the United Nations could contribute to the provision of one of the most basic functions of the embryonic global state, the enforcement of contract.

2 RECONSTITUTING THE BRETTON WOODS SYSTEM

The rapid growth and internationalization of international capital markets during the past two decades

since the collapse of the Bretton Woods System is too well known to require repetition here (Goldstein 1993). An optimistic view is that, when combined with international trade liberalization under GATT/WTO, it:

constitutes perhaps the most important opportunity for raising the welfare of both developing and industrial countries in the long term. ... Globalization comes with liberalization, deregulation, and more mobile and potentially volatile cross-border flows, which means that sound macroeconomic management commands an increasingly high premium. Penalties for policy errors rise. Globalization thus requires closer monitoring and quicker policy responses at the country, regional and global levels. ... The process of integration will affect countries unevenly and could increase international disparities. ... The global outlook is in general bright, but masks wide differences across regions and countries – for many, global optimism coexists with local pessimism. Accelerating outward-oriented growth in the poorest countries will be a special challenge.

(World Bank 1995: v)

The developing countries today suffer from international financial volatility in a number of ways, among which the most important are:

- i exchange rate instability, high real interest rates and low fixed investment all slow down growth in the industrial economies (IEs), and thus depress demand for the exports of the rest of the world (RoW);
- ii high interest rates raise the cost of debt service and cause fiscal strain in LDCs, generating macroeconomic instability and reducing private investment;
- iii global asset value uncertainty excludes many developing countries from access to private capital markets, and subjects others to destabilizing volatility in flows;

iv the inability of capital markets to work out debt burdens in response to government insolvency imposes a long-term resource burden on poorer countries and further reduces their attractiveness to foreign investors;

v the more vulnerable LDCs become subject to policy conditionality that goes beyond ensuring that international obligations are met and raises questions of sovereignty.

The institutional design at Bretton Woods in 1944 was clearly intended to help non-industrial countries; even if these were then Central and Southern Europe, the Dominions and the larger Latin American nations – in other words, what we now would call middle-income semi-industrial economies – rather than the colonies and backward states which subsequently became LDCs proper. Keynes's original plans for a global central bank, an international investment fund and a commodity stabilization board were not implemented in practice; but the common intent was clearly to stabilize the world economy and thus, by improving business expectations worldwide, raise investment and employment. In contrast, the Bretton Woods institutions today are not entrusted with this task despite the clear evidence that global macroeconomic coordination would increase aggregate welfare (McKibbin and Sachs 1991) and that the present process of globalization is progressively marginalizing poorer groups within developing countries (UNRISD 1995).

Moreover, the continued inconsistency in the savings, investment and fiscal positions of the major world economies on the one hand, and the speculative behaviour expressed through new financial instruments by expanding non-bank institutions, have led to increased volatility on world capital markets and thus to low rates of growth in industrial economies as well, due to the effect of uncertainty on investment decisions (BWC 1994). *A fortiori*, the less developed fiscal and enterprise structures in open semi-industrial economies have even less capacity to cope with volatility (FitzGerald 1995). Thus some consideration must be given to how the transmission of shocks between the IEs and from them to the RoW, can be dampened.

In fact, the Bretton Woods System only operated as a managed exchange rate system for 15 years between 1958 and 1972, and even then the lender of last resort was the US, which was fortunately creating

dollar liquidity at the time for other reasons (Tew 1988). In the two subsequent decades, a 'non-system' of flexible exchange rates emerged which had no central banker; while both the Fund and the Bank focused their attention on the non-industrial world. What monetary coordination there was between the industrial countries came about through the emergence of the Exchange Rate System in Europe (with the Bundesbank as its *de facto* central banker) and *ad hoc* arrangements between the G3 treasuries to handle currency crises (Walter 1993).

The International Monetary Fund itself did little to foresee or prevent the debt crisis of the 1980s, and in particular did not attempt to prevent commercial banks from over-lending (or indeed, countries from over-borrowing) until borrowers faced insolvency, in which case conditionalities were imposed for further multilateral lending which secured continued service of the debt but not its reduction. When in 1982 the Mexican moratorium threatened the US banking system, it was the US Treasury that bailed lenders out; the subsequent IMF stabilization programme of 1983-85 was notoriously unsuccessful in restoring growth or investment.

Indeed, over a decade later, even though the outstanding RoW debt no longer presents a systemic threat to international banks, it has neither been paid back nor written off in the way that a capital market is supposed to do. Fiscal transfers have been used to cancel no more than 10 per cent of the total LDC debt; the Bretton Woods institutions themselves, ironically enough, cannot do this. In other words, the global capital market is failing to act as an efficient pricing system and transactions mechanism for these assets – and thus cannot be considered as an efficient resource allocation model either. This inability to help capital markets work properly is possibly the major constitutional weakness of the Fund.

In the late 1980s the IMF even appeared to have lost its claim to be a global institution, and seemed to overlap with the World Bank to such an extent as to become redundant. However, the unexpected transition to market economics by the former members of the CMEA after 1989 enabled the Fund to adopt a new role as advisor and banker; a challenge to which it rose with energy and determination – although in retrospect the results are not quite what were expected at the time. Moreover, this was a regional rather than a global role.

A more positive interpretation might be to regard the activities of the Bretton Woods twins over the last two decades as constituting a partial response to market failure in the flow of capital between the IEs and the RoW. The Fund has resolved some of the agency problems associated with debt collection by acting as representative of multilateral and bilateral lenders; and has addressed the asymmetric information problem by signalling creditworthiness with its own lending. Similarly, the Bank has been attempting to overcome the Pareto problem that arises from poor countries' exclusion from international capital markets, and that of externalities by funding infrastructure provision. None the less, neither institution directly addressed the central problem of global capital market failure as such.

Under the circumstances, it is hardly surprising that many observers suggest a return to the supposed golden age of the Bretton Woods System of managed exchange rates to reflect purchasing power parity and last resort lending to prevent speculative attacks unrelated to fundamentals. There are even those who would still support a fixed exchange rate mechanism without central banking, where fluctuations in reserves force economies to adjust through the money supply. However, the bulk of informed opinion favours a managed system – within which the IMF or a successor institution would have a prominent role (BWC 1994).

A key issue in this debate is the governance of an emerging 'global central bank' (GCB). Two contrasting approaches can be identified. First, the proposals by the Bretton Woods Commission (*op cit.*) that the IMF should become in effect the secretariat of the G7. This would seem to have the advantage of giving the new GCB considerable authority, and would also require the member countries to raise the seniority of their permanent representatives so as to permit rapid decision making in moments of crisis. An added advantage would be the opportunity to rationalize the international institutions themselves, with the World Bank taking over the responsibility for all development lending, and the OECD becoming redundant.

However, this proposal would not reflect the importance of the RoW. This is not just a reflection of the fact that three-quarters of humanity live in the non-industrial countries, but rather of the fact that the RoW already generates 45 per cent of world production and absorbs 52 per cent of world fixed

investment (see Table 1). An alternative approach would be to bring any new GCB more firmly under the control of the United Nations – as had originally been intended at Bretton Woods. This might be done by establishing an 'Economic and Social Security Council' (ESSC) to supervise the operations of new global financial institutions based on the Bank and the Fund (Stewart 1995). Their enhanced powers would include the ability to force surplus countries to reduce their imbalances by demand expansion or increased aid – as originally proposed by Keynes – and the obligation to protect growth and employment in the deficit countries. In other words, to implement the first of the Fund's Articles of Agreement, where its aim is stated to be:

to facilitate the expansion of balanced growth in international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

This ESSC would have majority membership and veto powers for the G7 members, plus rotating minority membership for the RoW – either by election or perhaps regional representation by the larger regional powers.

3 THE PROBLEM OF MAINTAINING AN ORDERLY GLOBAL CAPITAL MARKET

A key characteristic of the schemes for the reform of IFIs discussed above are that they are **intergovernmental**, in the sense that not only do they relate to agreements between governments, but also to rules about the future conduct of governments and their subordinate central banks. However, the modern international capital market is largely a **private** market made up of transactions effected directly between commercial banks, using central clearing-houses of their own. These banks do not transact only in their own country's assets, but trade in those of a third country as well, so that 'border controls' have little meaning in any case. Indeed it is just this characteristic that makes international monetary coordination so difficult – and renders proposals for capital controls (including the so-called 'Tobin Tax') so unrealistic.

What is more, even if the G3 governments were to agree on a common course of macroeconomic action

designed to stimulate global activity, they are in no position to secure its implementation. On the one hand, the autonomy of legislatures and central banks may prevent the policy being implemented; and on the other, the international bond markets may not consider the implemented policy to be credible, in which case the desired change in expenditure patterns will not take place (van der Ploeg 1994).

Keynes's views at Bretton Woods as to international economic management were not just conditioned by the immediate post-War circumstances but rather by his concerns about a return to the unfettered private capital movements which had caused such instability in the inter-War period (Kindleberger 1988). His assumption that capital flows would be channelled through central banks is no longer true, while the existence of integrated international capital markets also means that, for instance, leading surplus governments are not necessarily in a position to implement expansionary policies even if they so desired. None the less, his underlying perception of uncertainty as a driving force in market sentiment, and the consequent need for institutional structures to reduce uncertainty and promote productive investment, seems even more relevant today.

The rapid development of international financial markets in recent years has had a paradoxical consequence. On the one hand, the increased marketability of assets has led to increased liquidity – thus decreasing the need for access to official borrowing in the case of most middle-income countries and many of the larger low-income countries such as India and China. Indeed, IFIs such as the World Bank have experienced a net negative resource flow towards this type of country in recent years (World Bank 1995). On the other hand, this liquidity has increased systemic risk because collapse or insolvency can rapidly be transmitted from one market or institution to another. Indeed it has been apparent for some time that this problem is particularly acute where regulatory systems have incomplete coverage or overlap in an inconsistent manner, creating opportunities for speculative profits (Goldstein 1993).

The process of financial deregulation (in terms of lines of business, location, credit restrictions, capital movements etc) in the IEs has undoubtedly increased efficiency and cut transactions costs, but has also

reduced the participation of banks in the financial intermediation between savers and investors. This 'disintermediation' process has been exacerbated by the domestic financial liberalization in the RoW (Gibson and Tsakolotas 1994) – itself often the result of reform pressure from the IMF and the World Bank. These developments in turn have generated new threats of default by small or under-capitalized market participants due to the large (and often leveraged) flows involved. Thus there is greater need than ever for organized settlement systems which will reduce systemic risk, and for clear rules as to the ability of international banks to be able to withstand sudden calls on their resources – as was recognized by the Basle Committee on Bank Supervision in 1993 (BIS 1994).

From the point of view of non-industrial countries, there are particular problems arising from this process: (a) the need for greater investor protection and incentives in order to encourage longer term investment; (b) the threat of contagion from default in the region spreading to other neighbours; and (c) the additional macroeconomic instability caused by fluctuations in narrow and shallow domestic security markets which attract foreign capital inflows.

In marked contrast to the International Monetary Fund, the Bank of International Settlements (BIS) – itself a pre-Bretton Woods institution, having been founded in 1930 – coordinates the increasingly autonomous OECD central banks (rather than representing ministries of finance), and focuses on maintaining payments systems rather than provision of liquidity. In other words, the BIS reflects the other aspect of global central banking – prudential regulation – which is becoming more important as international capital flows shift from public to private sectors.

The object of the BIS in practice is to curb excessive risk taking by lenders *ex ante* (instead of helping borrowers *ex post* as the Fund does) through regulations as to the asset portfolios of financial intermediaries. Although it can coordinate leading central banks in crisis situations (eg the 1995 Mexican crisis) the BIS does not make loans itself except in the form of bridging finance. In addition to its important work on a regulatory system, the BIS also acts as an agent and trustee – a role which has become more important in recent years – but much more could be done to improve market transparency through disclosure and to make

market infrastructure more resilient by strengthening settlement systems.

At present the Basle rules on capital adequacy refer to banks although the BIS sees a clear need to extend them to securities firms, to clearly define the jurisdictions of national regulators and to define the role of internal risk management systems. This is a particular problem because deposit insurance and lender-of-last-resort facilities are normally only available to banks, so that other intermediaries are more liable to collapse. There is also a steady trend towards allowing supervisory recognition of an institution's internal market risk management model, in order to cope with derivative trading and complex portfolios – which the traditional capital adequacy rules (based on the nature of the counterparty and the credit risk involved on individual asset classes) cannot do.

In contrast, the European Commission's Capital Adequacy Directive of 1993 applies to both credit institutions and securities firms, and takes certain unsettled obligations explicitly into account; but it can do this because the creation of a Single European Market in financial services – unlike that for goods – necessarily implies a transnational legal system in order to function (Lasok 1994).

Given the similarity in the concerns of the duty of oversight of payment and settlement systems, on the one hand, and that of prudential regulation and supervision, on the other, it is not surprising that both functions are usually performed by central banks – either *de jure* or *de facto* in close coordination with a financial superintendency of banks. Historically, both functions have their origin in the role of a central bank as an ultimate supplier of a risk-free medium to the financial system: the provision of liquidity is the last line of defence in the containment of systemic crises. As the Bank puts it:

Distinguishing solvency from mere liquidity problems is a difficult task; it becomes practically impossible without the necessary advance knowledge of the financial condition of participants the information needs of the central bank are an important dimension of the problem of the organisation of the lines of defence to deal with systemic risk ... (as) ... the progressive expansion in the sphere of markets and hence in trading can be expected to further heighten the risks involved in the execution of financial

transactions or by the intermediaries facilitating their completion.

BIS 1994: 191-2)

Although in fact the integration of financial supervision systems within the US and within the European Union are both currently under way, only the latter can as yet provide a model for eventual global arrangements. Unfortunately the other line of advance, that of international coordination between domestic security regulators (through the International Organization of Securities Commissions, IOSCO) has made little progress in establishing a parallel for securities firms to what the Basle accord has done for banking – mainly because of disagreement between the US and the other 50 member countries. In contrast, considerable progress has been made by OECD countries towards the integration of regulations on direct foreign investment, although this is unlikely to be extended under the WTO umbrella because of the unwillingness of developing countries to liberalize as quickly as industrialized ones.

A severe restriction on establishing a system of rules is that despite the globalization of private trade and capital flows, there is no system of private international law as such. Those rules that do exist (eg the GATT/WTO) derive from the treaty obligations of contracting states under international public law (Dixon 1993), and domestic governments are responsible for regulating or representing their citizens. In consequence, it is hardly surprising that the doctrine of private international law is known as 'conflict of laws' and the principle of *lex loci delicti* generally prevails (Hill 1994). Normally, therefore, parties to international financial contracts agree on an appropriate jurisdiction – which by custom usually means New York. However, it appears that there is a considerable lack of clarity and consistency even among New York courts as to the appropriate legal principles to be applied in international commercial cases in times of rapid change in market instruments, institutions and regulations (Morris and North 1984).

In the long run developing countries have a considerable amount to gain from a global commitment to improve the working of capital markets. These markets cannot clear investment and savings flows (and thus the current account imbalances) or re-value existing assets properly, due to problems of imperfect information and contract enforcement

which lead in turn to rationing behaviour by institutions. Any scheme for international monetary reform must contain, therefore, appropriate prudential regulations and information systems for such markets as well as discretionary intervention by an international central bank in order to provide liquidity when and where required.

4 A POSSIBLE ROLE FOR THE UNITED NATIONS?

The basic questions raised by the discussion so far are truly daunting in their scope: (a) what might the legal basis be for world market financial contracts and by extension for global central banking; (b) in what way might the United Nations contribute to this? Here I can only sketch the outline of one part of a possible solution, and to argue even this properly would require an extensive research programme in international law and international economics.

The present global economy regulatory system is mainly **intergovernmental** in nature. It is made up of a mixture of agreed rules without ready means of enforcement (eg the WTO), and discretionary intervention without oversight (eg the IMF) but without reference to private enterprise except as citizens of the countries involved – firms are represented by their governments and these governments are responsible for enforcing any decision on their firms. This then raises the issue of just what ‘their’ means in this context. Transnational firms are no longer necessarily ‘from’ major industrial powers: they may originate in small – often developing – countries; and may well be headquartered in some tiny tax haven (Dunning 1992). On the one hand, a particular firm may not be able to count on the support of a powerful government in international economic negotiations or may be in no position to enforce contractual claims against a firm based in another jurisdiction. On the other hand, a firm headquartered in a small country may not be able to count on diplomatic support in the event of a threat to its assets in another country, while their expatriate employees are no longer exclusively nationals of the great powers and thus cannot count upon the protection of the respective embassy.

The institutions and tradition of international public law do exist, of course (Dixon, 1993). There is a long tradition of cases and precedents before the International Court of Justice at The Hague –

where, incidentally, both UN General Assembly resolutions (such as the ‘right to development’) and UN Security Council decisions are recognized as sources of law. The Court itself is quite separate from the UN, having been founded by the League of Nations and its judgements being binding due to the specific treaty obligations of member states. An *ad hoc* system of arbitration tribunals for private disputes also exists, but these depend for their efficacy on the prior agreement of the contending parties to abide by the tribunal’s decision. International legal personality for individuals is extremely limited, and appears to be of general application only in the case of pirates and hijackers, who are considered to be *hostis humani generis*.

A standard textbook on international law states that:

(i)n the course of their commercial activities, states will deal not only with each other but with companies and trading concerns around the world. Normally, their legal relations with such bodies will be governed by the municipal law of one or more states. ... International personality exists only when relationships are governed by international law. However, that be said, it is possible for the contractual relationship between a state and a corporation to be governed by international law. For example, a concession agreement for the extraction of oil might be an ‘internationalized’ contract subject to rules of international law ... or states may have agreed that certain types of dispute with companies be settled by an international panel of judges applying international rules. Thus, the Convention on the Settlement of Investment Disputes 1964 established a permanent machinery whereby participation states and corporations could settle any differences arising out of investment agreements. Participation in such bodies, where the rights and duties of the company may be judged according to international law, entails international personality. Once again, however, the existence and extent of this personality depends ultimately on the agreement and recognition of states.

(Dixon 1993: 99-100)

The development of international law to cope with a single market is, of course, a feature of European Community Law – which has become essential not only for the enforcement of contracts between

corporations but also for effective regulation of markets and even for fiscal coordination (Lasok 1994).

For any proposed system of global central banking to work, not only must agreements be established on an intergovernmental basis as to the rights and duties of financial corporations, but also private financial intermediaries must have international personality. A possibility worth consideration is that the United Nations should provide the appropriate regulatory framework under international law (even if the IMF/BIS were to retain autonomy in order to implement the rules) and in particular confer appropriate personality on corporations. They could be registered subject to stringent reporting procedures which might eventually be extended to considerations of environmental and labour conditions. The benefits to transnational financial (or other) firms of access to a reliable system of contract enforcement and possible fiscal privileges would be considerable, as would the penalty of exclusion in terms of increased transactions costs and loss of reputation.

Developing countries would benefit in two ways. On the one hand, their companies would be able to operate internationally despite lack of domestic diplomatic support and thus penetrate export markets more effectively. On the other, LDC

authorities could have more effective redress against transnational corporations defaulting on their contractual obligations.

The United Nations itself might even find a sustainable source of income in the form of annual registration fees from participating corporations.

This idea might seem somewhat fanciful; and my argument is admittedly highly speculative. None the less, it is worth bearing in mind at least three interesting precedents. First, there are a number of international organizations which effectively regulate private firms directly and where compliance is ensured by the threat of exclusion – examples include the International Civil Aviation Authority and the International Postal Union. Second, the World Bank group offers to individual firms insurance against political risk through the MIGA scheme; although this is apparently not very extensively used, it does imply that international organizations can tackle market failure on an individual basis. Third, a number of countries offer quasi-diplomatic status (known as *mision internacional* in Spanish) to the local representatives of non-governmental organizations in the field of development cooperation – ranging from the International Red Cross to Oxfam – and there seems to be no logical reason why similar status should not be accorded international companies.

Table 1: The structure of the world economy, 1994

	No.	% World output	% World trade	% World investment
Industrial	23	55	71	48
G3	3	35	33	32
Other	20	20	38	16
Non-industrial	161	45	29	52
Africa	50	3	2	2
Asia	30	23	16	32
M.East	18	5	4	5
L. Amer	34	9	4	8
E. Eur	28	5	3	5

Source: Author's estimates based on data from IMF (1995). 'World output' refers to share of world GDP in 1994 on PPP basis; 'world trade' is share of world exports of goods and services in 1994; 'world investment' is the average investment to GDP ratio for 1994 applied to the region's share in world output.

The aggregate welfare gains from increased world investment and employment should be fairly widespread but there is also another potential benefit for the global citizen. To the extent that the origins of the civil rights of individual citizens in relation to

economic matters (ie. 'entitlements') are to be found in national legal systems originally established to maintain commercial contracts, it might not be too optimistic to suppose that a similar development might eventually be replicated worldwide.

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