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Avoiding financial Bosnias: The impotence of the IMF

By Rehman Sobhan

IMF and the Mexican Crisis

Financial Bosnias - I owe this evocative term to *Newsweek* (13/2/94) which uses the term to capture a process of financial disintegration of an economy in the same way as the current crisis in Bosnia captures the political disintegration of a nation state. The notion of financial collapse of a state has haunted the financial markets of the world in the wake of the Mexican crisis. This crisis manifested itself in the dive in the external value of the *peso*, and the flight of 'hot' capital out of Mexico, leading to a collapse of share values in its stock market. This crisis in the Mexican capital market triggered off panic in other so called *emerging markets* where 'hot' money had been parked for making quick capital gains. The Mexican crisis aroused sufficient panic both about the political future of Mexico as about the health of the global capital market for a massive financial rescue operation to be launched led by the United States, to stabilise the Mexican *Peso*. The United States sees itself as the financial patron of Mexico because of their partnership in the North American Free Trade Area (NAFTA). Due to this linkage much of the short term capital that has flooded into Mexico in the last few years, which now faces a collapse in its value, has been from the United States. Thus the global rescue operation to 'save' Mexico is as much a relief programme for US investors who were unhappy at paying the market price of their financial speculations on the Mexican stock exchange. It is also feared that if Mexico can move into an unscheduled financial crisis so can other *emerging* markets. Thus a move to rescue Mexico is deemed important because it will help to maintain the confidence of global financial speculators in other *emerging* capital markets.

Newsweek apprehends that more such Bosnias may be round the corner and indicts the International Monetary Fund (IMF) for its impotence as a global financial watchdog. However the current Mexican crisis and the prospect of other such Bosnias remains inherent in the new global financial order which has evolved over the last two decades. We today live in an age where capital market are increasingly interlinked through a global super highway, which moves trillions of dollars everyday from market to market. Such a crisis is thus not the first such crisis in a world of deregulated financial markets, nor will it be the last. What is significant about the Mexican crisis is that it came without warning. This has triggered off serious concern about the nature of both the global financial system as well as the fundamental health status of many post-reform developing economies.

This sense of panic is reflected in the quite extraordinary move by the IMF to commit 17.5 billion dollars in emergency assistance to sustain the Mexican economy. In contrast, the Clinton administration could not get its own rescue operation, for what is after all its client economy, passed through the US Congress to grant a special 40 billion dollars loan to Mexico. All that Clinton could do was to commit 20 billion dollars from an *Emergency Stabilisation Fund* at the disposal of the US President which was made available, not as a loan to Mexico, but as a guarantee for loans from the capital market. The serious money was extracted by Clinton from the IMF through pressure applied on the G-7 countries, to vote for this unprecedented jumbo loan to a single member country. The IMF, for those who continue to cherish illusions that it is an independent multilateral institution designed to serve the Third World, was exposed in all its nakedness as a foreign policy instrument of the United States. In its publicly proclaimed role of monitor of the global economy, as a lender of last resort to financially strapped economies, the IMF proved itself to be a helpless spectator. Its actions in this crisis were thus forced on it by the G-7 countries which not only demonstrated the IMF's weakness as a manager of global finances but also exposed its lack of internal democracy in its decision making.

So what does this tell us about the current global financial system? A whole book could be written on this but I am neither qualified to do this nor are the columns of a Dhaka news paper the place to begin one. I will thus address briefly three issues for reflection by Bangladesh's current and prospective policy makers and those here who reflect on issues of public policy. This relates to:

(a) The nature of the global system and what this implies for Third World countries.

(b) The role of the International Financial Institution (IFI) such as the World Bank and the IMF and the consequences of their advice to the Third World.

(c) The lessons for Bangladesh.

The New Global Financial Order

The Mexican crisis was the direct result of the opening up of Third World capital markets to the influx of foreign capital. This process began in the early 1970's in the wake of the delinking of the US dollar from a fixed price for gold and the explosion of *petrodollars* which flooded the international capital market following the rise in energy prices after the Ramadan War of 1973 between Israel and the Arabs. The *petrodollars* capital surpluses were recycled by the global financial system to the Third World through and explosion of bank lending which built up a debt liability of close to a trillion dollars within the Third World over the decade of 1974-84. This boom collapsed with the global economic recession induced by the rise in US interest rates in the beginning of the 1980's. This recession was designed to once and for all break the power of the OPEC countries by both reducing the long term price of energy and cutting down their share of the global investible surpluses. I had at that time occasion to study quite carefully the rise and fall of the *petrodollar* and have written a few papers on this episode in global financial history.

The consequence of this rise in global interest rates was the rise in debt service charges to Third World borrowers who had borrowed indiscriminately during the 1970's when real rates of interest were low. As a result most of the big borrowers, such as Mexico, Brazil, Argentina, faced financial collapse as they defaulted on their loans and sources of private capital moving to the Third World dried up as rapidly as it had moved there in the 1970s. The same multinational banks who pushed cheap money down the throats of Third World clients, encouraging their every economic excess, now withdrew from the market when funds were most needed by the Third World. As was remarked then it was like loaning someone an umbrella when the sun is shining but taking it back the moment it starts to rain. Such is the logic of the global financial system! To cope with their mounting financial crises, during the 1980's, most of the Third World's indebted countries were exposed to a regime of severe stabilisation and structural adjustment under the tutelage of the World Bank and IMF, in return for their debts being rescheduled and the resumption of capital inflows. The entire burden of adjustment, originating in the debt crisis, thus was thrown on the Third World whilst the G-7 countries and their financial institutions, absolved themselves of all responsibilities for the financial crisis. For nearly a decade Latin America was exposed to a net outflow of capital as its debt servicing costs exceeded new capital flows. Other Third World countries faced similar contractions in capital inflows in the 1980s. This process of capital outflow and economic austerity enforced by Bank Fund conditional lending exposed much of the Third World to a decade of economic stagnation which is still far from over.

Prof Rehman Sobhan

The resumption of international private lending to Latin American and other countries in the late 80's and 1990's was of a completely different character from capital flows in the 1970s. The new inflows into Mexico, Argentina, Brazil, originated in the complete deregulation of their capital markets. Under pressure from the IMF most Third World countries have made their currencies, in varying degrees, convertible on current as well as capital account and have been opening up their stock markets to foreign investors. This means that a Fund Manager in New York can now buy shares quoted in the Mexican or Dhaka stock exchange, hold these stocks for a month, and then sell them off and take the capital out of the market to buy shares on the Sri Lankan or Venezuelan stock exchange. To enable foreign investors to do this, foreign exchange laws must be flexible enough to permit both entry as well as sale and the capital markets must always be liquid enough to find buyers for the sale of such stock. This opening up of capital markets to external investors and the freeing of the capital account has been a relatively new developments for Third World countries, with the robust Stock Exchanges of Hong Kong and Singapore appearing as rare exceptions. Most countries, including giants such as the Republic of Korea, until quite recently, protected themselves against such short term speculative flows of capital from abroad. Foreign capital was, in varying degrees, welcomed but in the form of longer term fixed investment or in the form of term loans contracted by a borrowing country on the global capital market.

It was traditionally feared by both policy makers as well as the multilateral institutions that short term capital flows could be destabilising for weaker Third World economies due to the lack of depth in their capital markets and the uncertainty of their external reserve position. Even today few Third World countries, outside Asia, indeed even within Asia, have built up both the strong reserve position as well as the liquidity in its stock market to absorb a sudden withdrawal of funds on the scale which catalysed the Mexican crisis. To have totally deregulated their markets has thus exposed those Third World countries to sudden economic shocks which need not originate in their own economic fundamentals but could owe to speculative impulses of overseas investors, their sense of panic about an economy or the emergence of better investment options elsewhere. In this deregulated global system a large volume of short term funds have moved out of London and New York to some emerging markets, due to low interest rates on offer in developed countries. The recent upward pressure on interest rates in the US has thus contributed to a reverse flow of funds out of emerging markets back to London and New York.

So what has Mexico done to deserve this flight of capital? Until recently it was the darling of the World Bank and IMF, one of the really successful 'reformers' whose privatisation and financial deregulation programmes were deemed as a model for the Third World. How much of Mexico's economic revival was due to their reforms and how much to massive inflow of external funds, particularly short term capital inflows, was not pointed out by the World Bank. In 1992, when Mexico was still a great success story the World Bank, in its *World Development Report* for 1994, showed that Mexico had a net Balance of Payments deficit of 23 billion dollars compared to 1 billion dollars in 1970 and that its external resource deficit GDP ratio was 6 per cent compared to 3 per cent in 1970. This resource gap was heavily financed by short term inflow so that in 1992, Mexico attracted 5 billion dollars in portfolio equity flows which was 50 per cent of its net inflows of capital of 10 billion dollars. In contrast China attracted 23 billion dollars of foreign capital in 1992 but only one billion dollars came as portfolio capital, the rest came as Direct Foreign Investment (DFI), or long term borrowing on the capital market.

The role of the international agencies

I recollect no warnings from the World Bank or IMF over the last two years that Mexico's attraction for portfolio capital was a threat to the stability of its economy or that its economic fundamentals were unhealthy. The public image was of a booming economy, to be emulated in its reform agenda by all Third World reformers! Nor do I recollect any serious discussion at the IMF about the attendant risks of a global capital market where billions of dollars float around for entirely speculative motives, quite unrelated to the fundamentals of the economy, where the laws of the casino appear more relevant than the laws of economics. These are issues which should be central to the concerns of a prospective global watchdog on the world's finances.

Rather than discharge its role as a global agency and friendly advisor to the Third World the sudden collapse of the *peso* has exposed the double standards of the international agencies. As a long as you open up and deregulate your economy, the adverse macro-economic results such as a rising external deficit, are seen as temporary phenomena. It is only when a crisis hits the economy that we are reminded about the deteriorating external balances of Mexico and the weaknesses in its economic fundamentals. But then any fool can be smart after the event. The secret is to be forewarned of a crisis.

So what does the IMF do when it is faced by an economy which has been financing its external deficit by short term borrowing? Does it advise it to take steps to reduce short term borrowing? No, it moves in with a financial rescue operation of 17 billion dollars to reassure investors that if you go on speculating on the Mexican stock exchange your losses will be underwritten by the IMF. So will the IMF give Bangladesh 17 billion dollars to underwrite its capital market? Were the IMF to provide even 1.7 billion dollars let alone 17 billion dollars, to Bangladesh, I imagine both the Finance Minister and the Chairman of our SEC would faint with the shock of their good fortune. But they may both rest in peace. No such underpinning is available to such strategically peripheral countries as Bangladesh. No US President is going to arouse his counterparts in the European capitals in the middle of the night, to instruct their country Directors in the IMF to vote for a financial bail out for Bangladesh. Does the IMF now have the moral stature or even the professional authority to preach to Third World countries running payments deficits when it could neither forewarn Mexico nor discipline it but instead had to genuflect to the compulsions of the United States to financially salvage its political ally?

Will the Bank and Fund now give any cautionary advice to the Third World reformers to go slow on opening up their capital market? I see no signs of such a move. Right now the only pressure is to move towards convertibility as fast as possible on the capital account. Is Bangladesh being warned that inflows of short term capital could expose its fledgling stock market to some risk? It would need no more than half a dozen overseas Fund Managers to seek to liquidate their stock portfolio in the Dhaka Stock Exchange (DSE) over 3 working days, so that they can subscribe to new share offerings in Thailand or a Treasury Bill issue in the US. Could the DSE handle this sale and what would happen to investor's confidence if the Dhaka market could not find buyers for this sale?

The governance of the IMF

If the Third World is not to stand on the threshold of financial crisis - *Financial Bosnias* new ground rules should be developed at the global level to protect such countries from sudden flights of capital on portfolio account. This may be done by building an adequate global reserve fund which will be operated on agreed and transparent principles to serve all Third World members of the IMF. No such fund can be built if one country can claim 17 billion dollars on the basis of one nights debate on the Board.

Secondly we will have to rethink the way the IMF is managed. This agency is not a private financial institution at the beck and call of one member country. The United States has the largest holding in the subscribed capital of the Fund. This ownership can at any time be diluted by letting the US divest 50 per cent of its stake in the Fund to any of its members, with half of this offer reserved for subscription to each of its members on a pro rata basis based on its existing quota. A similar process of divestiture could make the World Bank's capital base and ownership more democratic.

Under such a restructuring of the ownership of the Bank and the Fund the US would not have reason to feel that the size of its holding gives it a prescriptive monopoly over the agendas of the IMF and World Bank. Since the United States is committed to promoting both democracy and good governance around the world it should support any attempt to apply these same principles to the World Bank and IMF which should in any case, as multilateral institutions, have always been run on more democratic principles. But now that there is no shortage of capital around the world to contribute to the democratisation of the share structure of these global institutions the persistence with a hegemonistic ownership and management pattern is both bad business as well as wrong politics. Thus if the United States or any other member country has a private agenda to help Mexico or any other client state, it should use its own-resources and not eat into the capital of an agency designed to serve all the world.

Lessons for Bangladesh

Reform of the IMF and World Bank remain long term agendas outside the control of any Third World country. Till such reforms do occur, Bangladesh should take its own initiatives to insulate itself from becoming one of many *emerging financial Bosnias*. The recent steps just taken by the Securities and Exchange Commission (SEC) to regulate the stock market would, under the circumstances, appear to be steps in the right direction. A compulsory residence period for portfolio funds coming in to the DSE seems a good working measure. If the IMF does not like this step by the SEC then it should think of extending a financial guarantee to Bangladesh on the lines of Clinton's intervention in Mexico. This could underwrite a special Mutual Fund which could absorb all offerings of overseas short term portfolio capital which cannot be absorbed by the DSE. Beyond such stabilisation measures, the goal of the Bangladesh government should be towards accessing more Direct Foreign Investments (DFI) where investors are willing to risk their capital in the efficiency and viability of a productive enterprise. What Bangladesh needs today is capital which stays long enough to create jobs, bring in technology, management skills and provides access to overseas markets. Bangladesh's economy is too immature to be permitted the excitement of a night out on its own in Monte Carlo.

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Iftikar new MD of EBL

A I M Iftikar Rahman has been appointed Managing Director of the Eastern Bank Limited, says a press release.

Prior to this, he was the acting Managing Director of the Bank.

Rahman obtained his BA (Hons) and Masters degree in Economics from Dhaka University. He is also an Associate of the Institute of Bankers, London (AIB).

Rahman started his banking career with National Bank of Pakistan, London, in 1963. Later, he served United Bank Limited, London, Janata Bank, Brussels and Head Office, Bangladesh in various capacities as Senior Executive.

Balanced budget amendment issue

White House attacks congressional leaders

WASHINGTON, Feb 25: The White House attacked congressional leaders Friday on moves to pass a balanced budget amendment, but the scheme was gathering pace ahead of a key vote in the Senate, reports AFP.

"This is unreasonable and horrendous economic policy," Treasury Secretary Robert Rubin said at the White House in a briefing held by President Bill Clinton's key economic advisers.

Rubin warned that an amendment to the constitution requiring the government to balance the budget by the year 2002 could prove "very unsound" if the economy went into recession, and could force spending to be cut too quickly.

Clinton, speaking to reporters in Ottawa, reiterated his opposition to the budget amendment, accusing Republicans who back it of making "war" on American youth and failing to say where spending would be cut.

"We do need to keep bringing this deficit down," Clinton said. "I am committed to doing that. I don't think this is the right way to do it."

Arabian Adventures introduces 2 new programmes this season

Arabian Adventures, the Destination Management Company of Emirates, has expanded its range of desert expeditions with the introduction of two new programmes this season, says a press release.

These are breakfast in the desert and the UAE "Grand Canyons" expedition, which will offer tourists more variety to soft adventure holidays in Dubai.

The breakfast tours will be launched at the end of March, as the first to combine authentic Bedouin lifestyles with modern day sports activities on the dunes. Tourists set off from their hotels at 7:00 am, driven in Arabian Adventures' four-wheel drive vehicles into the Al Khawaneej desert, where their adventure starts with 30 to 45 minutes of camel rides towards Arabian Adventures' exclusive campsite. There, a hot breakfast awaits them.

After breakfast and time to relax, the tour continues in the four wheel drive vehicles towards the magnificent rad dunes at Hatta, where tourists get to enjoy sand skiing a sport peculiar to Dubai. This is performed on mono-skis, with participants sliding from the top to the bottom of a high dune within a matter of seconds.

Peter Payet, Manager Operations Arabian Adventures, said: "The breakfast tours will introduce a new dimension to desert tours, exposing visitors to new activities and attractions."

Arabian Adventures, the Destination Management Company of Emirates, has expanded its range of desert expeditions with the introduction of two new programmes this season.

Export earnings of Rahimafrooz may rise to Tk 155 m this yr

By Rashida Ahmad

Export earnings of Rahimafrooz Batteries are expected to rise dramatically to Tk 155 million in 1995, from Tk 22 million last year, according to company officials.

"New target markets are opening up for us in the Middle East, and SAARC countries such as Bhutan, Nepal and Sri Lanka. We have also been getting promising enquiries from Moscow," Muniwar Moin, Asst. Manager of the Marketing and Manufacturing Division, informed The Daily Star.

"All this is in addition to our existing expanding export markets, for example, in Pakistan which has the fastest growing car-market in South Asia," he added.

Small scale export began in early 1992, when Rahimafrooz started manufacturing batteries for Chloride Singapore and selling industrial batteries to Thailand. Later that year, the company created their own brand, Volta, just for the export market.

It then went on to provide general assistance, through training and collaboration, in Pakistan, for Accumulators Private Ltd to set up a factory. "This turned out to be a big opening for us: We made a turnover of one million US dollars through this project," said Moin.

Rahimafrooz Bangladesh Ltd has long been the pioneer of lead acid automotive battery manufacturing in Bangladesh since they entered into collaboration with the Lucas Battery Company (UK), in 1959. In 1978, Rahimafrooz Batteries Ltd was created. Since then Rahimafrooz Batteries have expanded to include Yuasa Batteries Bangladesh Ltd and Industrial Batteries Ltd, as fully owned subsidiary companies.

"Acquiring Yuasa, in July '94, was a major step in meeting our growing demands for export. It is a fully modernised factory, and has a much greater production capacity than our previous facilities allowed," said Moin.

"But our most interesting subsidiary at present is Industrial Batteries Ltd. There are very few manufacturers of industrial batteries, for use in telecommunications, railway systems, solar power, industrial machinery, etc, in Asia. There is none, for example, in Thailand, Malaysia, Singapore or Pakistan. There are assembly facilities in some of these countries, but no production. India does have manufacturing plants, but they have been facing problems with their technology."

When asked whether expectations for this year's export sales were being met so far, the response was that sales in the Middle East have been slower than anticipated.

"Our biggest problem is image. As a country we face a tremendous problem in this respect. We simply are not regarded as an industrialised or having a manufacturing base. The government should give much more support to industry through increased PR and promotion abroad. The Export Promotion Bureau (EPB) is very closed as to what they regard as exportable goods. Their main concern is garments. They need to hire more visionary and resourceful people and train them much more adequately," Moin said.

"Other problems are the restrictions on our industries' investing abroad. There is a lot of talk about the open market and international trade, but economic alliances with other countries must work both ways. To have money coming in we must allow money to go out as well."

One thing the government could implement immediately is the reduction of various charges on import of raw materials, he suggested. "We are not asking for subsidies but genuine and justifiable rebates."

Display of Rahimafrooz export batterise at the recently held Dhaka Int'l Trade Fair '95