Remarks at the Opening Ceremony of the Inaugural Meeting of the Directors of Audit of the Regional Central Banks

Sir K Dwight Venner, Governor, ECCB

Monday 13th October, 2003
ECCB Headquarters, St. Kitts

On October 3rd 2003, the Eastern Caribbean Central Bank celebrated its 20th Anniversary. We have found it to be a particularly appropriate time to put ourselves in a reflective mode to review the first twenty years of our existence and to project a vision into the future of the role and contribution of our institution to our member countries, our Currency Union, and the rest of the region of which we are an integral part. It would also seem to be a singularly appropriate time for reflection as the world turns, so to speak, and places the international community, ourselves in the region included, at the crossroads of history.

This is a world of interdependence and interrelationships. Everything depends on everything else and no significant event anywhere in the world goes unnoticed or in the fullness of time fails to affect countries and communities far away from the original occurrence. The law of unintended consequences is alive and well. The international community and system seem not to be properly prepared or constituted for these constant shocks as while there is the need to respond nationally and/or globally to these circumstances, we are only in the evolutionary process of working out these responses at the international level. It can therefore be objectively claimed that while world governance is evolving, world government is certainly nowhere on the horizon.

This therefore leaves a vacuum for strong states to step into, particularly in the post 1989 period. After all it has been argued particularly by the major powers that the role of a hegemon is critical for the stability of the international system. The international financial system has been particularly vulnerable to volatility and crises and particularly since the Asian crisis of 1997 has led the way in the search for a new financial architecture.

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This has been manifested in the establishment of a wide range of standards and codes to cover almost all financial institutions and circumstances. The entire financial community which is composed of international institutions such as the IMF, the World Bank, the Bank for International Settlements and regional development banks; central banks and regulatory bodies, and the whole gamut of private financial institutions have been engaged in the monumental task of establishing rules for the smooth functioning and safe conduct of financial intermediation within countries and between countries.

Since the major business of financial institutions is intermediation there is a requirement for the proper conduct of business by those whose resources are being intermediated, particularly the recipients of funds or borrowers. Corporate governance has therefore become a major issue in the world of finance and business as the international system searches for new paradigms to ensure stability accompanied by sustainable growth.

Following the collapse of the Soviet Union and the demise of communism, the market mechanism has emerged victorious as the predominant if not the only means of efficiently allocating resources. Fortunately, however, the extent of reliance on market forces has always been a debatable issue and three major variants on this theme have been identified, namely, Anglo Saxon free market competition, European social market capitalism and Japanese corporatism. These all arrive at different methods of market discipline and corporate governance.

A number of governance mechanisms have been identified in which both financial and non-financial institutions can respond to the interest of their major shareholders. These are the Board of Directors, executive compensation, the market for corporate control, concentrated holdings and monitoring by financial institutions, debt, and product market competition. The extent to which these mechanisms are applicable is dependent on the development and structure of a country's economy and the historical evolution of its business practices.

In a rapidly globalising world however, there is bound to be extensive convergence on the core principles of governance and the setting of codes and standards which facilitate the process of convergence.

Richard Cooper in an outstanding book entitled "*The Economics of Interdependence*" stated: "the central problem of international economic cooperation is how to keep the manifold benefits of extensive international economic intercourse free of crippling restrictions while at the same time preserving a maximum degree of freedom for each nation to pursue its legitimate economic interests". This was written in 1968 but the circumstances of today highlight the major conundrum which faces the international system. In the face of terrorism and money laundering and the disproportionate distribution of power, the actions of the OECD, FATF and FSF can be seen as the hegemonic solution to a global problem, which however carries unequal burdens and distributes unequal benefits. All the peculiar arrangements of the current times simply illustrate the disjuncture between zones of economic and financial activity which are distinct from the territorial boundaries of political governance.

In the case of monetary arrangements among sovereign states, the problem of governance is a major and fundamental problem. To quote Andrews, Henry and Pauly, "whether in the case of a formal monetary union, the unilateral relinquishment of national control over monetary policy (currency boards or dollarisation) or even multilateral monetary arrangements ranging from the conservative gold standard to the more liberal regime of Bretton Woods, the one challenge is the same: how to organize monetary governance in a fashion that reconciles the market logic of efficiency and the political logic of authority". This particular viewpoint is of great importance to us in the currency union and we shall return to it.

At the more general or global level, the demise of the Bretton Woods system in 1971 had ushered in a new era of floating exchange rates which was accompanied by the deregulation of international capital flows. Fluctuating exchange rates imposed risks and costs on the private sector as they had to diversify their portfolios to mitigate foreign exchange risks. One could therefore conclude that under Bretton Woods foreign exchange risk was borne by the public sector while under the new system these risks were transferred to the private sector. Foreign exchange trading, the issue of international bonds, and direct foreign investment increased almost exponentially adding to the volatility of the system.

Eaton and Taylor concluded that the succession of major financial crises, namely, Latin America's Southern Cone crisis of 1979 – 81, the developing countries crisis of 1982, the crises in the Nordic countries and the ERM of 1992, the Mexican crisis of 1994 – 95, the Asian crisis of 1997 – 98, the Russian crisis of 1998 and the Brazilian crisis of 1999, have revealed two important characteristics of the new international financial system. First, the new international financial system is highly volatile, with exchange rates, interest rates, and asset prices subject to both large/short term fluctuations and longer term swings. Second, the new system is susceptible to contagion when financial tremors spread from their epicenter to countries and markets that have seemingly little connection with the initial problem.

There are six generic responses to this situation starting from the actions of the nation state and ending with the role of the international community.

1. *National autonomy* defines a situation at one end of the continuum in which national governments make decentralized decisions with little or no consultation and no explicit cooperation. This response represents political sovereignty at its strongest undiluted by any international management of convergence.

2. *Mutual recognition*, presumes decentralized decisions by national governments and relies on market competition to guide the process of international convergence. This entails exchanges of information and consultations among governments to constrain the formation of national regulations and policies.

3. *Monitored decentralisation* occurs when governments agree on numbers that restrict their freedom to set policy or that promote gradual convergence in the structure of policy.

4. *Coordination* goes further than mutual recognition and monitored decentralization in explicitly acknowledging convergence pressures. It also promotes intergovernmental cooperation to deal with such pressures. Coordination involves jointly designed mutual adjustment of national policies.

5. *Explicit harmonisation* requires higher levels of intergovernmental cooperation and explicit agreement on regional or world standards.

6. *Federal mutual governance* is at the other end of the spectrum and implies continuous bargaining and joint centralized decision making. To make this work requires greatly strengthened supranational institutions.

In this new environment and with all of these new arrangements one must clearly assess and review the role, responsibility and contribution of central banks.

Central Banks have evolved as critical socio-economic institutions over the last three hundred years, starting with the Bank of Sweden and the Bank of England. Central banks are the ultimate source of liquidity through their monopoly of the note issue. The question of who they are accountable to and in whose interest they are acting becomes a major factor. Economic history in chronicling the evolution of the currency issue illustrated the danger of an uncontrolled note issue with the first response being to give a franchise to some group followed by the take over of the function by the state. This was in recognition both of the needs of the state and the political implications of the power over the note issue.

When the needs of the autocratic state were simply for waging war against its neighbours and the self- aggrandisement of the ruler, the causes of instability were obvious. When, as democracy became more entrenched, there was the political incentive to lean on the printing presses, the situation became somewhat ambiguous.

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From the theoretical and technical standpoints the correlation between the currency in circulation and the price level was already recognized in the original Quantity Theory of Money. However, the belief in a self -regulatory economic system ran counter to the need for intervention of any kind.

The Keynesion revolution gave rise to the concept of a macro economy which could be manipulated and thus laid the stage for modern economic management. It is in this context that we can identify three major players:

1. The state
2. The financial sector
3. The non financial private sector

In the modern environment, rules and regulations, standards and codes have to be clearly established for all three, if we are to deal with the instability and volatility of the international economic and financial system.

Central Banks have also evolved to fit into a unique space in response to the external pressures on these systems. In recognition of the critical importance of a low inflation environment, central banks have been granted greater autonomy by the governments which has changed their modus operandi. They are now more publicly accountable and have moved quite appropriately from secrecy to transparency. With independence has come more accountability and the need to expose not only their policy stances but their internal operations as well.

This can be seen from the experience of three of the most important central banks, namely, the Bank of England, the Bundesbank and the Federal Reserve. Two of them, the Bank of England and the Bundesbank started as private institutions and became state owned. The Bundesbank has become known as the most powerful bank in the world due to its ability to take positions contrary to the government on the issue of inflation. This independence was a consequence of a perception that the bank would protect the interest of the German people against political elements. However, on the really important political elements like the absorption of East Germany, the political elements were predominant.

In the case of the Bank of England, recent developments illustrate the interplay of political and economic forces. The Bank was given the authority to adjust interest rates but the supervision of the financial sector was hived off to another institution. In the case of the Federal Reserve the separation of powers provided a significant level of autonomy which as we have seen has been accentuated by the leadership of its Chairman, Alan Greenspan, due to his perceived influence on the financial markets. It is interesting to note here an avenue for corporate governance and market discipline.

In this new era of standards, codes and transparency the credibility of central banks depends, as we indicated, both on good policies and the efficiency of their internal operations. The Russian incident led to a higher level of scrutiny through the IMF's Safeguards Assessments. The intensive review of a central bank's internal operations through the ELRIC methodology revealed the inadequacy of several accepted principles of business practices in what were presumed to be apex institutions. The absence of external audits and effective internal audit departments, lax internal controls and accounting standards and inadequate legal provisions. As conceivably, the most important policy and regulatory institutions both domestically and internationally this state of affairs was highly unsatisfactory and has paved the way to the reform of central banks internal operations. To put it another way moral suasion cannot be effective if moral hazard is the order of the day. Central banks cannot carry out due diligence and regulatory inspection of other institutions if they cannot account for their own domestic operations. Also, in the area of policy formulation and execution, credibility is critical to policy effectiveness.

Central banks have to review their internal operations in a most intensive manner so that they can lead the very critical process of standard setting in the domestic, regional, and international environments. This responsibility will fall squarely on the Internal Audit departments of the central banks. They will have to quickly ratchet up their standards to international levels in both traditional and new areas. International accounting and auditing standards relate to internal controls, however the critical challenge will be to audit monetary policy and regulatory processes which have become so important, given the environment we now inhabit.

Our reflections in the ECCU revolve around the objectives of the ECCB at this juncture and the role of the three major actors, namely, the Monetary Council, the Board of Directors and the management and staff. The legal parameters for their respective functions are outlined in the ECCB Agreement 1983, but these are flexible enough to require new thinking and application in the light of changed circumstances.

The arguments outlined above with respect to the distinction between economic efficiency and political authority apply with great force to our current situation and are even more pertinent for the region as a whole as we move towards the single market and economy.

The notion of independent central banks runs counter to the political imperatives of the day in the region where the political incumbents are held responsible for all aspects of our economic and financial arrangements. Our democracies while well entrenched at the level of political action, are not ready to cede responsibility to either domestic or supra-regional institutions. In contradiction to this one are an increasing number and range of international standards and codes in monetary operations, banking, insurance, securities, statistics, public finances and governance which are effecting an impressive convergence on the systems of regulation and conduct of both economic and financial enterprises.

At some stage there will have to be an effective compromise which allows us to meet international standards while at the same time retaining some degree of freedom either at the national or regional levels. The sovereignty issue then becomes trapped in the conundrum of ceding it either to international pressures or working with other states to retain some influence over the process. Central banks, in the circumstances, will and should become the effective interlocutors for the region by first of all ratcheting up their internal control processes and establishing regional best practices for themselves. From this platform they can collectively represent the regional viewpoint in international fora. This will require a distinct leadership role on the part of Internal Audit departments. They need to effectively lead the process of internal restructuring and by their knowledge and experience in standard setting help to establish the regional agenda for an effective participation in the international system.

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These are the most challenging of times, and opportunities abound.

I end with two quotations to illustrate the point.

"Challenges can be stepping stones or stumbling blocks
Its just a matter of how you view them."

Finally, one, by the greatest scientist of the 20th century, Albert Einstein.

"In the middle of difficulty lies opportunity."