The Political Economy of Codes and Standards –
The case of Small States in the New International Financial System
Sir K Dwight Venner, Governor, ECCB
(June 2002)

The basic thrust of this paper is that international financial stability is an international public good, but that the benefits are not evenly distributed because of the differences in the circumstances of the nation states which comprise the international community.

Standards and codes have therefore to be looked at from the point of view of the industrialised countries and the rest of the world. However, within the rest of the world category, there are states with different levels of importance. There are states that have geographical significance, for example, Pakistan, Turkey, Mexico. States which have commodities that are critical to international trade like oil, for example, Saudi Arabia. States which, like Brazil, have great regional significance.

There are also states that have large populations and political markets like China and India.

A review of the official classification of countries in the International Monetary Fund's World Economic Outlook divides countries into three categories, namely, Advanced, Developing and Transition. The developing countries are broken down by region, but the size of countries is not a basis for classification.

The Economist has a listing of emerging market indicators with sample countries taken from Asia, Latin America, Africa and the Transition. While this sample includes Singapore, and Hong Kong, two small countries, they are included for their economic and financial significance and not their size.

The point which is being made here is that the international community has among its membership a significant number of small and very small states whose capacity for economic growth and significance to the international economic and financial system is not equal to the other members.

There are therefore, major differences in the viewpoints on the distribution of the benefits of international public goods and by extension the application of international codes and standards.

The stability of the international financial system can be assumed to be on international public good to all states given the recent historical evolution of the international financial system. This system has been characterized by frequent crises of one kind or another and equal volatility. In the context of an increasingly integrated international economy, this volatility has had an impact on all states. This has been direct in terms of decreased growth and the public costs of resolving banking crises. It has also been indirect by way of the presumed loss of income and investment by those countries with whom they have close economic relations. For small countries these events can result in significant external shocks. On the face of this

argument small countries do benefit from a stable international financial system and would have a vested interest in the application of codes and standards that support such stability.

The application of standards of codes have to be viewed against the background of the evolution of the international financial system in the post World War II period.

The Bretton Woods system that was established in 1946 on the basis of a fixed exchange rate regime contributed to twenty-five (25) years of stability.

In 1971, the American Government, given its domestic circumstances, cut the connection between gold and the dollar and changed the basis on which the system functioned. This is significant for and understanding of the political economy of codes and standards and their implementation. This was a unilateral action by a very large state in response to their domestic concerns. The impact on the international system was commensurate with its place in the international economy.

The regime of floating exchange rates that replaced the Bretton Woods was interestingly more volatile and introduced an element of uncertainty. According to Eatwell and Taylor, "under the Bretton Woods system, foreign exchange risk was borne by the public sector. When that system collapsed, risk was privatized." There was pressure to remove regulatory barriers and the development of new instruments and institutions to engage in financial activities reflecting the new circumstances.

The increase in international transactions was dramatic. Figures from the Bank for International Settlements and the international Monetary Fund attest to the dramatic increase in cross border flows. Bank for International Settlements figures show foreign exchange trading money from a daily average of $80 billion to $1.3 trillion in 1999. This trade in format is mainly short term and speculative, and therefore has a great potential for destabilising the system.

There was also growth in the cross border trading of lands and equities as well as bank lending. Eatwell and Taylor state categorically that "the new international financial systems, created by liberalisation, is characterised by highly liquid capital being traded in large volumes in an over-expanding complex market for an evolving portfolio of instruments."

A number of commentators including the authors cited above, the IMF and other institutions have chronicled the number of crises and scandals that have occurred from the late 1970's to the present time as follows:

- the crisis in Mexico in 1981/82
- the stock market crash of 1987
- the crash of the ERM in 1992
- Mexico redux in 1994/95
- the Asian crisis in 1997
- Russia in 1998 and Russia in 1999.

Contemporary crises in Turkey and Argentina are today engaging the attention of the international community.

The international system has also been tested by significant institutional failure. The Hersteal Bank in 1974, Continental Illinois and the BCCI. In more recent times, the demise of long term capital Management and the scandal at Baring have resonated throughout the financial community. Despite these crises, there is an underlying theme in the evolution of the international financial system, and the international community as a whole, namely, liberalisation and the removal of restrictions.

There were two reinforcing and complementary circumstances. One was the philosophical movement to market oriented system which culminated with the demise of the Soviet Union and discrediting of socialism as an efficient method of resource allocation. The other was technological innovations in computers and communication. This facilitated the transfer of capital throughout the international system as it was stated " at the click of a mouse."

Institutional reform and restructuring also lead to the bridging or removal of barriers between various sections of the financial system. Banks and Insurance Companies trespassed on each other's turf and in some cases became almost indistinguishable. The barriers between commercial and investment banking which had been raised in prior periods of crisis now come tumbling down.

In light of the threat posed to the system by such extreme volatility, it is now necessary to look at financial systems from two points of view, namely, the purely domestic and the insertion of international dimension.

At the purely domestic level a financial system must display the characteristics of safety and soundness. The intermediary function and the critical role the payments system plays in any modern economy is absolutely critical and this places the banking system in a very special position, unlike other firms in the financial and real sectors. The fact that in most countries, and in particular emerging markets, the banking system dominates the financial system, further emphasises the critical role of the banking system.

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The IMF has reported that over the period from the late 1970s to the early 1990s, two-thirds of its membership experienced banking crises of various levels of severity. The cost of resolution of these crises amounted to over 20% of GDP in many cases.

One can conclude from this that all countries have a vested interest in a safe and sound banking system. However, this has to be reconciled with the trend towards deregulation at both the national and international levels.

At a particular point in the post Bretton Woods period, one could reasonably assert that, other things being equal, liberalization and significantly different economies and financial circumstances between countries could result in a national disposition of financial assets on a global basis. This could be explained by the following scenario or, as you wish, set of circumstances:

1. There could be a difference in per capita income levels, tax regimes, legal arrangements, regulatory requirements, and standards of disclosure between the more developed countries, and the rest of the world.

2. The prospects of very small countries in the production and trade of agriculture and manufacturing commodities are severely circumscribed by natural and man made constraints. Small countries do not have the critical mass in physical size nor population to produce competitively with larger countries with both managerial and technological superiority.

The end result was that high network individuals and firms doing international business were encouraged by financial entrepreneurs to take advantage of the differences between high and low regulatory regimes that we describe as regulatory arbitrage. This would be the push factor.

For their part, the small countries, cognizant of the lack of comparative advantage and further disillusionment of a seemingly unfair trading system where developed countries protect, their agricultural sectors, and having anti bumping legislation to protect their domestic industries have sought to imitiate the success of other small countries such as Switzerland, Luxemburg, Lechsenstein, the Bahamas and the Cayman Islands which have attracted tremendous amounts of off shore financial business based on a certain environment. It would be accurate to describe these activities as income earning as opposed to genuine intermediation as they were distinguished from the domestic banking system, hence the apellation of "off shore".

Several issues have arisen and have attracted the attention of the international community in a very direct way.

The first has to do with the stability of the international financial system itself and to what extent off shore activities in the "limited" form described above, and the broader issue of all cross border flows of currency, bank lending, bonds and equities can destabilise the international financial system.

The second has to do with the issues of tax evasion through differentiation in tax regimes and the extent to which it poses a clear and present damage to the fiscal regime and macro economic stability of major industrial countries and by extension to the international system. In other words, is this purely a domestic issue, or does it have international ramifications?

The third has to do with the issue of money laundering, and the concerned effect of criminal activities, particularly drug trafficking and terrorism, on the stability of the international system. In short, the anti-development impact of these activities could be overwhelming.

The final issue has to do with the resolution of these issues at both the national and international levels, bearing in mind the fact that countries differ in their circumstances and that equity and inclusion is certainly an objective of the international community.

The question of the internationalization of standards raises the issue of sovereignty and the level and scope of cooperation between countries of unequal influence.

The essence of this circumstance is the explicit recognition of the application of standards and Codes as international public goods which provide substantial benefits to all participating governments. This requires the international community to move in concert to manage international convergence in this area. In the preface the Herring and Lilon's book on Financial Regulation in the Global economy, the Brookings Institute sets out six responses to this. They are:

- national autonomy,
- mutual recognition,
- monitored decentralization,
- coordination,
- explicit harmonization, and
- federal mutual governance.

The evolution of standards and codes can be catalogued to a lesser or greater degree under these various headings.

The coverage of the standards is quite widespread and varies with respect to financial institutions covered as well the organisations which have responsibility for monitoring such standards and codes.

The following arrangements should be noted:

1. The Basel Committee on Banking Supervision (BABS)
2. International Association of Insurance Supervisors (IAIS)
3. International Association of Securities Commissions (IOSCO)
4. Committee on Payment and Settlements (CPSS)
5. Joint Forum comprising BCBS, IOSCO, IASI
6. IMF has set standards for data dissemination, Fiscal Policy Transparency, Monetary and Fiscal Policy Transparency, and Public debt management guidelines
7. World Bank – Guidelines on Insolvency regimes, corporate governance, accounting and auditing.
8. Financial stability forum
9. Joint Bank/Fund Financial Sector assortment program (FSAP)
10. The International Accounting Standards Committee (IASC)

Given the differences between countries, views on the implementation of codes and standards will differ over time and with changing circumstances.

Whose and what views will prevail is a matter of mutual recognition of fundamental interests, and the dispersion of political power and influence. The successful implementation of standards would depend on three critical factors according to the FSP, namely, ownership, incentives and resources.

From the perspective of the Central Bank of very small economies, these three criteria are of critical importance. The scale and scope of the areas outlined above place very serious constraints on the ability of small states to be directly involved in the negotiations of such standards.

These standards then tend to be handed down without regard to the particular circumstances of such members of the international community. There has to be a way through various mechanisms in the international community, for example, the International Financial Institution's (IFI), the Bank and the Fund that special efforts could be made to involve small states.

The efforts in the adoption of the GDPs as undertaken by the Bureau of Statistics in the IMF are indicative of what can be achieved with respect to the universal incorporation of the member states in implementing meaningful standards.

This is of crucial importance in that the setting of two levels of standards for states at different levels of capacity, an incentive is given for countries to choose at what level standards they would prefer to relate.

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The fundamental question is of the resources which small countries have to address, and even when technical assistance is provided, practical difficulties tend to confront such states. There is the matter of turnover of staff, or the migration to more lucrative position in regional or international institutions after they have been trained.

The fundamental issues for small states, however, are the terms to which international financial system relate, and how they react strategically with the perceived costs and benefits. The benefits that are perceived to accrue to small states, are assumed to come from the opening up of their economies. Small economies in practical terms are already open, then the ratio of trade to GDP is taken into consideration. The smaller the country, the wider is the range of imports in contrast to the exports which can be extremely concentrated. This high level of participation in the international economy makes these countries extremely vulnerable to sharp changes in the value of currencies and the soundness of both domestic and international banks. To survive the level of external trade, domestic banks must have good correspondent relationships, and insurance companies must have good re-insurance arrangements. Small countries therefore have a very strong vested interest in a small international banking and insurance industry.

In the Eastern Caribbean Currency Union, the Eastern Caribbean Central Bank has been given the mandate by the Monetary Council to regulate banking business as well as to promote the development of money and capital markets. The Currency Union comprises eight countries, and therefore addresses in its arrangements the very critical issue of shared costs. With the concentration of professionals in its Research and Bank Supervision Departments, the ECCB is in a good position to review and advise on the wide range of standards and codes that are required in our view for being successfully integrated into the international financial system.

The ECCB is itself now undergoing a safeguards assessment by the IMF which we hope will assure us that we can meet the standards for the conduct of monetary policy. This will be of tremendous value to us in formulating and implementing the appropriate policies that are required for macro economic stability. It will also send an important signal to both domestic and international creditors.

The ECCB has also taken note of the positive impact of the application of the Basle Accord on the domestic banking sector. This sector, and in particular the indigenous banks have been subject to strict regulatory standards and have not experienced any crisis over the last twenty-five years.

The thrust of the arrangement here is that regional collaboration at the highest level between these very small countries has reduced the cost and increased the capacity for effective regulation. The countries of the Currency Union experience with the FATF and the OECD have not however been so harmonious. The exercises started out on a non-participating basis

and has only in recent times evolved to a situation of meaningful and constructive interchanges. The experience to date, is therefore mixed on the process of defining standards internationally and implementing them nationally.

This process requires a clear recognition by all parties that if standards are to be appropriately designed for an international community that is so diverse in economic achievement, then collaboration is required at the highest levels in order to secure successful implementation. In a world of separate sovereignties the evolution of fair and equitable distribution of international public goods is a critical issue.

Eatwell and Jay In, Herring and Litan and Mavis Goldstein address the issue of superimposing either standards themselves for general application on a world financial authority. It would seem to me that small states are best served by well defined standards, which, while protecting domestic arrangements, are within the capacity of the local or regional authorities to manage and implement. The international community through the IFI, must ensure that technical assistance and monitoring arrangements are in place to ensure compliance with acceptable standards and codes. These standards and codes must not be the exclusive preserve of a few powerful states.

In conclusion, it must be said that if we agree that international financial stability is an international public good, then efforts must be made to persuade all sectors of the international community for the need to have a fairly equitable distribution of benefits, not only by getting and maintaining stability, but by also emphasizing the need for positive actions in the areas of development.