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The Search for a Stable and Equitable Global Financial System

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The financial crises of the late 1990s generated a broad consensus that fundamental reforms in the international financial system are needed to appropriately address the challenges of the 21st century: how to prevent financial crises and better manage them when they occur, and how to provide adequate net private and public capital flows to developing countries, in support of poverty eradication and sustainable development (Stiglitz and Bhattacharya, 1999; Griffith-Jones and Ocampo, 2003).

Efforts to improve the framework for crisis prevention and crisis resolution have encompassed both international and national actions. In this chapter, we focus on the global agenda for international financial reforms and particularly the global agenda for private capital flows.

We start with a broad overview of progress on international financial reforms. In the second section, we develop a conceptual framework to evaluate progress on the main challenge of international financial reform: crisis prevention. We use this framework to examine key features of the financial sector and its macroeconomic interactions, leading to a number of policy proposals. This framework will also be applied to an analysis of proposals on a new Basel Accord (Basel II). In the third section, we look at issues of post-crisis recovery, focusing

[1] The views expressed are those of the author and do not necessarily represent those of the World Bank.

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especially on encouraging private flows in times of drought, and trying to ensure that resulting flows are more stable. As in the previous section, this includes a review of counter-cyclical mechanisms, incentives and policies. In the fourth and final section, we examine issues of representation of developing countries in global economic and financial governance, including proposals under discussion for increasing their representation.

1 Progress on International Financial Reforms

1.1 Reduction of Vulnerability to Shocks

When the crisis erupted in East Asia, many observers argued that the primary cause of the crisis were weaknesses in macroeconomic and financial sector policies and institutions including the lack of transparency and disclosure. Even though we do not agree with this one-sided proposition, the East Asian crisis did point to the need for improvement in transparency and disclosure at all levels. Indeed, one of working groups established under the aegis of the G-22 focused on transparency and disclosure, and this gave a big impetus to what we now call the three standards of disclosure, notably the Special Data Dissemination Standard (SDDS) on data, the code on fiscal transparency, and the code on monetary and financial transparency.

The global community has accepted these codes as important standards and assessments of two-thirds of the membership of the Fund and the Bank with respect to these standards have been undertaken. Although there is a push towards greater transparency at the national level, the impact on country practices is unclear. Second, as we have seen from LTCM, from Enron and from many other debacles in industrial countries, failures in accounting and accountability are not just an issue of emerging market economies. An area where there has been considerable progress is greater transparency about the deliberations and assessments undertaken by the IMF and the World Bank. There is now a presumption that IMF papers on Article IV consultations are published with the concurrence of the authorities, and key Board discussions and decisions are posted on the website.

A second way to reduce vulnerability to shocks is through improved surveillance. IMF surveillance, which has been the most important in this regard, has been strengthened at the global, regional and national levels (IMF 2004b). In addition to the *World Economic Outlook,* the *Global Financial Stability Review,* which analyses developments and risks in global capital markets and the transmission of shocks to emerging markets, is now a central vehicle of the IMF's global surveillance. Regional surveillance efforts of the IMF have also been expanded, including surveillance of currency unions such as the euro area. Country-level surveillance is now more intensive and more frequent especially for systemically significant economies. The analytical foundations have also been strengthened, including the framework for vulnerability assessments and use of a balance sheet approach, which entails examining sectoral balance sheets and inter-linkages in order to detect currency mismatches and other balance sheet weaknesses. IMF surveillance has also been broadened to cover structural sources of macroeconomic vulnerability.

The two key inputs to this broader coverage of vulnerabilities have been the joint IMF-World Bank *Financial Sector Assessment Programme* (FSAP) and the *Reports on Observance of Standards and Codes* (ROSCs). To date 96 financial sector assessments have been completed or underway and more than 550 ROSCs prepared, with two-thirds of all countries now covered in full or partially by both programmes. At the global level, the Financial Stability Forum has also focused on the monitoring of global financial market vulnerabilities as well as examining specific issues of concern in more depth. The Forum brings together the international financial institutions and the standard setters, but country participation is limited to the G-7 and selective countries of systemic importance. In addition to the multilateral surveillance, there is now increasing regional surveillance. For example, in East Asia surveillance discussions are now taking place in ASEAN, ASEAN+3, the Manila Framework Group, the Meeting of East Asia-Pacific Central Banks (EMEAP), in various other sub-regional groups, and in APEC.

A third way to reduce vulnerability to shocks is the strengthening of financial systems. This was one of the three topics taken up by the working groups established by the G-22 in the aftermath of the East Asian crisis. It was also one of the areas of early attention by the Financial Stability Forum and has remained on the agenda of international discussion since including in the G-20. The more careful scrutiny of the role of the financial sector has led to four important conclusions: first, that there are clear perils to speedy and poorly sequenced liberalisation; second, that weaknesses in the financial sector can amplify vulnerabilities through the domestic credit channel; third, that a weak financial sector is less able to withstand macroeconomic shocks and external financial instability; and, fourth, conversely that deep domestic financial markets can lead to more prudent risk taking and avoid currency mismatches through excessive reliance on foreign intermediation. These discussions led to a renewed emphasis on adequate supervision and regulation and the enunciation of good practices embodied in the internationally agreed standards for banking, insurance and securities market supervision. But it is now also recognised that supervision and regulation need to be complemented by adequate incentives for prudent risk taking including the need to avoid excessive insurance and by robust institutional underpinnings. The institutional agenda encompasses many elements, but building strong and efficient payments systems, an incentive-compatible institutional framework for financial supervision, sound accounting and auditing practices and a well functioning legal system including for collateral and for bank and corporate insolvency are key priorities. Strengthening financial systems is a long-term and complex institutional building task which must be anchored in the local context and led by national authorities. The international community can however play an important supportive role given the scarcity of expertise in many key areas. The international financial institutions working in collaboration with standard setters and bilateral agencies are the main conduit for providing such support. The recommendations for reforms contained in FSAP and ROSC reports are now providing additional, more systematic, ways to identify technical assistance needs.

Another issue that has come to the fore since the East Asian crisis is appropriate exchange rate management. The early debate on exchange rate regimes was based on the effects of different shocks, monetary or real and domestic or external, and on fixed or floating exchange rate regimes. In the 1980s and early 1990s, with a preoccupation on price stability, the use of exchange rates as a nominal anchor gained increasing support. In the aftermath of the East Asian crisis, the dangers of pegged exchange rates in a world of large and volatile capital flows led to the two-corner view that countries should either adopt a floating or fixed exchange rate system. This view has progressively evolved. Although the norm that there is no right currency regime for all countries for all times still stands, most economists now agree that financial integration places a premium on exchange rate flexibility and that fixed exchange rate regimes are much more demanding in terms of required fundamentals. In a recent work, Morris Goldstein (2002) argues that the best regime for countries that rely heavily on private capital markets would be a managed floating plus regime, where "plus" refers to a supportive framework that includes inflation targeting and aggressive measures to discourage currency mismatching. There is also broad consensus that credible exchange rates must be based on credible institutional arrangements for macroeconomic policy such as central bank independence and fiscal discipline in the long-run based on automatic fiscal stabilisers and fiscal responsibility arrangements.

On debt and contingent liability management, a lot of new work has been undertaken at the international level. There is now an agreed set of principles and guidelines on sovereign debt management, and these guidelines focus much more on contingent liability management than previous practices emphasised.

An area where the views of the international community has changed most markedly since the East Asian crisis relates to capital account liberalisation. There is now wide agreement that capital account liberalisation needs to be sequenced carefully and with due regard to financial sector vulnerabilities. Conversely countries need to take steps to avoid boom-bust cycles associated with pro-cyclical capital flows and to minimise currency and maturity mismatches. In this regard, prudential regulation of financial systems can be as important as capital controls (Stiglitz and Bhattacharya, 1999).

1.2 Response to Shocks and its Aftermath

In assessing progress in the international financial architecture with respect to crisis response and crisis resolution, it is important to distinguish between two elements: how to prevent small shocks from becoming bigger ones, and how to facilitate restructuring when it becomes inevitable.

In addition to a renewed emphasis on investor-country relations, the main initiative taken to deal with the problem of fading investor confidence was the establishment of the Contingent Credit Line (CCL) by the IMF in 1999. To access the facility a country had to meet several tests and it could only tap the funds after an activation review by the IMF. Many countries were also concerned about the adverse signaling if they were to apply for the CCL. In the end the facility was never utilised and the IMF Board decided not to extend it when it relapsed in November 2003. In East Asia, partly in response to some of these concerns, the proposal to set up regional financial cooperative arrangements have gained some momentum. The so-called Chiang Mai Initiative which was set up initially as modest bilateral swap agreements between countries in the region is gradually evolving into a more multilateral arrangement and its scope expanded. Nevertheless the magnitude of this facility is likely to remain small in relation to the IMF and the size of potential shocks.

So the main instrument of response remains traditional IMF lending. Views on the scale and conditions associated with IMF lending however remains sharply divided. Some have argued with good basis that since the IMF is not a true lender of last resort, either in its ability to provide unlimited resources or to impose and monitor the necessary conditions, large scale IMF lending only adds to the problem by increasing moral hazard. Others have argued that neither IMF quotas nor the magnitude of Fund resources have kept pace with the growth of the world economy, and that the IMF can only deal with the problem of volatile capital and financial contagion with much larger and less conditional IMF support. Actual practice has fallen in between these two alternative visions of the role of the IMF. The Fund did provide large scale support in some cases, notably for Turkey and Brazil, but it has been less willing to do so in other cases. The debate on limits on IMF lending, and the criteria on which it should be based, is far from settled.

Views on how to deal with eventual debt restructuring in the event of a crisis also remain sharply divided. The reluctance to rely on the provision of large amounts of official finance to resolve debt service difficulties, coupled with potential problems in coordinating bond creditors, have led to increased interest in improving the framework for the restructuring of bonded debt. Bonds have become the preferred instrument of borrowing, and now account for 25 percent of the debt of emerging market economies, compared to 11 percent in 1990. Three proposals have been the focus of recent debates: a sovereign debt restructuring mechanism (SDRM), the greater use of collective action clauses (CACs) to facilitate coordination, and the development of a voluntary code of conduct that would help improve the environment for the resolution of debt difficulties.

At end-2001, the IMF proposed a formal bankruptcy procedure to enable an insolvent government to seek legal protection from external creditors, while negotiating a restructuring of its debt. The SDRM would enable creditors and debtors to negotiate a restructuring, aggregating across instruments, and ratifying an agreement binding on all by a specified super-majority. However, the requisite level of support among the Fund's membership to establish the SDRM through an amendment of the Fund's Articles of Agreement was not reached, in part reflecting opposition from the private sector as well as key emerging markets. The International Monetary and Financial Committee (IMFC) agreed on April 12, 2003 that while "it is not feasible now to move forward to establish the SDRM", work "should continue on issues raised in its development that are of general relevance to the orderly resolution of financial crises *(including)* inter-creditor equity considerations, enhancing transparency and disclosure, and aggregation issues".

In contrast, the international community has made considerable progress on collective action clauses, or CACs. There is now a broad consensus that greater use of CACs – that provide for the modification of terms on bonds by a substantial majority – can help impose debt-restructuring agreements on minority creditors, thus reducing the probability of a disorderly default. Although the inclusion of CACs has been a long-standing market practice in some jurisdictions, including bonds governed by English law, bonds issued under US law do not automatically have such provisions. After emerging market countries such as Mexico, Brazil, Korea and South Africa started in 2003 to include CACs in their bond issues governed by New York law, many other investment-grade countries have followed suit and such clauses are rapidly becoming the standard practice in the New York market, with no apparent effect on pricing. Sovereign issues containing CACs have grown to represent more than 90 percent of the total value of bonds issued since April 2004, and 40 percent of the value of the outstanding stock of bonds from emerging market countries as of end-July 2004.

The international community has also made encouraging progress on a voluntary Code of Conduct. Recent experience suggests that debtor-creditor dialogue is critical to the success of the debt restructuring process. Discussions within private and official sectors have taken place recently on the potential benefits of a voluntary Code of Conduct for creditors and debtors. Such a Code could, in principle, facilitate dialogue between creditors and debtors, promote corrective policy action to reduce the frequency and severity of crises, and improve the prospects for an orderly and expeditious resolution of crises. A draft code has been prepared on the basis of extensive consultations between several emerging market countries of the G-20 and private sector representatives. The draft principles provide a market-based, voluntary and flexible framework for cooperation between debtors and creditors that could potentially complement CACs in helping to contain crises at an early stage and facilitate restructurings when they become inevitable.

1.3 Assessing the Progress

The progress to date has been the greatest with respect to reducing vulnerability to crisis as a result of efforts of countries and complementary international actions. Developing countries have significantly improved their macroeconomic policies and financial systems, and international efforts have distilled, disseminated and supported the adoption of good practices. The steps taken to reduce vulnerability have also had a development payoff since much of the agenda aimed at reducing vulnerability is also key to accelerating and sustaining growth. Although it is difficult to assess the counterfactual if these steps had not been taken, the improved growth performance of developing countries and resilience to recent shocks suggests that developing countries are less vulnerable to potential instability. The ability of emerging markets to withstand turbulence in individual countries including the major crisis in Argentina also suggests that these steps have reduced the impact of financial contagion.

On the other hand, the impact of measures on crisis response is mixed, because of limited progress at the international and regional levels. The existing arrangements have not been able to deal speedily with the fading of investor confidence, that can last for a relatively long period and can give rise to adverse and self-fulfilling debt dynamics. Emerging markets that have private debt levels that make them susceptible to high and volatile risk premia, such as Brazil or Turkey, need to maintain large primary surpluses to maintain confidence and meet the high interest costs of rolling over the debt. Recent empirical findings show that emerging markets are susceptible to debt distress at far lower levels of debt to GDP than is the case for industrial countries. Partly in response to the experience of indebted emerging markets, developing countries that are able to are building up large pools of reserves in order to insure against potential instability. As a result of such excessive and inefficient insurance, and the reluctance of emerging markets to rely on private debt finance, developing countries have become net capital exporters which is developmentally perverse. Given more rapidly aging populations in the North and the higher marginal returns in the South, there are mutual benefits from net capital flows to developing countries.

The mechanisms to resolve financial crises when they occur are also unlikely to produce efficient outcomes. Differences of views on whether to provide large scale official support or to sanction a tough approach including standstills means that a voluntary approach must be the primary means to resolve a crisis and any eventual restructuring.

Although the adoption of CACs will facilitate debtor-creditor dialogue, it is unclear whether CACs by themselves can deal with the complex incentive and collective action problems that arise at a time of restructuring.

Finally, reforms to date have been characterised by insufficient developing country representation in key fora and institutions. This lack of participation by developing countries slows down progress in reform of the international financial architecture, and undermines the legitimacy and effectiveness of measures adopted.

2 The Limitations of Crisis Prevention Measures

Since 1997, much effort has focused on crisis prevention in response to the large number of crises in developing countries, which came with very high macroeconomic costs and damage to development and potential and real costs to the international financial system.

These efforts have been centred on the development of international codes and standards for financial sector regulation, and their implementation in developing economies. Two aspects have received less attention. The first is that there has been far less emphasis on improvements in global capital markets, especially in possible weaknesses in source countries.

The second, and perhaps least explored limitation of prudential efforts undertaken so far, is that they do not avoid unwelcome macroeconomic costs resulting from inherent imperfections of financial systems. This second limitation arises partly from insufficient (though growing) understanding of the relationship between imperfections in financial systems, their macroeconomic impact and the new regulatory needs. It has also been attributed to the insufficient application of the rapidly evolving insights to the practice of regulation and of macroeconomic policy, due to implementation difficulties, bureaucratic inertia, or power of vested interests.

The new insights (which draw on a tradition that starts with Pigou and Fischer, and was developed more by Keynes, Minsky and Kindleberger) stress the inherently pro-cyclical nature of financial markets and their interaction with the real economy. Indicators of risk perception decline sharply in good times – when in fact risk may be greatest – and increase sharply in bad times, overshooting both ways. Asset prices, risk spreads and provisions fluctuate sharply following risk perceptions. This partly reflects the fact that financial agents are far better at measuring the cross-sectional (in a moment of time) rather than the time dimension of risk, being on the whole rather bad at measuring and allocating risk over time (Borio and Crockett, 2000; Persaud, 2003; Borio and White, 2004). At the same time, there is a tension between individual rationality and desirable collective outcomes, reflected in phenomena such as herding. This implies that recent slowdowns (both in developing and developed economies) may not mainly result from a tightening of monetary policy, but from reversals of asset prices and levels of exchange rates, often accompanied by sharp reversals of capital flows in the case of developing economies. An alternative explanation is that the fear of financial distress or capital flow reversal may force economic authorities to follow "excessively" tight macroeconomic policies, which also discourage growth.

These new realities imply that in the prevention phase, far closer cooperation is needed between financial regulators and macroeconomic authorities. Even a well regulated financial system is unable to withstand major macroeconomic shocks, as illustrated clearly by the Argentinean experience in 2002. At the same time, imbalances or instability in the financial system often undermines macroeconomic performance. Furthermore, financial regulation needs to have a far stronger prudential dimension (Crockett, 2000; Ocampo and Chiappe, 2003; Borio and White, 2004). This is due to the fact that the evolution of risk is partly the result of the collective behaviour of financial players, and that risk perceptions are influenced by overall liquidity. By stressing pro-cyclicality of financial markets, this approach emphasises the need for countervailing or counter-cyclical measures in regulation (Ffrench-Davis and Griffith-Jones, 2003).

Instruments such as forward-looking loan-loss provisions for banks, or at least cyclically neutral provisions, have not only been amply discussed in the literature, but have begun to be implemented to a limited extent in countries such as Spain and Portugal. More generally, regulators could require prudential provisions when the growth of credit and key asset prices, such as stocks, accelerates sharply or exceeds some long-term average. These types of measures raise a number of fairly difficult questions about implementation. More broadly, they raise the issue of potential trade-offs between counter-cyclical regulation of the financial sector for crisis prevention and measures to warrant enough credit to support economic growth (Stallings and Studart, 2003). Many measures being discussed (e.g. proposals for Basel II, see below, or the SDRM proposal) discourage private flows to developing economies and thus reduce growth.

An important under-researched issue is how pro-cyclical and herding behaviour of financial actors can lead to complex and problematic interactions between different actors and flows (Griffith-Jones, 2003). Regulators also need to look at the interaction of risks between different actors as they affect one type of borrower or country, as well as the possibility of risk spreading across borrowers and countries. Increased coordination – or even better, integration, where feasible – between regulators in different financial sectors is required, both domestically and internationally.

Additionally, the close interaction between the financial sector and the economic system also seems to require changes in how macroeconomic policy is formulated, i.e. making it more counter-cyclical and taking account of longer horizons so as to allow for lack of predictability on the possible unwinding of financial imbalances.

Finally, to the extent that responsibility for preventing crises is not clearly allocated between national financial regulators and monetary authorities (and even more so internationally), there is a risk that problems can "fall through the gaps" with no economic authority taking appropriate responsibility. International institutional developments such as a sharper focus on systemic issues by the International Monetary and Financial Committee of the IMF and the creation of the Financial Stability Forum are valuable steps forward, but need to be built upon.

The tasks and aims of policymakers and regulators in developing countries have become more numerous and more complex, whilst the instruments have not been sufficiently adapted to the new realities. The aims include maintaining high and sustainable growth, avoiding financial imbalances that could result in financial crisis and maintaining relatively low inflation. Therefore, it is important to develop new instruments, for example of counter-cyclical regulation of the financial sector, to meet the challenges.

It is essential to evaluate progress on crisis prevention against the challenges posed by the above framework on a continuing basis. To what extent, for example, do codes and standards reflect the interactions and complexities outlined above? Are they "best practice" given the evolving state of knowledge? To what extent are the international measures sufficiently robust and consistent with the main problems being faced? Why, for example, is the new proposed Basel Capital Accord likely to increase pro-cyclicality, when so much research argues to the contrary, i.e. that regulation should be counter-cyclical? How should the objectives of the new Basel Capital Accord of better risk management be balanced with the goals of promoting sustained and stable capital flows to developing countries?

3 A New Basel Accord

As noted earlier, it is important to encourage more private capital flows to developing countries. But it is equally important to avoid an international regulatory framework that may have an unintended negative impact on these flows.

Basel II is intended to increase the sophistication of risk management practices globally in view of changing market developments and to address some of the inadequacies in the existing Basel capital accord such as the excessive reliance on a single capital ratio and mechanical application of rules and the narrow focus on credit risk. Improved risk management should strengthen the soundness of the international banking system, thus contributing to the avoidance of crises. Basel II implementation will be especially challenging for developing countries. Many developed countries have already been upgrading their risk management practices consistent with Basel II. Developing countries need to consider when and how to implement Basel II consistent with the stage of their banking sector development, market infrastructure including accounting, auditing and the legal framework, and the quality of banking supervision. Regulators and bank managers will have to upgrade skills and adopt a risk-based culture. As a result of the more explicit recognition of risks, capital requirements may change and flows of credit may be affected. In transition there is likely to be a mismatch between the regulatory regime of G-10-based bank and the regime appropriate for a developing country. All of these issues will require careful attention in the implementation of Basel II in developing and developed countries.

Another aspect of concern to developing countries is how the adoption of the new accord will affect the willingness and costs of bank lending to developing countries. Although Basel II has positive features with respect to better recognition of risk and the removal of the OECD/non-OECD distinction), in its present form it is likely to overestimate the risk of lending to developing countries. In particular it does not take into account the considerable benefits of international portfolio diversification. This may imply a significant increase in regulatory capital requirements for lending to developing countries, which in turn could result both in less lending to these countries and an increase in the costs of the lending that does take place.

The lack of inclusion of the benefits of international diversification has been highlighted as an important concern by both analysts and market participants. For example, Stanley Fischer, Vice Chairman of

Citigroup, argues that by not taking into account the risk mitigation effects of international diversification, "Basel II in its current form runs the risk of materially reducing the incentive for larger internationally active banks to maintain and expand their operations in emerging market economies." Given the economic and other benefits of such operations, says Fischer, this must be considered "a significant shortcoming".[2] A variety of financial institutions, including representative industry bodies such as the Institute of International Finance (which represents all major international banks) and The New York Clearing House Association (that represents several of the major banks), have argued strongly for the incorporation of the benefits of international diversification into the Accord.

Griffith-Jones *et al.* (2002) presented empirical work confirming that the degree of correlation between the real and financial sectors of developed economies is greater than that which exists between developed and developing economies. These results offer substantial support for the proposition that excluding the benefits of diversification introduces a significant bias against lending to developing countries.

An internationally diversified loan portfolio, with a range of developed and developing country borrowers would have a lower level of risk – in terms of the overall portfolio – than one that focused primarily on developed country lending. In order to test this hypothesis in the specific context of a bank's loan portfolio, Griffith-Jones *et al.* (2002) conducted a simulation exercise to assess the potential unexpected loss resulting from a portfolio diversified within developed countries, and one diversified across developed and developing regions.

The unexpected losses simulated for the portfolio focused on developed country borrowers were, on average, almost twenty-three percent higher than for the portfolio diversified across developed and developing countries. This offers more direct evidence that the benefits of international diversification produce a more efficient risk/return trade-off for banks at the portfolio level. In order to accurately reflect the actual risks that banks may face – Basel II should take account of this effect.

Further evidence using real data has been provided by the major Spanish bank, BBVA, in its document: "A practical proposal for improving diversification treatment in Basel II" (2003).

This analysis uses a "correction factor" which measures the error made when using a single factor model – such as that envisaged in Basel II –

[2] Presented as the William Taylor Memorial Lecture at the International Conference of Banking Supervisors, Cape Town, September 19, 2002.

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when in fact there are two (or three) factors affecting diversification of the portfolio. These factors could be geographical areas (emerging vs. non-emerging economies), industrial activities or a combination. The correction factor is defined as the ratio between the capital calculated with the two- or three-factor model and the capital obtained with the single factor model.

Given this and other evidence, as well as the widespread acceptance of the risk-reducing benefits of international diversification, it is important to consider how such benefits could be incorporated into the Basel II proposals. The new Chairman of the Basel Committee, Jaime Caruana, has noted that an obvious step to further enhance the risk-sensitivity of the capital framework would be "to incorporate calculations of diversification benefits into the framework".[3]

The intention of moving Basel to full credit risk models is highly welcome. However, we think it is important that in a transition phase – whilst they are developed – benefits of diversification are already incorporated in simpler ways. If this is not done, international banks may be inappropriately discouraged in the short term from lending to developing countries, a trend which may then take some time to reverse. Such a reduction of international bank lending could have negative impacts on output and poverty reduction.

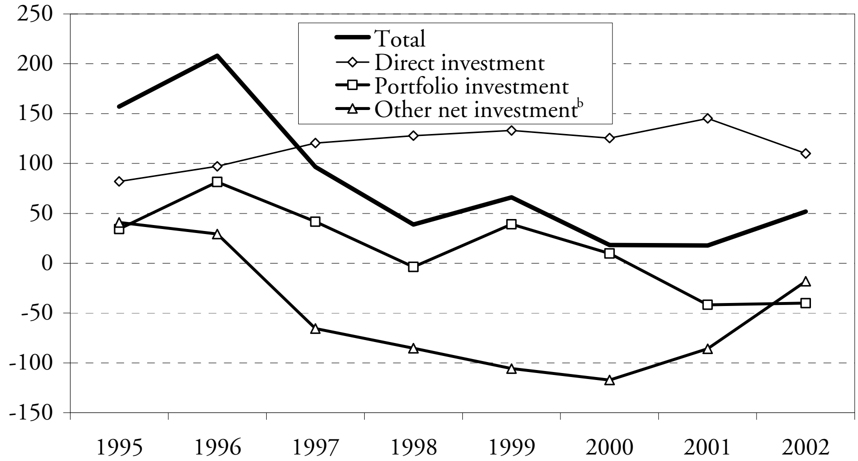
Very recent research (Griffith-Jones *et al.*, 2004) shows that incorporating these benefits of diversification also increases the stability of the risk/return relationship through time. This latter effect would imply that the appropriate inclusion of diversification benefits should, for example, smooth regulatory and economic capital requirements for banks; this would lead to more stable bank lending which could reduce excessive economic cycles, so harmful for long-term growth (in both developed and especially in emerging countries) and strengthen the stability of large international banks. The latter is a key economic objective, and an absolutely central one for G-10 bank regulators.

4 Capital Flows to Developing Countries

Private capital flows can be a vital source to support sustainable growth and poverty reduction in developing countries. However, they declined dramatically in net terms from 1996 to 2001, linked to the Asian and

[3] Speech to the British Bankers Association (BBA) on 9 October 2003 by Jaime Caruana, Chairman of the Basel Committee on Banking Supervision.

Figure 1 Net Private Capital Flows to Developing Countries, 1995-2002[a]
(in billions of dollars)



Notes:
[a] Excludes transition economies.
[b] Includes commercial bank lending (short- and long-term).
Source: UN, *World Economic and Social Survey, 2003.*

other crises, with a slight recovery in 2002 (see Figure 1). During this half decade, there was a virtual drought of private flows going to developing countries. Net transfers, that include all forms of financial payments, became increasingly negative since 1998, reaching minus $193 billion in 2002, according to the UN World Economic Survey (2003).

For the group of emerging market economies, net private capital flows has also declined since 1996, a decline which continued in 2002, reaching a 10-year low of $124 billion (see IIF, 2004). The partial recovery in 2003 is projected to continue in 2004, and has been associated with the current world economic recovery and low international interest rates, and to some extent to improvements in macroeconomic fundamentals and policies in emerging countries.

The recent increase in capital flows should be viewed with caution. First, the recovery reflects primarily cyclical factors, and is based mainly on increases in portfolio equity and bond flows, and to a lesser extent on bank lending, which tends to be the more volatile component of total flows. Foreign direct investment fell in 2003, reinforcing a moderately declining trend initiated in 2001. Second, the flows are concentrated mainly in Asia, which accounts for nearly 60 percent of the total flows to emerging markets, and for over 70 percent of their growth in 2003. This contrasts with the current share in total flows for Latin American and African/Middle East regions – currently at 14 percent and 2.6 percent respectively – and with the year 2001, when shares for Asia, Latin America and Africa/Middle East corresponded to 40 percent, 39 percent and 7 percent, respectively.

Given the role that cyclical factors have played in this recent recovery, and the fact that there seem to be structural factors (such as the fact that banks have "crossed the border" and established branches and subsidiaries in developing countries, from which they lend in local currency) that may be inhibiting international private flows, the level of private flows may remain relatively modest (Griffith-Jones, 2003). Furthermore, a large part of recent flows may be easily reversible.

Thus, two problems identified in the past regarding capital flows are still present in the recent upward trend: their potential reversibility and their geographical concentration, the latter implying that whilst some countries are facing surges of flows, others are still receiving insufficient flows. Moreover, a large group of developing countries, which includes the poorer ones, continue to be outside the radar of private capital flows, therefore remaining heavily dependent on aid flows. To meet the Millennium Development Goals, these countries need to receive much higher levels of concessional finance (see UN, 2003).

5 Public-Private Links for Increasing Capital Flows

To encourage increased stable capital flows, new public-private mechanisms could be created. In the case of private flows, in the following section, we discuss proposals for partial counter-cyclical guarantees, and public incentives for encouraging socially responsible investment (SRI) in developing countries. In the case of official flows, we discuss the International Finance Facility (IFF) proposed by the United Kingdom Treasury as a means to augment official development assistance in the near term.

5.1 Guarantees for Private Investment, Especially in Infrastructure

Encouraged by privatisation, investment in private infrastructure in developing countries surged from 1990 to 1997, with an associated increase in private investment flows. However, this investment was particularly badly hit by recent crises (see Griffith-Jones and Fuzzo de Lima, 2004).

Existing public guarantee mechanisms (granted by the multilateral development banks and export credit agencies) play a positive role in mitigating risks of long-tern investment and loans to fund important activities, such as infrastructure investment.

Existing guarantees have positive features in that they increase flows and extend maturities of debt instruments in developing countries. According to the World Bank (2001), this is up to twelve times what would have been without guarantees. Nonetheless, this does not imply that the guarantees can lengthen the duration of private credits not covered by the guarantee.

Another positive feature of guarantees is its ability to reduce spreads, not only for guaranteed loans, but also for non-guaranteed private credits.

In spite of all the advantages of existing loan guarantee mechanisms, they deal more with overall risks, rather than with the cyclicality of risks. It is widely accepted that international financial and banking markets tend to overestimate risk in difficult times and underestimate it in good times. As a result, private lenders are prone to boom-bust patterns that are often determined more by global factors, and not so much by country fundamentals. This provides a strong case for public institutions to play an explicit counter-cyclical role, for example in long-term trade credit.

There could be two paths for increasing the counter-cyclical role of national or international bodies. One would be for public international bodies like the multilateral development banks to provide more counter-cyclical lending than already occurs. Another path, that could provide more leverage of public resources, would be for multilateral development banks and export credit agencies (ECAs) to introduce an explicit counter-cyclical element in all the risk evaluations they make for issuing guarantees for lending to developing countries. This would imply that when banks or other lenders lowered their exposure to a country, multilateral and regional development banks or ECAs would increase their level of guarantees, if they believed that the country's long-term fundamentals were basically sound. When matters were seen by private banks to improve, and their willingness to lend increased, multilateral development banks or ECAs could decrease their exposure, for example by selling such guarantees in the secondary market.

Another alternative could be special stand-alone guarantee mechanisms for long-term trade credit, for example within multilateral or regional development banks, or even bilaterally, that had a strong explicit counter-cyclical element to be activated in periods of pre-crisis, during crises or for countries facing a sharp decline or dramatic increase in cost of capital inflows when they emerge from crises. Its aim would be to catalyse long-term trade credit, in particular for infrastructure in a broad sense.

Although a range of technical and operational issues would need to be sorted out, if properly designed and implemented, counter-cyclical guarantees could provide an important policy instrument to help deal with a genuine market failure, the boom-bust pattern of private lending. The desired policy outcome would be to help smooth private lending.

5.2 Social Responsible Investing in Developing Countries

Social Responsible Investing (SRI) assets have grown dramatically in recent years, reaching $2.7 trillion in 2001. In the US, they grew from just $1.0 trillion to over $2.0 trillion between 1997 and 2003. In the UK, SRI growth has been even more dramatic – with asset values quadrupling from just about £50 billion in 1999 to over £200 billion in 2001.

Changes in the UK legislation on pension funds have been pointed out as a key factor behind this increase. In 2000, the UK government modified the 1995 Pensions Act to require that pension funds report to what extent their investment decisions take into consideration social and environment issues. As a consequence, institutional investors hold over 80 percent of total UK SRI assets today.

However, the strong growth SRI has exhibited in the recent past has been a phenomenon limited mainly to the acquisition of developed country assets. Of the $2.7 trillion of total SRI assets in 2001, only 0.1 percent was emerging market assets (IFC, 2003). This is much lower than the share of emerging market assets held by mainstream investors, around 2 or 3 percent. There is therefore an enormous potential for SRI growth in emerging markets.

An acquisition of emerging markets' assets can be justified both on moral and economic grounds. On the moral side, SRI investors, could help developing countries grow faster, create jobs and reduce poverty by investing in these countries, especially if the flows are long term and fairly stable. This would lead to overall prosperity in developing countries and would therefore be coherent with SRI global sustainability concerns. On the economic side, investing in emerging markets can be justified by the fact that, historically, returns on emerging markets' bonds, equities and bank loans have been higher than developed country returns on each of these assets (Gottschalk, 2004). Furthermore, investing in emerging markets' assets may bring clear portfolio diversification benefits.

Despite these potential benefits, the SRI investor community points to a number of barriers for acquiring emerging markets' assets in a major way. Most of these barriers are related to pure lack of knowledge about the opportunities emerging markets can offer, and to informational gaps on environmental and social standards in emerging markets. The latter can only be overcome if demand for emerging markets increases to justify the establishment of research organisations that can provide systematic information on these standards (IFC, 2003).

The official sector in industrialised countries could provide incentives to encourage SRI investor community based in their countries to invest in emerging markets assets. For example, they could follow the UK example by modifying pension funds' legislation. They could even set a minimum developing countries' asset holding target to be reached over a certain time frame. Moreover, they could facilitate the establishment by the SRI industry of a set of principles to guide their investment decisions towards emerging markets, in the same way the IFC has done with major internationally active banks, in establishing the Equator Principles on social and environmental issues. The Millennium Development Goals could serve as a basis for the establishment of these principles. They could include supporting economic growth and poverty reduction, by generating jobs and paying at least minimum wages of the country and at the micro level encouraging a company to engage in the provision of health facilities and primary educational programmes, and training to the working force (Gottschalk, 2004; Williamson, Griffith-Jones and Gottschalk, 2003).

5.3 The International Finance Facility

While private capital flows are key to supporting growth in developing countries, there is now an increasingly shared view that substantially larger amounts of aid resources and more effective use of such resources will be needed to scale up efforts to meet the millennium development goals (MDGs) for two reasons. For many of the poorest countries that do not have access to external private capital, aid resources are the primary available means in the medium-term to support the expansion in public investment and social spending needed to meet the MDGs. Even for some middle-income countries aid can play a catalytic and supportive role in enhancing focus and increasing spending targeted to the poorest communities and the attainment of the MDGs.

The best approach to ensure that the needed aid resources to meet the MDGs are available is for donor countries to increase their aid budgets. Many countries have indeed done so in the lead up to and since Monterrey. Five additional countries – Belgium, Finland, France, Ireland and the United Kingdom – have laid out a clear timetable for achieving the 0.7 percent of official development assistance to gross national income target. Given that these and other sources of additional aid flows will take time to materialise, the UK has proposed the establishment of an International Financial Facility (IFF) to frontload the delivery of aid.

Under the scheme, the disbursements of resources raised would be concentrated in the years up to 2015, while the streams of donor's income to the IFF would be distributed over a 30-year period. Not all donors would have to agree to the facility for this to be implemented. And those donors agreeing to the facility would be able to allocate the resources raised linked to their contributions using the existing channels of aid disbursement. Moreover, they would be able to decide to which countries they would allocate such resources.

The IFF is based on four essential components: (i) government backing based on legally binding pledges of future increases in future aid commitments, but with a "high level" condition that would permit donors to suspend payments if recipient countries violated an agreed fundamental condition such as being in good standing with the IMF; (ii) a treasury platform for bond issuance; (iii) governance arrangements for channelling bond proceeds through existing multilateral and bilateral aid programmes; and (iv) repayments of bonds. According to the World Bank (2004a), although subject to the accounting, legislative and other circumstances of individual donors, the IFF appears to be technically feasible. Work is now underway in setting a pilot facility targeted to supporting MDG goals on immunisation. If this effort succeeds, it can provide the basis for a much larger IFF that can bring forward and improve the predictability of aid resources needed to meet the MDGs. Other innovative financing mechanisms are also under consideration. One important array of options are global taxes and voluntary contributions. Some of these options are technically feasible and efficient, but will take time to implement as they are likely to face political opposition. Another innovative approach is to blend aid flows with other forms of financing such as MDB lending to augment resources for targeted MDG spending in both low- and middle-income countries where governments do not have the revenue or borrowing capacity to finance such investments themselves. Together with the delivery of aid flows that have already been pledged, these innovative mechanisms can give much needed impetus to scaling up efforts in all developing countries to meet the MDGs.

6 Increasing the Voice of Developing Countries

An essential ingredient for improving global economic governance is strengthening the voice and participation of developing countries in the decisions of key international institutions and fora. Without adequate representation and voice, decisions reached will be less informed, less legitimate and less effective. The international community has focused increasing attention on the issue in recent years. The Monterrey Consensus adopted in 2002 encouraged the Bretton Woods Institutions (BWIs) to find pragmatic ways to "continue to enhance participation of all developing countries and countries with economies in transition in their decision making". Since then the Development Committee has urged both the Bank and the Fund to step up efforts already taken and to consider and elaborate upon all options with potential for broad support.

Efforts to date and ongoing discussions have spanned three important facets for enhancing voice of developing countries in the decisions of the BWIs: (i) enhancing country-ownership and perspectives in Bank and Fund supported programmes; (ii) greater support for Executive Directors of large multi-country constituencies; and (iii) dealing with structural issues related mainly to voting and capital structure (World Bank 2004b).

For low income countries, the adoption of the Poverty Reduction Strategy (PRS) Initiative represents a major shift in programme formulation and implementation by the BWIs. By providing a sharper focus on country-driven and country-owned poverty reduction strategies, the PRS has started the process of putting developing countries more firmly in charge of the formulation and implementation of their development programmes. While a number of challenges remain to enhance the effectiveness of the approach including further strengthening of the country-driven process, the PRS marks an important and welcome shift towards greater country ownership. The PRS has been supported by increasing decentralisation of staff at the World Bank and by steps that are underway to harmonise donor policies and practices and better align them to country-driven strategies.

A number of steps have also been taken to enhance the capacity of Executive Directors of large multi-country constituencies: (i) the two sub-Saharan African offices, which each have more than 20 countries, have been authorised three additional senior positions; (ii) communications with capitals have been improved; (iii) a secondment programme to the Bank is underway to develop capacity to engage in discussions at the BWIs; (iv) an Analytical Trust Fund has been established with the aim of providing the two sub-Saharan African Directors with independent technical and research support; and (v) a learning programme has been established for staff in Executive Directors' offices. The Bank and Fund have also supported the G-24 as a means to enhance the voice of developing countries in the deliberations and decision making of the BWIs.

The area where shareholder views remain most divided and where there has been least progress relates to the so-called structural issues. The primary focus of these discussions have been on voting structure in the IMF and the World Bank, and the composition of the Board of Executive Directors. Three proposals in particular have been central to this debate:: (i) an increase in the share of basic votes to allow greater representation of smaller economies; (ii) amending of the quota formula to reflect the more rapid growth of some developing economies; and (iii) to add at least one seat for African countries in the IMF and World Bank Boards.

Basic votes currently represent just under 3 percent of total votes compared with around 11 percent at the founding of the BWIs. If it were agreed to return Basic Votes to their original proportion, the developing country share of total votes in the Bank would increase from 40 percent to 43 percent. IMF quotas and the voting structure in the Bank also do not reflect changes that have taken place in relative roles in the world economy over the past 60 years. As Table 1 and Buira (2003) point out, large countries like Brazil, China, Korea and Mexico have a share of quotas that are far below their share of gross domestic product (GDP), whilst countries like Belgium and Switzerland have quotas far larger than their share of GDP. This is true for both GDP measured at market exchange rates and at purchasing power parity, particularly the latter. The third change that would redress a major imbalance is to add at least one additional seat for sub-Saharan Africa to enhance voice and reduce the workload on the two African constituencies that jointly represent 45 countries.

Kelkar *et al.* (2003) have made a proposal for quota and voting power of the Board of the IMF that increases the overall voting share of

Table 1 IMF Quotas and GDPs for Selected Countries
(billions of SDRs and percentages)

	Quota as of December 31, 2002		Share of world aggregate GDP in purchasing power parity, 2002	GDP, 2002 (billions of dollars converted at market exchange rates)
	billions of Special Drawing Rights	As a proportion of total quotas		
Canada	6,369	2.99	2.01	728
People's Republic of China	6,369	2.99	12.67	1,237
Russian Federation	5,945	2.79	2.68	346
Netherlands	5,162	2.43	0.88	449
Belgium	4,607	2.16	0.59	247
Switzerland	3,458	1.63	0.45	268
Brazil	3,036	1.43	2.63	448
Mexico	2,586	1.22	1.90	642
Denmark	1,643	0.77	0.33	172
Republic of Korea	1,634	0.77	1.78	462

Source: Buira (2003), based on IMF World Economic Outlook Database.

developing countries while preserving the dominant weight of industrial countries in quotas. A similar proposal could be applied for the World Bank. In the Kelkar *et al.* proposal, voting power would be determined by weighted averages for PPP-GDP (88.7 percent) and basic votes at the historic ratio (11.3 percent).

As can be seen in Table 2, this would mean that the voting share of developing countries would go up in the IMF from 30.5 percent to 42 percent, thus clearly increasing their voice, whilst developed countries would reduce their voting share from 62 percent to 51 percent, but maintain their majority. Both the US and the EU would retain their veto power. If united, Asian developing countries would also have veto power.

Discussions are continuing between shareholders on how to make progress on this set of interlinked issues. Although there are difficult political tradeoffs entailed, progress on enhancing voice and representation is key to securing the legitimacy and effectiveness of the international financial institutions.

While much of the discussions have been centred on the BWIs, there is a need for a broader approach to enhancing voice of developing countries

Table 2 Present and Proposed Quota and Voting Power[a]
(billions of SDR and percentages)

Country category[b]	GDP-PPP 1997-99 Average in billions of SDR	Present Quota Share	Proposed Quota Share on basis of GDP-PPP	Present Voting Share	Proposed Voting Share on basis of GDP-PPP (87.7%) and BV (11.3%)[c]
Advanced economies	16,303	62.763	55.492	61.768	50.950
Major advanced	13,375	46.030	45.523	45.146	40.811
Other advanced	2,929	16.732	9.969	16.622	10.139
USA	6,315	17.383	21.494	17.030	19.127
Japan	2,282	6.229	7.767	6.110	6.951
EU	5,900	30.106	20.083	29.647	18.740
Developing countries	11,320	29.697	38.530	30.529	42.019
Africa	1,086	5.493	3.695	5.962	6.427
Of which sub-Saharan Africa	873	4.496	2.970	4.952	5.599
Asia	6,181	9.120	21.038	9.250	20.390
Western Hemisphere	2,504	7.456	8.523	7.666	9.536

Notes:
[a] BV stands for Basic Votes; PPP refers to GDP valued at purchasing power parity.
[b] Country categories based upon IMF World Economic Outlook.
[c] Does not add up to 100 percent, as transition economies are not included.
Source: Kelkar *et al.* (2003).

in global economic governance. The representation of developing countries in other fora and informal groupings that have an important role has been quite limited in the past. The extent of participation though has varied significantly from universal or almost full participation in standard setting bodies such as UNCITRAL and IOSCO to virtually none in the case of the BIS, the G-10 and the Financial Stability Forum.

Since the East Asian crisis, a range of steps have been taken to include developing countries in global discussions by giving them representation in existing or new fora or by undertaking more systematic outreach to them when they are not represented. An important example of the former is the establishment of the G-20, which in the five years since it has been established, has become an important forum for policy dialogue and agenda setting on global economic and financial issues between the larger developed and developing countries. Examples of greater efforts at outreach include the OECD, the BIS, the Basel Committee and the Financial Stability Forum. Such efforts are useful, but if standards are to be truly global, it is important to go beyond consultation to full representation of developing countries in bodies that deliberate and set international norms and action plans on the global economic, financial and development agendas.

One such important grouping is the Basel Banking Committee whose members are from the G-10 plus Switzerland. Each of these countries is represented by their central bank and by the authority responsible for banking supervision in that country where this is not the central bank. The composition reflects the world political order in the middle of the twentieth century. There is no representation of emerging market economies and developing countries on the Basel Banking Committee.

Given that the Basel Capital Accord is a global standard that is likely to have a very large impact on emerging economies, and that emerging markets are critical to the global economy, the composition of the Basel Committee needs to be changed. One alternative would be to chose countries in terms of their weight in global GDP. The ten largest economies would bring in China, India, Brazil and either Mexico or Russia to the Committee to join the US, Japan, Germany, UK, France and Italy. The new countries are critical to the global economy and to cross-border bank lending.

Another possibility is that current membership could remain and India, China and Brazil could be added. Alternatively or in addition, one or two representatives per each developing country regions (Asia, Latin America and Africa) could be added for a four-year period. There could then be rotation for different countries to be represented (from each of the three regions). The principle would be similar to the one under which the Executive Boards of the IMF and World Bank operate.

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