EGDI
Expert Group on Development Issues

Summary

What Progress on International Financial Reform? Why so Limited?

Stephany Griffith-Jones and José Antonio Ocampo

The financial crises in East Asia, Russia and Latin America in recent years have had a dramatic impact on a large number of developing countries. Outflows of capital, disruptions in domestic financial systems and terms of trade deterioration have led to slow or negative GDP growth, and to economic welfare decline. The crises have also generated a broad consensus that fundamental reforms are needed in the international financial system. In the aftermath of the crises, the Expert Group on Development Issues (EGDI) asked Stephany Griffith-Jones and José Antonio Ocampo to analyse the emerging international financial architecture from a developing country perspective. This brief is a summary of their findings, presented in EGDI Study 2003:1. The brief also contains a short update on recent developments, for example outcomes of the IMF/ World Bank Annual Meetings in September 2003.

Goals of a new international financial architecture

The paper argues for renewed and broader goals of the international financial architecture. The rationing of poor countries from private financing even during periods of booming capital flows, as well as the significant contraction of private financing to all developing countries since the Asian crisis, implies that, besides the objective of achieving international financial stability, an equally important objective is the provision of adequate capital flows to different categories of developing economies. Thus, the *goals* of a new international financial architecture from a developmental perspective are twofold: (a) to prevent currency and banking crises and better manage them when they occur; (b) to support the adequate provision of net private and public flows to developing countries, including in particular low-income ones. The paper attempts to assess progress on international financial reform in relation to these two goals.

How to fulfil the objectives

To fulfil the two objectives, the international financial architecture must: a) guarantee the consistency of national macroeconomic policies with stability of growth at the global level as a central objective; b) offer appropriate transparency and regulation of international financial loan and capital markets, and adequate regulation of domestic financial systems and cross-border capital account flows; c) provide sufficient international official liquidity in crisis conditions; d) supply accepted mechanisms for standstill and orderly debt workouts at the international level; e) provide appropriate mechanisms for development finance.

The first two mechanisms are essential for preventing crises. The third and fourth mechanisms would help manage crises better to make them less costly, but can also have preventive effects. Development finance is essential to channel flows to low-income countries, in particular the ones that do not have sufficient access to private flows. It is also essential to guarantee an adequate supply of funds to middle-income countries during periods of insufficient private capital flows.

EGDI Studies in Brief summarise recently published EGDI studies. The responsibility for the summary is with the EGDI secretariat.

Problems in progress

Progress so far has suffered four serious problems:

1. There has been no agreed international reform agenda.

Priorities have been set by a few industrialised countries that have not always been explicit and have varied through time. The Monterrey Conference in March 2002 provided, on the other hand, a full international agenda that must become the guide to future developments in this area.

2. Progress made has been uneven and asymmetrical in several key aspects.

The focus of reforms has been largely on the national component of the architecture (strengthening macroeconomic policies and financial regulation in developing countries) while far less progress has been made on the international and, particularly, the regional components. In addition, there has also been an excessive focus on crisis prevention and management, mainly for middle-income countries, which has led to a neglect of the equally important issues of appropriate liquidity and development finance for low-income countries.

3. Some advances in the international financial architecture run the risk of reversal.

4. The reform process has been characterised by an insufficient representation of developing countries in key institutions – such as the IMF, the World Bank and the Bank for International Settlements – and their exclusion from others – the Financial Stability Forum and the G-10 Basel Committees.

Progress on international reforms

The authors evaluate progress on international reforms, differentiating three groups of areas according to the level of progress.

1. An area where visible progress can be noted is the development of codes and standards for crisis prevention in capital recipient countries.

Advances have been particularly important in data dissemination, monetary and fiscal policy transparency, and banking supervision. Nonetheless, institutional, legislative and human resource constraints in implementing these policies have proven to be high and participation of developing countries in developing codes and standards has been low. Among the advances, the design of new IMF financial facilities, particularly the Supplementary Reserve Facility and the Contingency Credit Line, should be included. The Heavily Indebted Poor Countries (HIPC) Initiative, launched in 1996, and the enhanced HIPC approved in 1999, are also major steps towards bringing the external debts of low-income countries to sustainable levels. However, its degree of implementation has been considered to be slow by many poor countries and several analysts, and the scenarios for debt sustainability too optimistic.

2. Partial progress has been made in macroeconomic surveillance and mechanisms to guarantee the coherence of macroeconomic policies.

Progress has been important in this area in relation to preventive surveillance of emerging economies, the development of vulnerability and early warning systems, more regular analyses of financial markets and the design of mechanisms of consultation between the Bretton Woods institutions and private financial actors. One particular area of progress has been the creation of the Financial Stability Forum (FSF) to identify vulnerabilities and sources of systemic risk, to fill gaps in regulations and to develop consistent financial regulations across all types of financial institutions. The common understanding of the principle of "ownership" of macroeconomic and development policies as a guide to international financial co-operation, as well as the agreement on streamlining IMF conditionality, should also be seen as advances.

3. A third group, where no important progress has been made, includes the use of special drawing rights (SDRs) as an instrument of IMF financing.

There have been several proposals in recent years to issue SDRs, either as a countercyclical mechanism to meet the large demand for IMF emergency financing during crises, or on a permanent basis to guarantee, through a multilateral instrument, the increasing demand for international reserve assets. Nonetheless, neither type of proposal has led to action.

Commitments made at Monterrey with respect to Official Development Assistance will hopefully lead to a reversal of stumbling aid flows but represent only a fraction of the resources needed to halve extreme poverty by 2015. Also, only limited commitments have been made on enhancing the role of multilateral development banks in financing low-income countries; providing partial counter-cyclical financing to middle-income countries; acting as catalysts for new forms of private investment; and supporting capacity building, institutional development, and the provision of global and regional public goods.

Finally, the essential role that regional institutions can play in all areas of the international financial system continues to be one of the most prominent items missing from mainstream discussions and agendas on international financial reform.

Grand bargain

To correct the slow pace of reform, the paper suggests that developing countries could attempt to design and offer a "grand bargain" on international and national financial reform that would be attractive to a whole range of actors in developed countries.

First, developing countries could be more keen to implement initiatives of interest to developed economies if rich countries agreed to reform the global financial system in ways that would facilitate more and more stable capital flows to developing countries, and make costly crises in these countries less likely.

Second, the paper argues that the asymmetries in the international financial reform process reflect certain political and political economy characteristics of the world. The most powerful governments (the G-7) have not thrown their weight consistently behind a deep international reform. One of the best ways to support progress on an international financial reform that is more supportive of development would be to strengthen the voice of developing countries in that discussion. To do that, it is important not just to increase participation of developing countries in the key fora, but also to enhance their technical knowledge of increasingly complex issues. In this regard, the authors recommend that a fund or resource centre could be created that would provide systematic, timely and independent support to representatives of developing countries in the boards and fora where the international financial reform agenda is being discussed.

Recent development on international financial reform

In the following and final section one of the authors, Stephany Griffith-Jones, provides an update on recent developments on international financial reform, including some of the outcomes of the 2003 Annual Meetings of the IMF and the World Bank in Dubai September 2003.

The author argues that recently, progress on international financial reforms, seems to have slowed down even further.

Perhaps the most significant, though negative, decision has been the rejection by the IMF Board of proposals for a structured orderly debt work-out - the Sovereign Debt Restructuring Mechanism (SDRM), a proposal that had received strong endorsement previously from IMF management, at the most senior level. It would seem that the main reason behind this rejection may have been the opposition by the private sector, which opposes rules, which they perceive would facilitate debt restructuring. Many analysts, however, believe that the main effects of a mechanism such as SDRM are to facilitate a more orderly restructuring, by overcoming collective action problems. Should the restructuring of the Argentine debt prove very intractable, the SDRM discussion however could return. A second reason that may have contributed to a rejection of the SDRM is that some emerging countries fear that the introduction of such a mechanism could further discourage private flows to them, which are already at a low level.

The author also points to an important innovation that has occurred recently, which is that seven developing countries (including Mexico, Brazil, South Africa and South Korea) have introduced collective action clauses into their recent bond issues. These clauses will facilitate any restructuring of those particular bonds, should this become necessary in the future. It is encouraging that introducing collective action clauses has had negligible or no impact on the pricing of these bonds. Though far less comprehensive than the introduction of the SDRM, the author finds that the introduction of collective action clauses is a positive step.

A source of concern to developing countries is that the proposed new Basel Capital Accord, which is the major regulatory change being introduced since the

Asian crisis, could have negative effects on developing countries. There is important evidence that the impact of Basel 2, if not modified in the final discussions, could increase the cost of international bank lending to developing countries (especially the poorer ones), quite significantly as well as reduce further the already insufficient level of bank lending to these countries. There is also a great deal of concern that Basel 2 could increase severely the pro-cyclicality of lending, both domestic and international, which is particularly damaging for developing economies.

As the approval of Basel 2 approaches rapidly, it becomes very important for modifications to be introduced, that would ameliorate these negative effects. Such changes would be technically correct from a regulatory perspective, as they would reflect the clear diversification benefits of lending to developing countries that are not incorporated into the current proposals.

A further source of possible concern for developing countries is the recent review by the IMF of access policy in the context of capital account crises. The author argues that though it was encouraging that no presumptive limit on cumulative exceptional access was introduced, tighter criteria will need to be met for exceptional access in case of capital account crises. This, and related changes, could potentially lead to delays in approach, that would be counter-productive, in that they could allow crises to deepen.

Another recent development that the author finds encouraging is that the IMF is reviewing its' policy towards countries, especially low-income ones, when they face exogenous shocks, such as due to the deterioration of their terms of trade or natural disasters. The desirability of changes is clear, as at present countries receive no or low conditionality loans to smooth their adjustment, and it is hoped that appropriate instruments will be designed. This discussion will be important in the preparations for the 2004 IMF/World Bank Spring Meetings.

The author concludes on a positive note, by commending an important initiative that has been launched by the UK, to create an International Financing Facility (IFF). This would bring forward a significant increase in aid spending to the poorest countries so as to deploy a critical mass of development finance over the next 10 to 15 years, to facilitate meeting the Millennium Development Goals. It would be even more encouraging, it is argued, if either the IFF were quickly adopted or other measures taken to boost urgently needed development finance.

Overall, however, progress on reform of the international financial architecture continues to be slow and insufficient, and there have been some reversals.

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