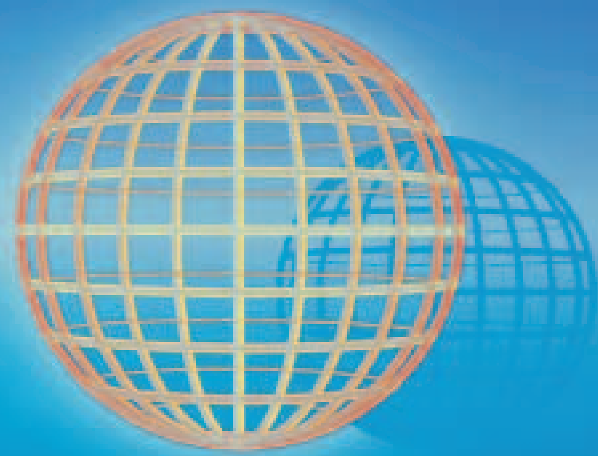

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Foreword

In the aftermath of the recent wave of currency and banking crises in East Asia, Russia and Latin America the Expert Group on Development Issues (EGDI) has asked three authors to analyse the emerging financial architecture and the role of different policy instruments that countries posses for managing the effects of boom-bust cycles. The book contains two separate studies on these issues.

The first study ***What Progress on International Financial Reform? Why so Limited?***, by Stephany Griffith-Jones and José Antonio Ocampo, gives an overview of the emerging international financial architecture and what it brings with regard to achieving international financial stability and provision of adequate capital flows to developing countries. It also discusses the insufficient representation of developing countries in key financial institutions and what can be done to overcome that deficit. The study is a follow up to an EGDI-study released in 1999 on this subject by the same authors entitled *The Poorest Countries and the Emerging International Financial Architecture* (EGDI 1999:4).

The second study ***Counter-Cyclical Prudential and Capital Account Regulations in Developing Countries***, by José Antonio Ocampo and Maria Luisa Chiappe, explores the role of counter-cyclical prudential regulations on domestic financial intermediation, and capital account regulations from a developing country perspective. The paper also highlights the experiences with capital account regulations in the 1990s by Chile, Colombia and Malaysia.

I hope that the two studies will contribute not only to an increased understanding of the issues involved but also to a generation of ideas on how to reform the international financial architecture and national policies to handle boom-bust cycles. All in order to contribute to global poverty reduction, our overarching objective.

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State Secretary

Stephany Griffith-Jones and José Antonio Ocampo

What Progress on International Financial Reform? Why so Limited?

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List of acronyms

ASEAN	Association of South East Asian Nations
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
C and S	Codes and Standards
CCL	Contingency Credit Line
CPSS	Committee on Payment and Settlement Systems
DAC	Development Assistance Committee
ECLAC	Economic Commission for Latin America and the Caribbean
FATF	Financial Action Task Force on Money Laundering
FDI	Foreign Direct Investments
FSAP	Financial Sector Assessment Programs
FSF	Financial Stability Forum
G-7	Group of Seven
G-10	Group of Ten
G-20	Group of Twenty
G-24	Group of Twentyfour
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Countries
HLIs	Highly Leveraged Institutions
IAIS	International Association of Insurance Supervisors
IASC	International Accounting Standards Committee
IFA	International Financial Architecture
IFAC	International Federation of Accountants
IFIs	International Financial Institutions
IMF	International Monetary Fund
IOSCO	International Organizaion of Securities Commissions
IRB	Internal Rating Based (approach)
LDC	Least Developed Countries
MDB	Multilateral Development Banks
NGOs	Nongovernmental organizations
ODA	Official Development Assistance
OECD	Organization for Economic Co-operation and Development
PD	Probability of default
PPP	Purchasing Power Parity
PRSP	Poverty Reduction Strategy Paper
ROSC	Reports on Observance of Standards and Codes
SDRs	Special Drawing Rights (of the IMF)
SDRM	Sovereign Debt Restructuring Mechanism
SMEs	Small and medium-sized enterprises
SRF	Supplementary Reserve Facility
UNCTAD	United Nations Conference on Trade and Development
WB	World Bank

Executive Summary

The recent wave of currency and banking crises that began in 1997 in East Asia generated a broad consensus that fundamental reforms were needed in the international financial system to adapt it to the requirements of the 21st century. 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, in turn, 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: to prevent currency and banking crises and better manage them when they occur, and to support the adequate provision of net private and public flows to developing countries, including in particular low-income ones. In this paper, we attempt to assess progress on international financial reform in relation to these two goals.

To fulfil these objectives, the international financial architecture must provide five different services: a) guarantee the consistency of national macroeconomic policies with stability of growth at the global level as a central objective; b) 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) provision of sufficient international official liquidity in crisis conditions; d) accepted mechanisms for standstill and orderly debt workouts at the international level; and e) appropriate mechanisms for development finance.

The first two mechanisms are essential for preventing crises, which have proven to be developmentally, socially and financially very costly. The third and fourth mechanisms would help manage crises better to make them less costly, but can also have preventive effects, as a system better suited to manage crises is less prone to destabilising capital flows. Finally, development finance is essential to channel flows to countries, especially low-income 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, and the international financial architecture can also provide other important developmental functions.

Progress so far has suffered four serious problems. First, there has been no agreed international reform agenda. Furthermore, the process has responded to priorities set by a few industrialised countries that have not always been explicit and have varied through time. The United Nations Conference on Financing for Development held at Monterrey in March 2002 provided for the first time a full international agenda, which must thus become the guide to future developments in this area. Second, progress made has been uneven and asymmetrical in several key aspects. The focus

of reforms has been largely on strengthening macroeconomic policies and financial regulation in developing countries – i.e., on the national component of the architecture – while far less progress has been made on the international and, particularly, the regional components. Another set of asymmetries relates to the excessive focus of the reform effort on crisis prevention and management, mainly for middle-income countries. Important as this is, it may have led to neglect of the equally – if not more – important issues of appropriate liquidity and development finance for low-income countries. Third, some advances in the international financial architecture run the risk of reversal. Fourth, 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.

This paper evaluates progress on international reform at a disaggregated level, differentiating three groups of areas according to the level of progress in reforms. A first group, where there has been progress, includes the development of codes and standards for crisis prevention in capital recipient countries, by far the area that has been the focus of most attention. 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, particularly for small and poor countries, and participation of developing countries in developing codes and standards has been low.

The design of new IMF financial facilities, particularly the Supplementary Reserve Facility and the Contingency Credit Line, should also be included as an advance, though the latter has not yet been used, reflecting fears of how this would be interpreted by private markets. 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. Nonetheless, 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.

A second group, where partial progress has been made, includes macroeconomic surveillance and mechanisms to guarantee the coherence of macroeconomic policies. It is, indeed, peculiar that macroeconomic policy coordination by major industrialised countries is not even recognised as part of the required reforms of the international financial architecture. 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.

An additional 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. Nonetheless, this advance has been partial due to the limited capacity of the FSF to influence decisions taken by national regulators in capital source countries, and by the lack of participation of developing economies in the main body of the FSF. The proposed modification of the 1988 Basel Capital Accord may represent an advance in aligning banks' regulatory capital with actual risks but is likely to exacerbate pro-cyclical tendencies within the banking system and could further ration lending to developing countries, particularly those (the large majority) that do not enjoy investment grades.

The agreement on the principle of "ownership" of macroeconomic and development policies as a guide to international financial cooperation, as well as the agreement on streamlining IMF conditionality, should also be seen as advances. Nonetheless, the implications of "ownership" have been limited in terms of increasing the effective choices faced by developing countries. This reflects the fact that alternative reform packages are not provided by the Bretton Woods institutions to developing countries that want to diverge from traditional macroeconomic and structural adjustment packages. This highlights the fact that effective "ownership" requires international financial institutions embracing intellectual diversity as a major goal, thus becoming more representative of the heterogeneous views that exist on macroeconomic and development policies.

A third group, where no important progress has been made, includes the use of special drawing rights (SDRs) as an instrument of IMF financing. Indeed, in recent years, there have been several proposals to issue SDRs, either as a counter-cyclical 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. The debate on the design of international debt standstills and workout procedures has advanced, particularly with respect to the use of collective action clauses in bond contracts, but there are still significant differences of opinion on the need for a complementary sovereign debt restructuring mechanism. Also, the tendency to interpret debt workouts as an alternative rather than a complement to emergency financing, and the lack of proposals (such as guarantee funds) aimed at facilitating reinsertion into private capital markets after restructuring, implies that developing countries continue to see the partial approach to this issue as a source of additional risks, – that it could further reduce the already limited access of developing countries to private capital markets.

Commitments made at Monterrey with respect to official development assistance (ODA) will hopefully lead to a reversal of the adverse trend experienced by bilateral aid in recent decades 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 recognition of 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.

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. Such a grand bargain would have two sets of elements. Developing countries could indicate that they would be more keen to implement initiatives of interest to developed economies if, and only if, those 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. Such a bargain would provide incentives for developed countries to make necessary international changes, as they would know that these would ensure the changes they desired to take place in developing countries, and vice versa.

Finally, 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 – and especially their financial authorities – have not thrown their weight consistently behind a deep international reform. Thus, we claim that one of the best ways to support progress on an international financial reform that is more supportive of development and poverty reduction is 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, we 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.

I. What Progress on International Financial Architecture?

1.1 Aims of reform of the International Financial Architecture (IFA): their links to development and growth

The wave of currency and banking crises that began in 1997 in East Asia, then spread to Russia and other emerging markets, and even threatened to spill over to the US, generated a broad consensus that fundamental reforms were required in the international financial system. Particularly during 1997 and 1998, the view became dominant that existing institutions and mechanisms, based on a design made in the mid-1940s, were inadequate for preventing and managing crises in the dramatically changed world of the 21st century, and that a significant reform – as well as strengthening – of global financial governance was urgent.

Besides the objective of achieving international financial stability, an equally important objective, to which insufficient attention has been given, is the provision of adequate capital flows, both private and public, to different categories of developing economies. These flows can complement domestic savings, and provide additional foreign exchange and technology to these economies. This does not imply a return to the excessive levels of easily reversible private lending that characterised the first half of the 1990s, but sufficient levels of stable private and official flows that contribute to higher growth in both low and middle-income countries.

The two major goals for a new international financial architecture from a developmental perspective are thus: a) to prevent currency and banking crises and better manage them when they occur, and b) to support the adequate provision of net private and public flows to developing countries, including in particular low-income ones. In this paper, we attempt to assess progress on international financial reform, in relation to these two goals. In this sense, our paper is broader than most of the literature on the subject, which has focussed on achieving international financial stability and avoiding contagion.

It should be stressed that such a development-oriented international financial architecture would not only benefit developing countries. Stable growth in these countries provides growing markets for developed country exporters and profitable opportunities for developed country investors. More generally, avoidance of crises in developing countries reduces the risk of such crises spilling over to the developed countries. Although small, this risk is significant, as the Latin American debt crises of the 1980s and the combined effect of the Asian and Russian crises of 1997-1998 have shown.

Though changes have taken place, the fact that deep crises have continued to occur, most recently in Turkey and Argentina, indicate that the international financial system now in place clearly needs further changes in the area of crisis prevention and management, in parallel with further improvements in domestic economic policies in developing countries. On top of these issues, the availability of sufficient external finance has emerged as a particularly urgent issue in recent years, given that net private capital flows both to emerging economies and to low-income countries have fallen very sharply since 1997. To the extent that private capital flows do not recover sufficiently (either spontaneously or encouraged by government policies), a greater role would need to be played by official liquidity and development finance. A particular source of concern is that an important part of this decline may be due to structural reasons, and not just to cyclical ones (Griffith-Jones, 2001, and IMF, 2001a). This would imply that net private flows to developing countries could remain very low for a fairly long time period.

1.2 Broad overview of progress so far

Almost five years after the Asian crisis and with new crises still unfolding, it is time to evaluate progress achieved on reforming the international financial system. Some progress has been made, but it is clearly insufficient. The mechanisms that existed previously and the adaptations made in recent years clearly do not fully meet the demands created by financial globalisation.

The extensive debates that have been going on in recent years indicate that the international financial architecture must provide five different services: a) guarantee the consistency of national macroeconomic policies (now regional in the case of European monetary and exchange rate policy), with stability of global economic growth as the central objective; b) appropriate transparency and regulation of international financial loan and capital markets, as well as adequate regulation of domestic financial systems and cross-border capital account flows; c) provision of sufficient international official liquidity during crises; d) accepted mechanisms for standstill and orderly debt workouts at the international level; and e) appropriate levels and instruments of development finance.

The first two mechanisms are essential for preventing crises, which have proven to be developmentally, socially and financially very costly. The third and fourth mechanisms would help manage crises better to make them less costly, but also have preventive effects, as a system better suited to manage crises is less prone to destabilising capital flows. This has indeed been the experience of national financial systems in relation to the lending of last resort by central banks. Finally, development finance is essential to channel flows to countries, especially low-income 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 and, as we will see below, serve also other essential developmental functions. It should be emphasised that these five services can be provided by different mixes of world, regional and national institutions. Thus, the international financial architecture should be seen as a network of institutions that provides such services rather than as a set of world institutions specialised in each of them.

Progress so far has suffered four serious problems.

Firstly, there has been no agreed international reform agenda. Furthermore, the process has responded to priorities set by a few industrialised countries that have not always been explicit and have varied through time. In this regard, the "Monterrey Consensus" of the International Conference on Financing for Development of the United Nations, held in March 2002 (United Nations, 2002), provided, for the first time, an agreed comprehensive and balanced international agenda, which should be used to guide and evaluate reform efforts. The sections of the Consensus on increasing international financial and technical cooperation for development (Par. 39-46), external debt (Par. 47-51) and systemic issues (especially Par. 52-63), are particularly relevant to reforming the IFA.

Secondly, progress made has been uneven and asymmetrical in several key aspects. The focus of reforms has been largely on strengthening macroeconomic policies and financial regulation in developing countries – i.e., on the national component of the architecture – while far less progress has been made on the international and, particularly, the regional components. Indeed, there has actually been general disregard and, in some cases, open opposition to the regional dimension. These are major weaknesses, as crises have not just been caused by country problems (even though these have obviously been important) but also by imperfections in international capital markets, such as herding, that lead to rapid surges and reversals of massive private flows, and multiple equilibria, that may lead countries into self-fulfilling or deeper crises.

Another set of asymmetries relates to the excessive focus of the reform effort on crisis prevention and management, mainly for middle-income countries. Important as this is, it may have led to neglect of the equally – if not more – important issues of appropriate liquidity and development finance for low-income countries. Moreover, the problem of availability of development finance has clearly moved to centre stage for all developing economies. Thus, although some of the reforms adopted will be crucial in the future to help prevent a new wave of crises, at present, and – most likely – for several years to come, the problem is the opposite, namely, insufficient private flows. Therefore, an additional important task is to design measures that will both encourage higher levels of private flows (especially long-term ones) and provide counter-cyclical official flows (both for liquidity and for development finance purposes) during the periods when private flows are insufficient. These important tasks have been relatively neglected in recent years, certainly in the policy field and even in the academic debate. They now require urgent attention.

Within the realm of crisis prevention and management, progress has also been uneven. In the area of crisis prevention, much work has been done in relation to strengthening domestic financial systems in developing countries and in drafting international codes and standards for macroeconomic and financial regulation. Much effort has also concentrated on the review of the Basel Accord on international banking regulation. In contrast, aside from enhanced macroeconomic surveillance of developing country policies and a few ad hoc episodes of macroeconomic coordination among industrialised countries, few steps have been taken to guarantee a more coherent macroeconomic policy approach at the global level. Also, the drafting of new IMF financing facilities has received much more attention than international debt standstills and workout procedures. In the area of IMF financial facilities, frustration has been the hallmark of the design of the new facility to manage contagion, the Contingency Credit Line (CCL). Some advances have been made in redefining IMF conditionality. The IMF quota increase and the extension of the arrangements to borrow, which became effective in 1999, have also been an advance, but several proposals made on the more active use of Special Drawing Rights (SDRs) as a mechanism of IMF financing have not led to action.

Thirdly, some of these advances in the international financial architecture run the risk of reversal. Recently, there has been growing reluctance by developed countries to support large IMF lending (or to contribute bilateral short-term lending) to manage crises better. The main arguments given have been that these large packages lead to excessive moral hazard, which implies that both borrowers and lenders behave more irresponsibly, knowing that they will be "bailed out", and that taxpayer money from industrialised countries should not, in any case, be risked in these operations. These arguments have been vastly overstated, as we will see below, but have been quite influential in recent international action.

Fourthly, as we will see in detail below, the reform process has been characterised by an insufficient participation of developing countries in key institutions and fora. As regards the international financial institutions (especially the IMF, World Bank and BIS – the Bank for International Settlements) more balanced representation needs to be discussed in parallel with a redefinition of their functions. It is also urgent that developing countries be fully represented in the Financial Stability Forum, and in standard-setting bodies, like the Basel Banking Committee, as they will be asked to implement the standards there defined.

In what follows, we will evaluate progress at a more disaggregated level, distinguishing in different cases the three domains of action: national, regional and international. The discussion will differentiate according to the level of progress in reforms. Thus, in section 2, we will focus on areas where there has been progress. Section 3 will deal with those where advance has been very partial, whereas section 4 will deal with those where, although there are several proposals on the table, no significant progress has been made. The division is somewhat arbitrary, as some areas included in the first group have major weaknesses, while there have been some advances in some of the areas that are included in the second and even the third groups.

The first area, where there has been progress, includes: a) the development of codes and standards for crisis prevention in capital recipient countries, by far the area that has been the focus of most attention; b) the design of new IMF financial facilities; and c) the Heavily Indebted Poor Countries (HIPC) Initiative aimed at bringing the external debts of low-income countries to sustainable levels. The group where partial progress has been made includes: a) macroeconomic surveillance and mechanisms to guarantee the coherence of macroeconomic policies; b) improvements in worldwide regulatory standards; and c) the redefinition of conditionality. Finally, the third group, where no important progress has been made, includes: a) the use of SDRs as an instrument of IMF financing; b) the design of international standstills and workout procedures; c) development finance; and d) regional schemes in all areas of the financial architecture. The lack of adequate participation of developing countries in global financial governance should be added to the latter group.

1.3 Representation of developing countries in international financing institutions and fora

Indeed, a very important reason for slow progress in reforming the international financial architecture and the inherent asymmetry in the measures taken has been the limited participation of developing countries in the fora where reform has been discussed, and – more generally – in the institutions of global financial governance. As a consequence, enhancing the participation of developing countries in these institutions would have one particularly vital advantage. It would imply a significantly greater impulse for necessary changes in the global financial architecture. These changes, and the resulting positive impact on global financial stability and growth, would not just benefit developing countries; they would also have significant direct and indirect benefits for the developed world.

There are, naturally, other very important benefits of greater developing country participation in global financial governance. First, developing countries would enjoy a stronger voice. Second, international institutions would benefit from enhanced legitimacy; after all, developing countries represent 85 per cent of the world's population and a significant proportion of global GDP, especially when measured using Purchasing Power Parity (PPP) methodologies. Finally, greater participation by developing countries in global financial governance would ensure greater commitment by these countries to open markets, an aim shared by developed countries.

Since the Asian crisis, participation of developing countries has emerged as an important issue. However, actual progress on it has been very limited.

Two new fora have been created to support the process of international financial reform. One is the Financial Stability Forum (FSF). Unfortunately, the composition of the FSF is very problematic as developing countries are excluded (except major financial centres – Hong Kong and Singapore), even though they have some ad-hoc participation (by invitation only) in the Working Parties. The FSF has also recently started to organise outreach regional activities, such as meetings in Asia and Latin America. However, full participation by some developing countries has not been granted, even though when the Forum was established by the G-7, they stated that "while initially the FSF would be limited to G-7 countries, it is envisaged that other national authorities, including from emerging economies, will join the process at some stage."(Griffith-Jones, 2000)

In contrast, the other forum, the G-20, was created to facilitate dialogue between a broader group of countries on international financial reform, partly as a response to criticism of the G-7 as an exclusive grouping. Its composition was carefully designed to include those developing and transition countries whose size or strategic significance gives them a particularly crucial role in the global economy. They include ten developing countries, nine industrial ones (including the G-7) plus Russia.

The existence of a forum where developed and major developing countries' most senior financial authorities can informally exchange views and explore policy responses is clearly valuable. Some concrete progress has also been made at the G-20 on specific modifications to the international financial architecture of interest to developing countries, such as changes to IMF and World Bank lending facilities. However, there are major limitations in the way this forum has operated until now. The main one is the fairly narrow orientation of its formal agenda, which should thus be broadened. It should ideally comprise key subjects on reform of the international financial system, including systemic issues, such as enhanced liquidity and development finance, as well as better coordination of macroeconomic management at the world level. A far more ambitious agenda could transform the G-20 from a body useful at a fairly basic level, to one with the potential to make a truly valuable contribution to the reform of the international financial system. Another important limitation is that small and low-income countries are not represented at all.

More broadly, for enhanced participation by developing countries it is firstly important to increase developing country influence in the institutions to which they belong, but where they are under-represented due to existing governance structures, such as the IMF and the World Bank Group. Second, it is essential to expand significantly the participation of developing countries in the Bank for International Settlements, where important but still insufficient progress has taken place in the second half of the 1990s. Third, and perhaps most importantly, developing countries should be included on a rotational basis in crucial fora from which they are currently excluded, including the Financial Stability Forum and the Basel Committees.

The governance problem at the heart of the IMF, namely the outdated and complex quota system, has yet to be properly addressed. The Cooper Report on Fund quotas[1] proposes a new quota calculation system that has positive aspects, but would increase the voting power of some of the already powerful countries and decrease that of many of the poorer countries. An alternative proposal could be based on elements such as the restoration of the importance of basic votes, and the use of PPP-based GDP estimates, as the combination of both elements would help correct the underrepresentation of developing countries in the Executive Board, and therefore also in the International Monetary and Financial Committee.

The voting power of an IMF member has two components. As a symbolic recognition of the principle of the legal equality of states, and to help ensure participation of smaller and poorer countries, each member country has 250 basic votes. Each member also has one additional vote for every 100,000 SDRs of its quota. Because the number of basic votes has not increased as quotas have grown, the ratio of basic votes fell from around 11 percent of the voting power of the 45 founding members in 1944 to less than 3 percent in the 1990s, even though the number of countries tripled. Restoring the share of basic votes to the original 11 percent would require a more than fivefold increase in the basic vote of every country. More ambitious solutions would assign basic votes a larger share of total voting rights. Furthermore, the use of PPP-based GDP estimates in the quota formulas, in order to avoid the current underestimation of the economic size and ability to contribute to quotas of developing economies, would also enhance the role of developing countries in the IMF Board.[2]

An additional measure that would improve Fund governance would be to reform the constituency representation on the Executive Board. For example, the number of chairs allocated to the Sub-Saharan African countries, which are only two in total, could be increased to three. A similar analysis can be applied to the World Bank Board, where basic votes could also be increased and PPP GDP could play a larger role in calculating shares. It should be emphasised that in the case of the World Bank it would be easier to change shares and representation, as there is no formal quota system. Also, there is the relevant precedent of regional development banks like the Inter-American Development Bank, where developing country borrowers have slightly over 50 percent of the vote.

Another matter of grave concern is the clearly insufficient participation of developing countries in the Bank for International Settlements, an institution that is increasingly important, due both to its technical excellence

[1] "Report to the IMF Executive Board of the Quota Formula Review Group", submitted in April 2000.

[2] See, on these issues, Buira (1999).

and the growing significance of its main mandate, the pursuit of financial stability. Since the mid-1990s, there has been increased involvement of developing countries in this institution. However, it seems important and urgent to: a) ensure participation of developing countries in the Board of the BIS; b) ensure greater – and more formalised – participation of developing countries in crucial meetings, for example in monthly meetings of Central Bank Governors; c) increase the number of developing country staff in the BIS (including some LDC participation); and d) expand the number and types of developing countries included in the BIS, also including representation from low-income and small countries.

Equally important, developing countries should be represented in the crucial fora where they currently have no voice, and where important decisions that affect them are being taken. As mentioned, this would certainly include the Financial Stability Forum and the Basel Banking Committee. Although efforts to increase ad-hoc consultation with developing and transition economies, which these bodies have increasingly carried out in recent years, is clearly welcome, it is no substitute for appropriate and formal representation. Developing countries could be included in these fora on a rotational basis, without significantly increasing the size of these groups and therefore not jeopardising their effective working methods. For example, there could be two representatives per developing country region (Latin America, Asia and Africa), who would be nominated for two years and then rotated.

Specifically on the Basel Banking Committee and its recent work on the New Basel Accord, it would appear that the lack of systematic representation from developing countries has impacted negatively on the nature of their analysis and their recommendations. The proposals in the New Accord, particularly those related to the use of banks' internal risk management systems, would seem to be driven largely by major G-10 international banks. However, this is not necessarily good for the stability of the international financial system in general, nor for the developing world in particular. Many negative impacts of these proposals on developing countries have not been properly addressed, due to lack of participation by developing countries.

2. Areas of Progress

2.1 Codes and standards for macroeconomic policy and financial sector regulation in capital recipient countries

One of the aspects which the international community has stressed most for crisis prevention is the development of codes and standards for macroeconomic policy and financial sector regulation in capital recipient countries. As we will discuss in more detail below, there has been far less (and insufficient) emphasis on improvements in global regulations, especially regulations in source countries.

As regards implementing codes and standards (C and S) in developing and transition countries, the main targets are strengthening domestic financial systems and promoting international financial stability by "facilitating better-informed lending and investment decisions, improving market integrity, and reducing the risk of financial distress and contagion" (Financial Stability Forum, 2000). The content of the standards largely reflects concerns arising out of recent crises, though they often also build on past initiatives involving mainly developed countries. As Cornford (2001) has argued, the development of standards could be viewed as part of a process of "groping towards a set of globally accepted rules for policy which could provide one of the pre-requisites for provision of international financial support for countries experiencing currency crises". They would thus become an international analogue of national rules for financial sectors, compliance with which would facilitate the availability of lender of last resort financing. However, at present, there is no international lender of last resort, nor even automatic limited international liquidity in times of crisis. Indeed, developing countries' compliance with C and S would probably increase if counterpart actions were taken towards providing abundant and unconditional official liquidity during crises caused by contagion (see below).

As regards C and S, the Financial Stability Forum (FSF) has compiled 65 of them; of these, the FSF has identified priority C and S in 12 subject areas. These are detailed in Table 1.

In order to assess progress in the implementation of C and S, the IMF has been charged with preparing, with relevant authorities of countries, Reports on Observance of Standards and Codes (ROSC). This process is a modular one with observance of the separate codes or standards assessed independently. As of December 2000, 83 ROSC modules had been produced for 32 countries, with 67 being published (see Table 2), with some 100 modules being added in 2001. As can be seen from Table 2, the greatest progress in the observance of codes and standards has been in four areas: data dissemination; fiscal transparency; monetary and fiscal policy transparency, and banking supervision. In some instances these reports represent free-standing processes; in others they have emerged as by-

Table 1. Key standards for sound financial systems

Subject Area	Key Standard	Issue by
Macroeconomic Policy and Data Transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices in Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard/ General Data Dissemination Standard	IMF
Institutional and Market Infrastructure		
Insolvency	Principles and Guidelines on Effective Insolvency Systems	WB
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)	IASC
Auditing	International Standards on Auditing (ISA)	IFAC
Payment and settlement	Core Principles for Systemically Important Payment Systems	CPSS
Market integrity	The Forty Recommendations of the Financial Action Task Force	FATF
Financial Regulation and Supervision		
Banking supervision	Core Principles of Effective Banking Supervision	BCBS
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance supervision	Insurance Supervisory Principles	IAIS

Source: FSF website http://www.fsforum.org/Standards/KeyStds.html

products of the Fund's regular surveillance activities under Article 4 or derived from the Financial Sector Assessment Programs (FSAPs) carried out by the Fund and the Bank. The FSAP is a vast and costly exercise (both financially and in terms of human resources), even on the current scale, which is providing only partial coverage (24 countries by 2001). If more countries and areas were included, the exercise would become far larger and costlier.

Developing and transition governments are broadly supportive of the activities concerning C and S, which they see as valuable in the long term.[3]

[3] See, on this issue, Acharya, (2001).

Table 2. ROSC modules completed and published by 4 December 2000

Data Dissemination	Fiscal Transparency	Monetary and Financial Policy Transparency	Banking Supervision	Insurance Regulation	Securities Market Regulation	Payments Systems	Corporate Governance
Argentina Albania Australia Bangladesh Bulgaria Czech R. Hong Kong Russia Tunisia Uganda UK	Argentina Australia Azerbaijan Bulgaria Cameroon Czech. R. France Greece Hong Kong Pakistan Papua New Guinea Russia Sweden Tunisia Turkey Uganda Ukraine UK	Argentina Australia Bulgaria Cameroon Canada Colombia Czech R. Estonia France Hong Kong Iran Ireland Lebanon Russia South Africa Tunisia Uganda UK	Algeria Argentina Australia Bahrain Bulgaria Cameroon Canada Colombia Czech R. Estonia Hong Kong Iran Ireland Lebanon South Africa Tunisia Uganda UK	Cameroon Canada Estonia Ireland South Africa	Canada Czech R. Estonia Ireland South Africa	Cameroon Canada Estonia Ireland South Africa	Malaysia Poland Zimbabwe
Total completed 11	18	18	18	5	5	5	3
Total Published 9	17	13	13	4	4	4	3

Source: World Bank (2001)

There are, however, important differences in the degree of enthusiasm about implementing C and S. Paradoxically, the former Argentine authorities were enthusiastic supporters and this country was thus one of the most active in implementing C and S, yet this proved clearly insufficient in supporting domestic financial stability; obviously, major macroeconomic problems determined this result.

This confirms the serious concern expressed by many developing countries about the extent to which implementing C and S would be actually meaningful in avoiding crises. A related concern accepted in recent IMF and World Bank documents is that C and S had on the whole too much of a “one size fits all” element, and that not enough account was taken of countries’ specific features, institutions and history. Another complex issue is that whilst countries – and increasingly IFIs – want a more nuanced and sensitive assessment of C and S, the private markets have a preference for simple (or simplistic) quantified assessments, that can be directly integrated into risk assessments systems and that can allow for cross-country comparisons and rankings.

It is also the view of the smaller and poorer countries that, while C and S are important, the rhythm of implementation required is very high, and that they face especially large institutional, legislative and – above all – human resource constraints in implementing so many standards. This implies that technical assistance to them may be very helpful, though it will not by itself be able to overcome the problem.

Perhaps two of the main concerns of developing countries are that C and S should remain voluntary and that C and S are defined mainly in G-7 or G-10 fora, with insufficient participation of and input from developing countries. However, more recently there has been some effort by these standard-setting bodies, and especially by the Fund and the World Bank, to consult more with developing countries through the process of defining standards and with respect to problems in their implementation. However, the issue of fuller participation of developing countries in standard setting remains very important.

2.2 The design of new IMF financing facilities

During the 1990s, capital account liberalisation and the large scale of private capital flows greatly increased the need for official liquidity to deal with sudden and large reversals of flows. As a result of the 1997-1998 Asian and Russian crises, IMF resources were significantly enhanced. This facilitated the provision of fairly large financial packages that helped in the management and containment of crises, though the conditionality applied was often problematic.

Particularly, two new facilities were designed as a result of these crises. The first was the Supplementary Reserve Facility (SRF), which facilitated the provision of fairly large, more expensive, relatively short-term loans to countries hit by crises. Indeed, the SRF provides financial assistance for exceptional balance of payments difficulties due to large short-term financing needs resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the member's reserves. The SRF was useful in providing large loans to countries like South Korea and Brazil, once they were hit by major crises.

Contrary to the relative success of this new facility, several of the G-7 countries have recently expressed their wish to establish limits on the scale of lending through the SRF. Potential borrowers rightly do not wish such limits to be set up, as in a multiple equilibrium situation they could diminish the effectiveness of the SRF in restoring market confidence and thus lead to deeper crises in individual countries, as well as more risk of contagion to other countries. Thus, delays in granting IMF support or loans of an insufficient size may well lead to a worse outcomes than more rapid IMF lending in adequate quantities. Recent events in Latin America can be interpreted in this light. Delays in IMF negotiations with Argentina are one of the factors that led to a hypersensitivity of financial markets to developments in South America and, therefore, to a stronger regional contagion during 2002 than was originally expected (ECLAC, 2002c). This seems to have led to a renewal of large-scale IMF lending to South America in mid-2002, which, nonetheless, has been slow in restoring confidence.

The second facility created after the Asian and Russian crises was a preventive one, the Contingency Credit Line (CCL). As the IMF defined it, the CCL was created as "a precautionary line of defence readily available against future balance of payments problems that might arise from international financial contagion". For a country to qualify to draw on it, the increased pressure on the recipient country's capital account and international reserves must thus result from a sudden loss of confidence among investors triggered by external factors (for a detailed description of the CCL and initial criticisms see Griffith-Jones, Ocampo with Cailloux, 1999).

The creation of the CCL was a potentially very important and positive step because it could significantly reduce the chances of a country entering into a crisis, by providing contingency lending agreed in advance. However, the problem is that – at the time of writing, three years after its creation – no country has applied to use it. This is the case, even though terms and conditions have been somewhat modified to make the CCL more attractive to borrowers. These include less demanding requisites for the country to meet when negotiating it, expeditious review of the country's policies when it seeks to activate the CCL (though also a post-activation review, where future policies will be agreed), and a reduction in the commitment fee and in the surcharge for drawing on the CCL (for more details, see Kenen, 2001). Clearly, these modifications have proven insufficient in generating a demand for this credit line.

The key problem is that countries with "good" policies, and which are perceived as such, fear that there could be a stigma attached by the markets if they applied for a CCL. In particular, countries fear being the first to apply on their own for a CCL, as they are concerned that the application could be counter-productive, and reduce – rather than strengthen, as is the intention – market confidence in that country.

To make this facility more attractive, and diminish or eliminate any potential stigma attached to it, some modification could be introduced. Particularly, it could be agreed that all countries that have been very favourably evaluated by the IMF in their annual Article 4 consultations would automatically qualify for the CCL, giving a country a right to draw on the CCL should the need arise. This would imply that quite a large number of countries – including the developed ones – would qualify for the CCL (even though few would use it), thus eliminating the current stigma on its use. This proposal is quite similar to one being suggested by the UK Treasury, whereby after a positive evaluation in Article 4 consultations a country would automatically become eligible for the CCL; in this latter variant, the country would still have to apply for the CCL, but it would make this step far easier, because it would already know it was eligible. The fact that countries would be named as eligible for the CCL by the IMF would make it a sign of strength (indicator of good policies), rather than – as currently feared – a request for a CCL being seen as a sign of possible future weakness. An important virtue of this type of approach is that both developed and developing countries could either be granted access to the CCL or be eligible to CCL loans, if the need arose in future. The fact that countries could have access to the CCL would hopefully diminish the likelihood of crises and therefore the need for countries to draw on it.[4]

Other complementary steps could be taken to encourage use of the CCL. One would be to persuade several developing and/or transition economies to apply simultaneously, to eliminate the first applicant fear. Another possible step, also being evaluated by the UK Treasury, is that a target could be given to the IMF (e.g. a certain number of countries joining the CCL before the end of 2003). This would follow a similar targeted approach used for progress on HIPC programmes, which worked very well in that case. It seems also a constructive and interesting idea, though in the CCL case, it may be more difficult for the IMF to implement it, as countries would be more reluctant to apply, whilst HIPC countries were keen to use the corresponding Initiative.

[4] Reportedly an actual commitment to a CCL loan to developed countries is problematic in the sense that significant IMF resources would have to be reserved against possible use of such a CCL. This seems unjustified, as the possible use of the credit line would not be associated (in fact, it should be negatively associated) with the number of qualified countries. It is thus important to guarantee that qualification for the CCL (as we propose) or eligibility (the UK Treasury suggestion) would not require extra reserves from IMF funds.

2.3 The Heavily Indebted Poor Countries (HIPC) Initiative

The launching of the Heavily Indebted Poor Countries (HIPC) Initiative in 1996 and the approval of the enhanced HIPC Initiative in September 1999, following the Cologne G-7 Summit, have been major steps in the solution of the debt overhang of poor countries. Advances in this area serve also as a contrast to the significant lag in the design of multilateral mechanisms to face debt overhangs of middle-income countries (see section 4 below).

As of January 2002, 24 out of the 42 highly indebted poor countries had reached the "decision point" of the Initiative, at which interim relief begins and eligible countries commit to adopt a Poverty Reduction Strategy through a participatory process, the basic condition for advancing to the "completion point". At that date, only four countries (Bolivia, Mozambique, Tanzania and Uganda) had reached this stage, at which debt relief is irrevocably committed. For the 24 countries, debt relief in net present value terms represents USD 22 billion, nearly half of their total debt. Together with more traditional debt relief mechanisms, it is expected that these countries will experience a 62 percent reduction of external indebtedness in net present value terms. With respect to debt service effectively paid, debt relief is less substantial: USD 2.0 billion a year in 2001–2003 vs. USD 2.9 billion in 1998–1999 (World Bank, 2002).

Aside from the complex issues associated with the conditionalities involved (see section 3 below), several criticisms have been levied against this Initiative, which relate to the characteristics of the debt relief mechanisms, its inadequate financing, and its long term effects on access to financial markets.[5] With respect to the first of these problems, it has been claimed that the three-year period between decision and completion points is too long. More importantly, it has been argued that scenarios for debt sustainability (average GDP growth of 5.5 percent and average export growth of 8.6 percent over the next decade) are too optimistic and do not take into account external shocks and uncertainties that low-income countries face. Also, there are no binding arrangements for non-Paris Club (particularly commercial) creditors to ensure adherence to the HIPC Initiative terms, and the cutting point for liabilities eligible for reduction (the first Paris Club re-negotiation) excludes a significant amount of debts in some countries. For all these reasons, even the enhanced HIPC Initiative may not provide sufficient debt relief to enable countries to permanently eliminate their debt overhang and to achieve the development goals agreed

[5] See, for example, United Nations (2002 b) "Summary of Conclusions of the Interregional Meeting on Financing for Development organized by the Regional Commissions of the United Nations", January 2002 (http://www.un.org/esa/ffd/0102reg-conclusionsmexico.pdf); and Botchwey (2000).

in the United Nations Millennium Declaration (particularly, halving extreme poverty by 2015). Additionally, it has been argued that eligibility criteria are too stringent and have resulted in exclusion of countries whose economic and social conditions are very similar to HIPC countries.

Inadequate financing has led to developing, including many poor and middle-income, nations having borne a large share of the costs of the Initiative, either directly (when they are creditors to HIPC countries) or indirectly (through higher spreads of World Bank loans, or reduction of technical assistance from multilateral development banks). Also, many regional and sub-regional banks have heavy costs which have been inadequately funded from the HIPC trust account, seriously affecting their financing and technical assistance activities.

Finally, the Initiative is paradoxical in terms of the history of debt rescheduling mechanisms. Indeed, a traditional assumption of debt rescheduling is that it should facilitate renewed access to financial markets, by bringing debt service to manageable levels. Although this assumption is not always fulfilled, the HIPC Initiative explicitly forbids countries from accessing private markets for a long time period (up to two decades). This reflects the fragile external and fiscal sustainability position of most HIPC countries, and the concern of the official creditors that they do not enter into an unsustainable debt situation again, as well as the potential for moral hazard on the side of both private lenders and HIPC countries. However, this condition may also be seen as the counterpart of what is effectively an insufficient debt relief, which may thus reduce the positive impact of the Initiative on growth and development in HIPC countries. An additional implication is that these countries will be subject to an equally long period of conditionality. This stresses the importance of how the PRSP process is managed, guaranteeing an effective respect for ownership and diversity of development strategies.

3. Areas of Partial Progress

3.1 Macroeconomic surveillance and mechanisms to guarantee the coherence of macroeconomic policies

The emphasis on the need to strengthen the regulatory environment in which financial markets operate has not been matched by a similar focus of attention on the coherence of macroeconomic policies worldwide. The major issue in this regard is guaranteeing that the externalities that macroeconomic policies generate for other parts of the world economy are adequately internalised by policy makers in the industrialised world. Expressing it in the terms of the Group of 24 (2000b), there is an "imperative need for better coordination, coherence, and mutual reinforcement of macroeconomic and structural policies among the three major economies in order to reduce the risks and uncertainties in the global economy". From the point of view of developing countries, the risks associated with movements in the exchange rates of major currencies are a major problem and reflect a paradoxical feature of current arrangements: the fact that the value of *international* monies is determined by *national* policies.[6]

In this area, actions have been limited to the regular meetings of finance ministers and central bank governors of the Group of Seven. The meetings of the IMF International Monetary and Financial Committee and of central bank governors in the BIS also provide opportunities to jointly review events in the world economy. Consultations have led to some positive coordinated policies, such as the interest rate reductions in 1998 following the Russian crisis, and similar moves following the September 11, 2001, terrorist attack on the United States. Nonetheless, major exchange rate misalignments among the dollar and the euro have been the feature of the international economy in recent years and lags in interest rate reductions by the European Central Bank have been viewed by the IMF and many other institutions as an ingredient in the worldwide recession of 2001.

In any case, the absence of macroeconomic coordination among the major economies in the regular reports by the IMF on reforms of the international financial architecture indicates that this issue is not viewed as an ingredient of the required reforms. Nonetheless, the IMF provides regular reports on the major economies based on Article 4 consultations, as well as regular publications of the *World Economic Outlook*, where events in these economies are a major focus of attention. The most important advance in this area has been the more regular analyses of financial markets and new mechanisms of consultation with private financial actors. The excellent quarterly review

[6] See also Group of 24 (2000a) and a different point of view in Council on Foreign Relations (1999).

of emerging financial markets, which started to be published in the second semester of 2000, is a case in point.

The surveillance of developing country policies is, of course, a regular practice of the IMF, both as part of the Article 4 consultations and in the reviews of financing arrangements with specific countries. Probably the most important advance in this area has been the more preventive focus that has been placed on Article 5 consultations. Countries have also been pressured to release the reports of these consultations, and many have followed this guideline. The design of the CCL includes a more direct link between Article 5 consultations and access to this facility. This may serve, once the CCL becomes an active facility, to correct the asymmetric features of IMF macroeconomic surveillance during booms and busts, particularly the limited relevance of surveillance during booms.

As part of the design of codes and standards, some have been adopted in the areas of fiscal and monetary policies (see above), as well as guidelines on management of international reserves and foreign debt policies. An interesting element in this process has been the widespread use of new indicators of vulnerability, particularly the ratio of short-term external debt to foreign exchange reserves. This is the result of work on vulnerability indices and early warning systems, on which important progress has also been made.

3.2 Strengthening world regulatory standards

As pointed out above, one of the key functions to be met so that a globalized financial system works effectively to sustain both stability and growth, is that of appropriate transparency and regulation of international financial loan and capital markets.

Capital and credit markets have become increasingly integrated between countries, in what is becoming an increasingly internationalised market; these markets have also become more integrated amongst each other, as big financial conglomerates combine activities in banking, securities, insurance and other financial fields.

For regulation to be efficient, it is essential that the domain of the regulator is the same as the domain of the market that is regulated. Ideally, this would imply the need to create a world regulatory authority, as Kaufmann (1998), and Eatwell and Taylor (2000) have suggested. However, this seems at present unlikely, both because of the complexity of the task, and because of the unwillingness of national governments and regulators to give up sovereignty on this issue.

A second best alternative to creating a global regulatory authority is to significantly improve exchange of information and coordination amongst regulators, both across countries and across financial sectors. In the last two decades, there have been initial steps in this field, mainly via the three Basel

Committees, of which the main one is the Banking Committee, which have started to generate, via soft law, common regulatory standards that are initially applied by the regulatory authorities of the countries participating in the Committees, and then – either by peer encouragement, or by pressure from the IMF and the World Bank and/or from the markets – are implemented by developing and transition regulatory authorities.

As pointed out, the 1997–1998 crises in emerging markets led to a very important institutional innovation: the creation of the Financial Stability Forum 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. Through its Working Parties, the FSF has produced high quality reports, such as the one on capital flows, and the one on highly leveraged institutions (HLIs). The former had numerous recommendations for measures to be applied by developing countries, many of which have begun to be implemented. The latter had important proposals to be implemented by source countries, though in an initial stage it did not suggest applying a system of direct regulation of currently unregulated institutions. However, the FSF Working Party did recommend important improvements on far greater transparency of hedge funds and other HLIs. Even these rather modest, though important steps, have not been implemented, because in the US – the major country where HLIs operate – Congress rejected two bills for improved transparency (White, 2000).

This outcome illustrated two significant weaknesses in the operation of the FSF. One is its limited ability to influence decisions to be taken by national regulators, especially in source countries. The second is the total lack of participation of developing and transition economies in the main body of the FSF. This poses not just problems of legitimacy, but also of efficiency, as it accentuates the types of asymmetries in the international financial system. It is also disappointing that even though key figures have supported developing country membership in the FSF, this has not been implemented; a far less satisfactory, though obviously positive step has been to increase outreach activities of the FSF, including regional meetings (see above).

The potentially most important regulatory development since the 1997–1998 crises in emerging markets is the proposed modification of the 1988 Basel Capital Accord, which could have profound impacts both on international bank lending (its level, cost and cyclicality) to developing countries and on bank lending (its cyclicality and distribution) within developing countries.

Whilst the effects on developing countries are not central to the new Basel Capital Accord (both because its aim is to try to align banks' regulatory capital requirements with actual risk, and because developing countries have no representation in the Basel Banking Committee), very significant effects of the new Accord would be felt in developing countries. This is particularly problematic given the fact that bank lending to developing countries has become negative since the Asian crisis (BIS, 2001). Serious concerns existed that the January 2001 proposal could have large net negative effects on developing countries. Later modifications, especially those introduced in November 2001, have dealt with some of the problems, and somewhat diminished others. This is encouraging. Nonetheless, the possibility that the proposed new Basel Capital Accord could further discourage lending to developing countries is still a matter of great concern.

The key proposed changes relate to the measurement of credit risk. In the proposed Accord, there would be two basic approaches, the standardised and the internal rating based (IRB) ones.[7] The new standardised approach addresses several previous concerns raised by developing countries, for example by reducing the incentive towards short term lending. However, the IRB approach, if implemented in its current form, could have important negative implications.

The first problematic aspect is that the proposed IRB approach could further reduce international bank lending and increase costs of such lending to developing countries, particularly those (the large majority) that do not have investment grades.[8] Both effects would institutionalise increased perceived risk.

Secondly, and equally seriously, the proposed IRB approach would exacerbate pro-cyclical tendencies within the banking systems. The drive for risk weights that more accurately reflect the probability of default (PD) is inherently pro-cyclical; during an upturn, average PD falls, and the IRB approach, based on banks' internal risk models, would reflect lower capital requirements; during a downturn or recession, average PD will increase, as deteriorating economic conditions cause existing loans to "migrate" to higher risk categories, therefore raising overall capital requirements. As it is difficult to raise capital in a recession, this may lead to a credit crunch, which would further deepen the downturn. Concerns about the increased pro-cyclicality of the proposed new Capital Accord are widespread (see, for example, Goodhart, 2002).

Increasing pro-cyclicality would go against what is increasingly accepted as best practice, which is to introduce a neutral or counter-cyclical element into regulation, so as to counteract the natural pro-cyclicality of banking and capital markets (BIS, 2001; Borio, , 2001, Ocampo, 2002; Ocampo and Chiappe, 2003). For developing countries, increased pro-cyclicality of bank lending is particularly damaging, given that this increases the likelihood of crises, as well as their development and financial cost.

[7] For a more detailed discussion of these issues see Griffith-Jones, Spratt and Segoviano (2002). See also Griffith-Jones and Gottschalk (2002) for views of the Basel Committee and the Bank of England

[8] For different estimates of potential cost increases, see Reisen (2001) and Powell (2001).

The Basel Committee seems to have accepted this criticism, and is reportedly planning to include measures to combat pro-cyclicality in the next consultative proposal.

A new Basel Capital Accord proposal that would overcome some of the problems listed above should include some of the following elements: a) possible postponement of the IRB approach, for further research and improvement of internal bank models; b) if the IRB approach is to be implemented, capital requirements should be lowered for low-rated borrowers, which include most developing countries; this would imply a significant flattening of the IRB curve; c) a special curve for small and medium-sized enterprises (SMEs) is being considered by the Basel Committee; if that is implemented, the possibility of a separate curve for developing countries should be seriously studied, to avoid excess discouragement of bank lending, and to more accurately reflect the risk of lending to them, particularly the benefits of diversification; and d) serious attention given to counter-cyclical elements, to mitigate the inherent pro-cyclicality of the IRB approach.

Possible negative effects of the proposed Basel Capital Accord could also take place within developing countries – unless sufficient modifications are introduced – as domestic bank lending could become more pro-cyclical, and access to banks including by SMEs could become even more difficult (for the latter, see Lowe and Segoviano, 2002).

3.3 The redefinition of conditionality

One of the most important conclusions reached in recent debates on international financial issues is that conditionality is ineffective or at least an inefficient means to attain objectives that the international community wishes to attach to financial support. So long as there is no true "ownership" of the policies involved – i.e., so long as they are not backed by strong domestic support – they are unlikely to be sustained. This is strongly associated with the fact that "ownership" is essential to institution building, which is generally recognised today as the clue to successful development policies.

In the case of the IMF, conditionality has long been a central area of contention. However, in recent years – and even decades – the issue has become increasingly troublesome for three different reasons. Firstly, the scope of conditionality has been gradually expanded to include domestic economic and social development strategies and institutions which, as the United Nations Task Force has indicated, "by their very nature should be decided by legitimate national authorities, based on broad social consensus".[9]

[9] United Nations Executive Committee on Economic and Social Affairs (1999), Section 5.

The broadening of conditionality to social policy, governance issues and private sector involvement in crisis resolution has been criticised by developing countries in the Group of 24.[10] The need to restrict conditionality to macroeconomic policy and financial sector issues is shared by a broad group of analysts with quite different persuasions as to the future role of the IMF.[11] A similar view was expressed in the external evaluation of surveillance activities of the Fund.[12]

It must be emphasised that similar issues have been raised in relation to development finance. With respect to this issue, a 1998 World Bank report that analyses the success of structural lending, according to its own evaluation, comes to the conclusion that conditionality does not influence the success or failure of such programmes.[13] Nonetheless, according to the same report, aid effectiveness is not independent of the economic policies that countries follow. In particular, the effects of aid on growth are higher for countries that adopt "good" policies, which, according to their definition, include stable macroeconomic environments, open trade regimes, adequate protection of property rights and efficient public bureaucracies that can deliver good-quality social services. Curiously, the study draws the conclusion that conditionality "still has a role – to allow government to commit to reform and to signal the seriousness of reform – but to be effective in this it must focus on a small number of truly important measures".[14] This statement is certainly paradoxical if the conclusions of the report are taken at face value.

These arguments and controversies have been instrumental in the acceptance of "ownership" as a central feature of ODA (OECD/DAC, 1996) and, more recently, of IMF and World Bank programmes (Köhler and Wolfensohn, 2000). They also led to the agreement that IMF conditionality should be streamlined,[15] a subject which was discussed by the IMF Board in 2001, based on an internal evaluation of experience with conditionality (IMF, 2001b). This evaluation recognised that structural conditionality had indeed been overextended, particularly in relation to the reform processes of transition economies and during the Asian crisis. Moreover, it accepted that ownership of adjustment programmes is essential for IMF emergency

[10] Group of 24 (1999).
[11] Council on Foreign Relations (1999), Meltzer *et al.* (2000), Collier and Gunning (1999), Feldstein (1998), Helleiner (2000) and Rodrik (1999).
[12] Crow, Arriazu and Thygesen(1999).
[13] See World Bank (1998), Ch. 2 and Appendix 2. See also Gilbert, Powell and Vines (1999) and Stiglitz (1999).
[14] World Bank (1998), p. 19.
[15] See International Monetary and Financial Committee (2000) and Köhler (2000). The difficulties are associated with the fact that, although the IMF is expected to focus on macroeconomic and financial issues, it should also look at "their associated institutional and structural aspects". Such a broad definition led to the increasing scope of conditionality over the past two decades.

financing to function properly and, therefore, that conditionality should "not intend to infringe on national sovereignty" (Par. 2). However, it also clearly stated that an essential element of IMF policies should be to safeguard the Fund's resources, for which conditionality was required (Par. 9).

A major weakness of both reports is a lack of a clear understanding of the way conditionality effectively works to reduce, eliminate or distort "ownership". The mechanism is not – or, at least, not always, or not mainly – an imposition by the IMF or World Bank staff or the Boards of these institutions. Rather, four additional channels are crucial: a) the conditions on which financing is available severely constrain the choices countries face; b) under crisis conditions, possible World Bank or IMF support affects internal discussions within governments, increasing the negotiating power of groups that are inclined to the points of view of those institutions; c) the technical support that the institutions provide to countries also biases internal discussions; and d) involvement by the staff of these institutions in internal discussions has a similar effect.

A major issue in this regard is the considerable confusion regarding the term "structural reforms". Indeed, there are at least two meanings of the term that are relevant to the debate on conditionality. The first refers to institutional factors that directly affect *macroeconomic* balances, i.e., balance of payments equilibria (e.g., inconsistent exchange rate regimes, or a capital account that has been liberalised without adequate prudential provisions) or public or private sector deficits (e.g., problems in the design of decentralisation, a poorly regulated domestic financial system, etc.). The other refers to institutional factors that may be important for the functioning of the economies but have a more indirect effect on macroeconomic balances: in the terminology of the IMF paper on conditionality, factors that determine the "efficiency and resilience of the economy". World Bank and IMF structural reforms have a particular understanding of what is desirable in this regard: liberalised economies are more "efficient" and "resilient".

The discussion thus critically hinges on this distinction. Structural macroeconomic balances can be produced, and in fact have been produced in the past, in economies with high degrees of public sector intervention. Also, considerable academic debate still goes on as to whether more liberalised economies are superior in terms of their resilience, their efficiency and their ability to grow. We know that vulnerability may, in fact, increase with liberalisation, particularly vulnerability to capital account shocks; without adequate correction for market failures, efficiency is not guaranteed; and liberalised economies do not necessarily grow faster. A well-known paper by Rodríguez and Rodrik (2001) makes this point clear: macroeconomic stability is essential for growth but more liberalised economies (particularly in relation to trade) do not necessarily grow faster. Furthermore, this paper shows that traditional measures of opening that have been extensively used in IMF analysis are clearly inadequate.

This implies that "ownership" requires meeting several additional conditions: effective alternative reform packages should be available to countries; such alternatives should be provided by the Bretton Woods institutions with the same technical rigour as traditional reform programmes; these institutions should be ready to provide such support when asked to do so; for this purpose, the composition of IMF and World Bank staff should be representative of the heterogeneous views that exist on structural and macroeconomic adjustment, and these institutions should be ready to call organisations or economists who think differently to support the design of alternative programmes. This clearly means that IMF conditionality should be restricted to macroeconomic policies, and that a *strong negative presumption* should be established against *any* form of structural conditionality that goes beyond factors that directly hinge on macroeconomic balances. It also means that "ownership" can only be promoted by an effective plural discussion on the virtues of alternative types of "structural reforms" (i.e., alternative to the traditional liberalisation packages), explicitly promoted by both institutions.

Some of the problems outlined above, and the need for an alternative understanding of policy "ownership", are reflected in the recent history of the Poverty Reduction Strategic Framework for HIPC and other low-income countries. This process, and the papers (PRSPs) that materialise countries' strategies within this framework, undoubtedly represent important advances in international cooperation, as frameworks for coordinating donors under the leadership of recipient countries, and for promoting national dialogues in these countries. In this regard, they follow principles that are now widely accepted for the relations between donor and recipient countries (see the analysis of development finance in section 4). On the other hand, PRSPs have also been viewed as a mechanism adding a further layer of conditionality associated with a complex process (indeed, a case in which not only content but processes are subject to conditionality), which simply "repackages" structural conditionality, thus in fact providing very limited degrees of freedom for poor countries to adopt alternative development strategies. This mechanism has also been seen as generating additional risks of micro management by multilateral institutions and bilateral donors.

These problems are underscored in a recent UNCTAD (2002) report on Africa, which concludes that: "The emphasis on ownership and participation appears to aim at granting considerable autonomy to countries in the design of safety nets and targeted anti-poverty spending programmes. However, freedom of action of recipient governments in the determination of the nature and content of macroeconomic stabilisation and structural adjustment programmes, or more generally of their development strategies, continues to be severely constrained by conditionalities. In fact, new governance-related conditionalities have been added to those traditionally considered as pertaining to the core competences of the Bretton Woods institutions"

(p. 58). It is thus essential to closely review progress in the implementation of PRSPs to guarantee ownership, diversity and effective recipient country control.

Finally, it should be added that the inclusion of social criteria in the design of IMF and World Bank programmes, particularly the focus on poverty reduction, represents a significant improvement in the programmes of both institutions. However, this should *not* be understood as an argument for increased conditionality either. Furthermore, in this regard, there is the risk that conditionality will end up spreading one particular set of views of how to organise social programmes in the developing world, and not necessarily the most adequate one. In particular, the question of how to take social issues seriously into account in adjustment programmes is not only a question of designing adequate safety nets; indeed, this compensatory view of the role of social programmes has been seriously questioned.[16] It is, even more importantly, a question of mainstreaming the social implications in the design of macroeconomic policy and structural reforms.

[16] See United Nations, Executive Committee on Economic and Social Affairs (2001).

4. Areas of Inadequate Progress

4.1 The active use of SDRs

The creation of Special Drawing Rights (SDRs) in 1969 was a major result of international financial debates in the 1960s, both those associated with the North-South negotiations and controversies among industrialised countries about the international role of the US dollar. Two series of allocations have been made since 1970, the last of which was finalised in 1981. A proposal for a one-time allocation of 21.4 billion SDRs was made in September, 1997. The United States has veto power over such allocations.

The creation of SDRs was a major advance in the design of the international financial system. Particularly, it created a truly world money, to be used exclusively as a reserve asset, thus generating a more balanced distribution of seignorage powers. In a world characterised by the use of the national currencies of major industrialised countries as international monies, the accumulation of international reserves generates, in fact, a redistribution of income from developing countries to the major industrialised countries. Despite the move towards floating, the accumulation of international reserves by developing countries has experienced large-scale growth in recent years, largely associated with the demands created by increasing international financial volatility. Paradoxically, SDR allocations were suspended when the demand for reserves by developing countries grew. This adverse distributive factor has thus become increasingly important.

Also, over the past two decades, the increasing need for IMF funds to finance their services has been satisfied by increases in quotas and arrangements to borrow. As these funds have been clearly insufficient, major rescue packages have involved additional bilateral contributions from major industrialised countries. This process has two major weaknesses. First, it makes such rescue operations dependent on decisions by a specific set of countries, a fact that reduces the multilateral character of IMF support and introduces discretionary elements in an area which should certainly be rules-based. Secondly, it reduces the stabilising effect of rescue packages if the market deems that the intervening authorities (the IMF plus the additional bilateral support) are unable or unwilling to supply funds in the quantities required (see the analysis on IMF financing facilities in section 2).

Proposals to renew SDR allocations have been increasing in recent years. They follow two different models. The first is the temporary issue of SDRs during episodes of world financial stress, which would be destroyed once financial conditions normalise (see, United Nations Executive Committee on Economic and Social Affairs, 1999; Council on Foreign Relations, 1999;

Ocampo, 1999 and 2002; and Camdessus, 2000).[17] This procedure would develop a counter-cyclical element in world liquidity management, as a reduction in private lending would be partly compensated by increased official liquidity. At the same time, it would avoid creating additional long-term liquidity at the world level, since the normalisation of private lending would be reflected in repayment of extraordinary IMF loans, which would lead to a parallel destruction of the SDRs through which they were financed. Therefore, this proposal would solve the problems of adequately financing extraordinary IMF requirements, but not the distributive issues associated with the uneven distribution of seignorage powers.

The second variant focuses on the latter issue, and thus regards SDR allocations as a counterpart to the increasing demand for international reserve assets. Allocations would thus be permanent. It is interesting to note that several proposals of this type see such allocations as the means to finance other international objectives, particularly the provision of global public goods and international development cooperation. This is, indeed, the nature of the proposals made to the United Nations Conference on Financing for Development by the Zedillo Panel of Experts (Zedillo , 2001), as well as of recent statements by George Soros and Joseph Stiglitz. Similar associations between SDR allocations and international cooperation were made in the 1960s and 1970s and were rejected at the time. It must be emphasised, however, that the argument for permanent allocation is independent of proposals on the specific use of funds.

No formal negotiations have begun on the possible implementation of either of these two groups of proposals.

4.2 International debt standstills and workout procedures

Although no actions have been adopted, the extensive discussions on the need for international rules on debt standstills and orderly workout procedures seem to be leading to some agreements. As is well known, such mechanisms are required to avoid the coordination problems implicit in chaotic capital flight, to guarantee an appropriate sharing of adjustments between lenders and borrowers, and to avoid "moral hazard" issues associated with emergency financing. In international discussions, UNCTAD (1998, 2001) has presented the most consistent and strongest defence of mechanisms of this sort. In turn, recent proposals by the IMF (Krueger, 2001 and 2002), and the discussions of this issue in the IMF Board, the International Monetary and Financial Committee and in different country groupings, have speeded up the international debate. In some proposals by developed countries, it has figured prominently as an explicit alternative to large rescue packages.

[17] See, also, for similar proposals, Ezekiel (1998), Ahluwalia (1999) and Meltzer (chair) (2000).

There is, however, opposition from developing countries, which consider that this mechanism would impair the volume and conditions of their access to private capital markets (Group of 24, 2002), as well as private sector opposition in industrialised countries to non-voluntary arrangements (Institute of International Finance, 2002).

Furthermore, due to the practical difficulties involved in designing a mechanism of this sort, there are considerable disagreements on its desirable features.[18] As summarised by the International Monetary and Financial Committee (2000) and Köhler (2000), these difficulties are associated with the need to strike a balance between broad principles, needed to guide market expectations, and operational flexibility, which requires elements of a "case by case" approach. The relative role of voluntary negotiations by the parties vs. the interventions required to solve the collective action problems involved is also subject to heated debates. In any case, a purely contractual approach is clearly insufficient, and thus a debt restructuring mechanism of some sort is required to facilitate uniformity of interpretation, and to create an international judicial entity that would verify creditors' claims, the resolution of disputes, and the supervision of voting (Krueger, 2002).

Among the issues involved, the first relates to the introduction of collective action clauses in debt contracts in order to facilitate eventual renegotiations. The most delicate issue in this regard is the possible discrimination against countries or group of countries that adopt them. For this reason, such clauses should be *universal*. Thus, the G-7 countries must actually lead the process, as they suggested in October 1998, shortly following the Russian crisis (Group of Seven, 1998). In this regard, recent support for this mechanism by the Group of Ten (2002), although welcome, unfortunately focuses on emerging market debt rather than universal provisions, thus generating risks of adverse discrimination by private agents against emerging economies. Some industrialised countries (such as the UK, Canada and, as it has been announced, the European Union) have taken steps to introduce such clauses into their own bond issues, but important countries (especially the US) unfortunately have not. Exit consent clauses can also play an important role.

There is broad agreement that declaration of a standstill by the debtor country should be voluntary but, as already mentioned, there is still considerable disagreement on a SDRM (Sovereign Debt Restructuring Mechanism) that would give such standstills legitimacy and avoid disruptive legal processes. Although, due to the effect on their credit rating, debtor countries are unlikely to abuse a possible mechanism of this sort, its use

[18] See a review of some of the controversies involved in IMF (1999, 2000a, 2000b), Boorman and Allen (2000) and Fischer (1999).

should be subject to control to avoid moral hazard on the side of borrowers. The IMF seems to be best placed to play this role, particularly if the provisions of Article 6 of the Articles of Agreement are interpreted as providing the basis for such a mechanism to be put in place.

It is also agreed that negotiations should be voluntary, and should include in an integral manner public and private sector debts. An international mediator or, possibly, arbitrator could facilitate negotiations. However, in this regard, the IMF is not the appropriate international agent as, due to its status as a lender, it fails to meet the "neutral mediator" requirement. So, a different institution would have to play that role, probably within the United Nations system. An alternative would be for the IMF to have the power to convene independent international panels to play such roles – following similar practices in the World Trade Organisation – on the principle that it would accept their recommendations. In any case, as an international judicial entity would be required to play certain functions (see above), it might be easier to give the same institution the role of mediator/arbitrator, including the possibility of convening such panels.

Seniority should be granted to lenders who facilitate funds during crises and indeed such "bailing in" operations could be a requirement to benefit from restructuring, as it is typical in national bankruptcy procedures. Agreements that include automatic rescheduling provisions for likely events (e.g., a price collapse in a commodity-dependent country) could also be encouraged. A very controversial issue relates to whether IMF and multilateral bank lending should be included in renegotiations. In any case, lending by IFIs should be given automatic seniority, as these institutions are clearly involved in "bailing in" counter-cyclical operations.

There is also broad agreement that capital controls must be in place in debtor countries throughout the process and during the post-crisis period.[19] Also, capital controls on inflows in developing countries facing a rapid build-up of debt should be encouraged early on by the IMF as a result of its preventive surveillance activities.

The most controversial issue relates to the relation between this mechanism and rescue packages. Indeed, as already noted, some industrialised countries have supported this mechanism as an alternative to rescue packages. There is a clear case for this view when countries face *solvency* problems (i.e., unsustainable debt burdens), but it is more debatable when *liquidity* issues are involved.[20] Indeed, due to the multiple equilibria considerations

[19] This covers only one possible case for capital controls. For a broader discussion of this issue, see Ocampo and Chiappe (2003).

[20] This view is implicit in recent proposals by the IMF, which refer to "timely restructuring of unsustainable… debts" (Krueger, 2002; emphasis added). However, these proposals avoid analysing what is the adequate balance between debt workouts and emergency financing, including who judges what are unsustainable debt burdens.

that characterise liquidity crises, emergency financing is essential for supporting "good equilibria" results. The clearest case is that in which liquidity constraints, by reducing investor confidence and forcing countries (or firms, in a national context) to pay excessively high interest rates, effectively lead into a solvency crisis. Alternatively, in order to avoid borrowing at high interest rates under a liquidity crisis, countries could adopt very restrictive macroeconomic policies that may lead equally to a loss of confidence by investors, as they perceive that dwindling domestic resources would be insufficient to service debt payments, or that political support would be lacking for full payment of the external debt. Although some domestic policy issues were certainly involved, the recent Argentine crisis had some elements of these multiple equilibria issues.

It should be emphasised that there are alternatives to debt standstills for countries facing liquidity constraints. In particular, during both the Korean and the Brazilian crises, regulatory authorities in the industrialised countries strongly encouraged commercial banks to renew short-term credit lines to these emerging economies.

These considerations imply that, although an international orderly debt workout procedure would certainly help, adequate regulation of capital flows in the source countries and macroeconomic surveillance will continue to play the most important role in avoiding moral hazard by both lenders and borrowers. The basic complementary role that adequate regulation, lending of last resort and debt workouts play in preventing and managing crises has been accepted for decades in domestic policies. It is hard to understand why they still tend to be seen as substitutes in international financing.[21]

Indeed, an alternative system would significantly increase market instability and/or "solve" moral hazard issues by increasing spreads or severely rationing financing to developing countries. The recent experience shows, indeed, that the large rescue packages of the 1990s have been serviced normally. This indicates that the problems faced by the emerging economies that led to large-scale emergency financing had an important (and, in some country experiences, a dominant) element of illiquidity rather than insolvency, a fact that argues for more rather than less emergency financing.[22] The case against emergency financing also underestimates the threat that developing country crises can pose for global financial stability, and greatly

[21] There are obviously differences between domestic and possible international bankruptcy procedures. Particularly, in domestic crises, there is collateral, a fact that implies that capital owners are facing actual risks. This is unlikely to be as important in international bankruptcy procedures.

[22] This does not mean that other structural issues were involved, but rather that liquidity issues were the major ingredient in the *sudden* stop of external financing.

overestimate the risks involved in providing funds, as indeed not a single cent has been lost by taxpayers of industrialised countries in such operations.

Finally, it must be argued that multilateral credit support mechanisms, particularly by multilateral development banks (MDBs), would be required during the period following debt renegotiation. As an essential role of such support should be to catalyse the reinsertion of countries into private capital markets, a possible mechanism could be a guarantee fund managed by MDBs. This mechanism would guarantee private sector lending to private or public sector borrowers in the affected countries with adequate provisions (partial guarantees, higher in the initial years, at an appropriate cost). This issue has not been included in recent debates and should thus be added as an integral element of any international debt workout scheme.

This analysis implies that, aside from the debate on the complementarity between the contractual and statutory (SDRM) approaches, on which much of the recent debate has concentrated, it is necessary to adopt a broader framework to overcome the legitimate fears of developing countries that a partial solution to this problem would impair their access to financial markets. A broader solution would imply viewing debt workouts as a complement rather than a substitute for emergency financing, and the design of specific mechanisms that would facilitate reinsertion of developing countries into private capital markets after restructuring.

4.3 Development finance

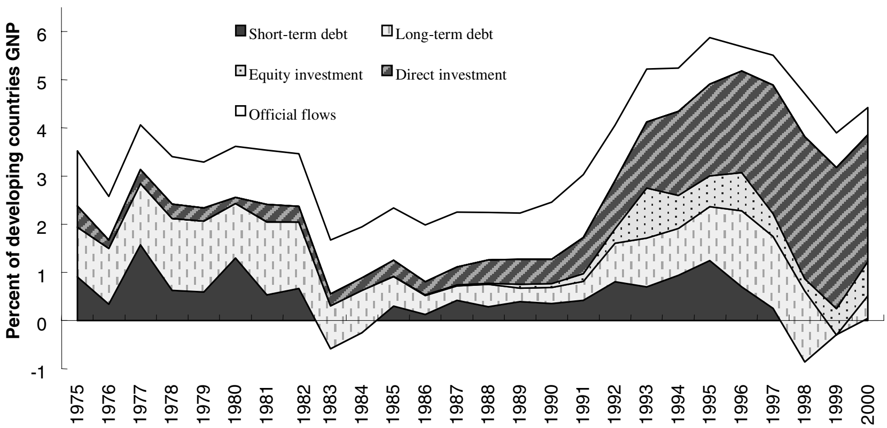
The issues of volatility of private capital flows and contagion have been at the centre of discussion on the international financial architecture in recent years. However, they only capture some of the most problematic features of international finance. Another worrisome issue, the marginalisation of the poorest countries from private capital flows, is equally important. These countries depend on official development assistance, whose largest component, bilateral aid, has lagged behind.

The significant lag in official capital flows during the 1990s is shown in Figure 1. In particular, bilateral aid has fallen in real terms, leading to a strong relative reduction: from 0.35 percent of the GDP of industrialised countries in the mid-1980s to 0.22 percent in 1998–2000, i.e., one-third of the internationally agreed target of 0.7 percent of GDP. Trends are not uniform, however. Some countries – Denmark, Netherlands, Norway and Sweden – meet that target. A few increased ODA in the 1990s, particularly the UK in the late 1990s. The overall trend and the low current level of ODA are thus largely determined by the evolution of aid flows from a few large countries, particularly the United States.

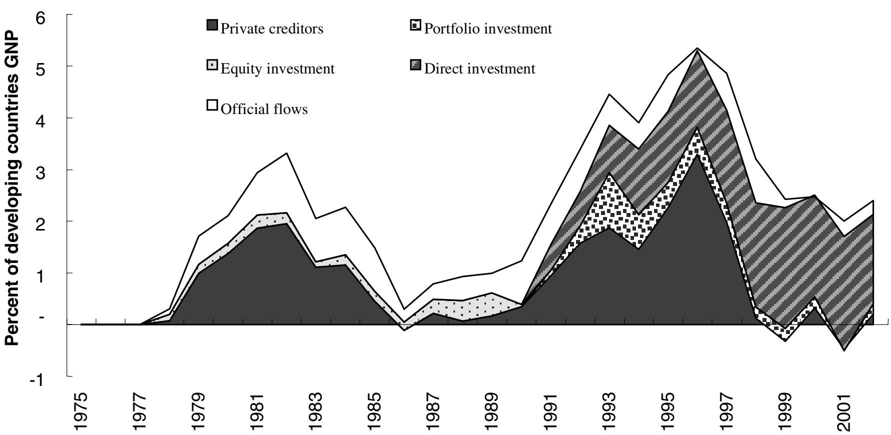
Figure 1 also shows the strong volatility of private capital flows, in particular short-term debt but also long-term debt and equity flows. These private flows experienced a strong decline during the Asian crisis and have

Figure 1. Net flows to developing countries

A. World Bank estimates: 1970-2000



B. Institute of International Finance estimates: 1978-2002



Source: ECLAC, based on World Bank and Institute of International Finance data.

never recovered. Thus, although the initial reduction was viewed as a sign of volatility, it led to more permanent regime change in terms of the availability of private financing. This has been accompanied by deterioration in the conditions – spreads, maturities and options – under which such financing is provided. Therefore, the evolution of private financial flows may be viewed as characterised by two different cycles: a short-term one, associated with volatility in the strict sense of the term, and a mediumterm cycle, in which phases of "risk appetite" are followed after some years by periods of strong risk aversion. The only steady source of private external financing has been foreign direct investment. Even in this case, however, the strong upward trend characteristic of the 1990s was interrupted at the end of the decade and has been followed by a moderate decline, particularly during the recent world recession.

The strong concentration of private capital flows in middle-income countries is shown in Table 3. The share of low-income nations in private financing has been lower than their share in the total population of developing countries, but also lower than their share in developing countries' GDP. This fact is particularly striking in bond financing, commercial bank lending and portfolio flows, if India is excluded in the latter case. In all these cases, private financing to poor countries is minimal. A striking feature of FDI is its high concentration in China, which captures, on the other hand, a smaller proportion of financial flows. The high concentration of the most volatile flows in middle-income countries, excluding China, has implied, in turn, that issues of financial volatility and contagion have been particularly relevant to them.

Low-income countries have thus been marginalised from private flows and have depended on declining official development assistance, particularly grants coming mostly in the form of bilateral aid. If we again exclude India, this is the only component of the net resource flows to developing countries that is highly progressive, in the sense that the share of low-income countries in net flows exceeds not only their share in developing countries' GDP but also population. This is also marginally true of multilateral financing, excluding the IMF.

Due to the importance of ODA in financing of low-income countries, this issue has received significant attention in recent debates. Commitments made at the United Nations Conference on Financing for Development in March 2002 will lead to a reversal of the adverse trend experienced by bilateral aid in recent decades. Nonetheless, these commitments represent only a fourth of the $50 billion aid requirements estimated by the Secretary-General of the United Nations (and similar estimations by the World Bank) to halve extreme poverty by 2015 and would equally remain below the target of 0.7 percent of GDP, which was reiterated at the Conference. The third United Nations Conference on Least Developed Countries, held in 2001, as well as the Monterrey Conference, also reconfirmed the specific target of 0.15–0.20 percent of GDP of industrialised countries to be provided as ODA to LDCs.

The principles on which aid should be given have also been subject to significant discussion in recent years. In this regard, the 1996 OECD guidelines on ODA were an important step forward. The Monterrey Consensus contains a set of agreements that summarise recent international debates (United Nations, 2002a). If fully applied, they will certainly change

Table 3. Net flow of resources, 1990–1999 (annual averages, USD billions and percentages)

	Direct foreign investment		Porfolio equity flows		Grants		Bilateral financing		Multilateral financing (excluding IMF)		Bonds	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage
Developing countries	**103.7**	**100.0**	**27.6**	**100.0**	**29.8**	**100.0**	**4.2**	**100.0**	**15.8**	**100.0**	**30.6**	**100.0**
Excluding China	75.4	72.7	24.7	89.5	29.5	99.0	2.6	61.9	13.9	88.0	29.4	96.0
Low-income countries	*10.2*	*9.8*	*3.9*	*14.1*	*15.2*	*51.0*	*2.4*	*57.1*	*6.7*	*42.4*	*1.7*	*5.6*
India	1.5	1.4	1.7	6.1	0.5	1.8	0.0	0.0	1.1	7.2	0.7	2.2
Other countries	8.7	8.4	2.2	8.0	14.7	49.2	2.4	57.1	5.6	35.2	1.0	3.4
China a/	*28.3*	*27.3*	*2.9*	*10.5*	*0.3*	*1.0*	*1.6*	*38.1*	*1.9*	*12.0*	*1.2*	*4.0*
Middle-income countries	*65.2*	*62.9*	*20.8*	*75.4*	*14.3*	*48.0*	*0.2*	*4.8*	*7.2*	*45.6*	*27.7*	*90.4*
Argentina	6.6	6.4	1.1	4.0	0.0	0.1	–0.2	–4.8	1.1	7.0	4.9	15.9
Brazil	10.9	10.5	2.8	10.1	0.1	0.2	–0.8	–19.0	0.6	4.0	2.6	8.5
Mexico	8.2	7.9	3.8	13.8	0.0	0.1	–0.4	–9.5	0.5	3.3	4.2	13.7
Indonesia	2.1	2.0	1.6	5.8	0.3	0.9	1.3	31.0	0.6	3.8	0.9	2.8
Korean Republic b/	2.6	2.5	3.7	13.4	0.0	0.0	0.4	9.5	0.8	5.1	4.9	15.9
Russian Federation	1.8	1.7	0.8	2.9	0.8	2.7	1.1	26.2	0.7	4.3	1.6	5.4
Other countries	33.0	31.9	7.0	25.4	13.1	44.0	–1.2	–28.6	2.9	18.1	8.6	28.2

	Commercial bank loans		Other loans		*Net long-term resource flows*		*Short-term debt net flows*		Total net resource flows		Memo:	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	GDP Percentage	Population Percentage
Developing countries	**17.1**	**100.0**	**4.0**	**100.0**	**232.8**	**100.0**	**22.6**	**100.0**	**255.4**	**100.0**	**100.0**	**100.0**
Excluding China	16.6	97.1	1.1	27.5	193.2	83.0	21.7	96.0	214.9	84.2	88.2	74.8
Low-income countries	*0.8*	*4.7*	*0.4*	*10.0*	*41.3*	*17.7*	*0.7*	*3.1*	*42.0*	*16.4*	*17.1*	*46.7*
India	0.5	2.9	0.1	2.5	6.1	2.6	–0.4	–1.8	5.7	2.2	6.3	19.4
Other countries	0.3	1.8	0.3	7.5	35.2	15.1	1.1	4.9	36.3	14.2	10.8	27.3
China a/	*0.5*	*2.9*	*2.9*	*72.5*	*39.6*	*17.0*	*0.9*	*4.0*	*40.5*	*15.9*	*11.8*	*25.2*
Middle-income countries	*15.8*	*92.4*	*0.7*	*17.5*	*151.9*	*65.3*	*21.0*	*92.9*	*172.9*	*67.7*	*71.1*	*28.1*
Argentina	0.6	3.5	–0.1	–2.5	14.0	6.0	3.4	15.0	17.4	6.8	4.5	0.7
Brazil	5.2	30.4	–0.4	–10.0	21.0	9.0	1.0	4.4	22.0	8.6	11.0	3.3
Mexico	2.6	15.2	–0.3	–7.5	18.6	8.0	0.3	1.3	18.9	7.4	6.7	1.9
Indonesia	0.2	1.2	–0.1	–2.5	6.9	3.0	0.9	4.0	7.8	3.1	2.9	4.1
Korean Republic b/	–0.9	–5.3	–0.1	–2.5	11.4	4.9	5.9	26.1	17.3	6.8	7.0	0.9
Russian Federation	0.2	1.2	2.0	50.0	9.0	3.9	–0.8	–3.5	8.2	3.2	7.6	3.1
Other countries	7.9	46.2	–0.3	–7.5	71.0	30.5	10.3	45.6	81.3	31.8	31.4	14.1

Sources: World Bank, Global Development Finance 2001, CD-ROM version and World Development Indicators 2001, CD-ROM version, (for GDP and population data).

a/ The World Bank considered China a low-income country until 1998. Since 1999 it is included as a middle-income country. In this Table it is considered as a separate category.

b/ The World Bank considers it a high-income country, but it is included as a middle-income country in Global Development Finance 2001.

the aid relationship in a significant manner. They are based on the principles of effective partnership between donors and recipients, national leadership and ownership of development plans, and a central focus on poverty reduction (Par. 40). Following this approach, the Consensus includes commitments on: harmonisation of operational procedures to reduce transaction costs and make disbursements and delivery more flexible; untying aid; designing budget, procurement and other support mechanisms to enhance the absorptive capacity of recipient countries and the effectiveness of aid; increasing the use of local technical assistance resources; using ODA to leverage additional financing for development; and strengthening South-South cooperation (Par. 43 of the "Monterrey Consensus[23]"). It must be noted, however, that some of these objectives have been part of the international agenda for a long time – e.g., untying aid and South-South cooperation – with only modest progress having been made so far. Thus, the follow-up to these commitments within the annual review of commitments of the Conference will be essential to guarantee a significant advance in this area.

Contrary to the importance given to ODA, the role of multilateral development banks (MDBs) has been subject to less attention. In this regard, the most controversial proposal was made in 2000 by the Meltzer Commission of the United States Congress: to phase out multilateral bank lending to developing countries with access to private capital markets, thus transforming the World Bank into a World Development Agency focused on low-income countries, with grants as the essential financing instrument (Meltzer (chair), 2000). It furthermore suggested that finance should be provided directly to suppliers rather than governments. In response to this report, the United States Department of the Treasury (2000) strongly supported the existing role of MDBs. In this regard, it not only defended the essential responsibilities of these institutions vis-à-vis poor but also middle-income countries, associated in the latter case with their fragile access to private capital markets. The U.S. Treasury also defended the role of large-scale lending by those institutions during crises, to support fiscal expenditure in critical social services and financial sector restructuring. It argued, in any case, for a focus of the MDBs on areas of high development priority, larger contributions to soft windows, more selective lending to emerging economies and eventual graduation of these countries from development assistance.

The Bush Administration has insisted on a larger component of grants in MDB financing and graduation of middle-income countries, and has pushed for raising productivity of developing countries as the central priority of

[23] United Nations, 2002 a , *Monterrey Consensus*, International Conference on Financing for Development, March, www.un.org/esa/ffd/aconf198-3.pdf

these institutions, an important change in relation to the poverty-reduction focus that was the central feature of debates on MBDs in recent years (O'Neill, 2001). President Bush proposed that the World Bank should move to 50 percent grant financing to poorest countries (Bush, 2001). It must be emphasised, however, that this would require a strong commitment by the donor countries to transfer regularly at least a similar amount of resources to avoid de-capitalisation of the Bank.

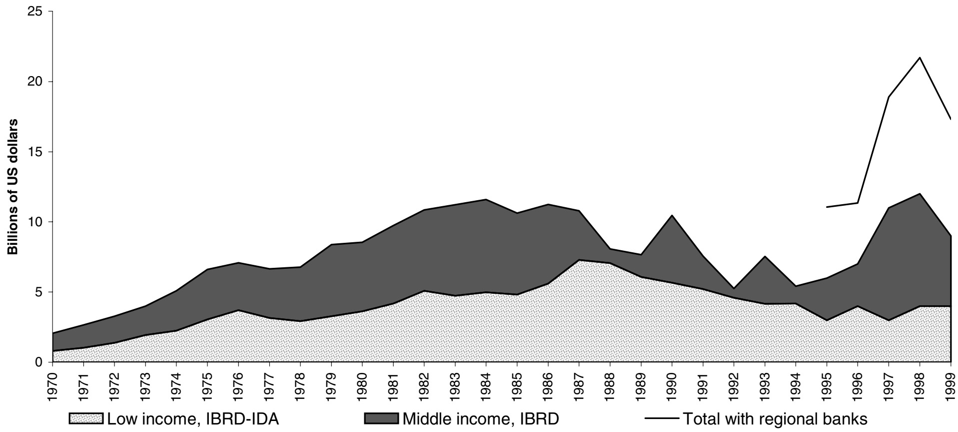
Two recent independent reports on MDBs have underscored the essential role that these institutions will continue to play in the international financial system. The report by the Institute of Development Studies of the University of Sussex (2000) emphasised three essential roles of MDBs: financial resource mobilisation; capacity building, institutional development and knowledge brokering; and provision of global and regional public goods.[24] It also emphasised the need for a more systemic approach, in which the World Bank and the regional and sub-regional development banks are viewed as a network providing common services to developing country shareholders. The report correctly underscored the need for MDBs to embrace intellectual diversity in their role as knowledge brokers. This was also emphasised by Stiglitz (1999), who has defended the need for an open debate in order to avoid the hegemony of a single view of economic development.

The report of the Commission led by Gurría and Volker (2001) focused on the financial role of MDBs vis-à-vis emerging market economies. It noticed, along similar lines to the United States Treasury response to the Meltzer report, that volatility of financial markets implies that the access of emerging markets to private capital markets can be "unreliable, limited and costly". As crises hurt the poor, the counter-cyclical character of MDB financing is consistent with their poverty-reduction role. It suggested, nonetheless, that pricing of loans by MDBs should be set in a way to encourage graduation. It also emphasised the need to strengthen the relationship between MDBs and the private sector, particularly to encourage private infrastructure financing in developing countries. The catalytic role that MDBs can play in this regard should be based on guarantee schemes, through which MDBs help to cover the government and regulatory risks that private investors are likely to face.

A close look at the evolution of multilateral development bank lending in recent years (Figure 2) supports the view expressed by both the United States Treasury and the Gurría and Volker (2001) report. Indeed, it shows that, whereas financing to low-income countries is steadier, lending to middle-income countries is strongly counter-cyclical. It should be emphasised, in any case, that if multilateral development financing is not significantly expanded, this counter-cyclical role will necessarily be limited. This is

[24] Similar views have been put forward by Gilbert, Powell and Vines (1999).

Figure 2. The counter-cyclical character of multilateral development bank lending



Source: ECLAC, on the basis of World Bank, Global Development Finance 2001.

underscored by the data from Table 3, which indicate that multilateral financing in 1990–1999 represented only 15.5 percent of that provided by the private sector, excluding FDI, and only 8.4 percent in the case of middle-income countries. Thus, a useful counter-cyclical function vis-à-vis emerging economies would require a significant increase in resources available to MDBs or a more active use of co-financing and credit guarantees by these institutions. Interestingly, to the extent that MDB financing falls when there is an adequate supply of private capital to emerging economies, the controversy on graduation is largely irrelevant. Indeed, such a pattern indicates that graduation will be automatic once countries have steady access to private capital flows.

MDBs will thus continue to play an essential role in five basic areas: financing low-income countries; providing (partial) counter-cyclical financing to middle-income countries; acting as catalysts for new forms of private investment; supporting capacity building and institutional development; and supporting the provision of global and regional public goods. The specific financial commitments that this implies from the international community have not received adequate attention.

4.4 Regional schemes

The role of regional institutions in the international financial system is one of the most prominent items missing from the mainstream discussion and agenda on international financial reform. It is absent from the main Northern reports[25] and from the views on financial reform which come from the Bretton Woods institutions.

This is an important deficiency. There are, indeed, several sets of arguments for a strong role for regional institutions in international finance.[26] The first group are related to the growth of macroeconomic linkages at the regional level, as a result of the growth of intra-regional trade and capital flows. This creates a demand for regional surveillance and consultation of macroeconomic policies, as well as for peer review of national prudential regulation and supervision of domestic financial systems. One advantage of regional surveillance is that asymmetries of information are smaller at this level.

The second group are the classical risk-pooling arguments. Regional and sub-regional development banks, even those made up entirely of developing countries, are likely to face lower risks than individual members. This creates the potential for profitable financial intermediation. Also, contagion of crises often starts within regions; therefore, regional mechanisms for liquidity provision can provide a first line of defence in deterring contagion. This preventive line of defence is facilitated by the fact that, despite contagion, critical demands for funds do not coincide exactly in time, a fact that generates a useful role for regional reserve funds and swap arrangements. Moreover, the sense of "ownership" of regional and sub-regional development banks and reserve funds by developing countries creates a special relationship between them and member countries that helps to reduce the risks that these institutions face, further encouraging the virtues of risk pooling.

The third set of arguments relates to the virtues of an international order that combines world and regional institutions. Given the heterogeneity of the international community, world and regional institutions can play useful complementary roles, particularly in macroeconomic policy coordination, in the adaptation of international norms to the specific regulatory traditions, and in reducing learning costs and sharing experiences in institutional development. At the same time, for smaller countries, the access to a broader alternative set of institutions for crisis management and development finance, including regional ones, may be particularly valuable, as they have relatively less influence and bargaining power vis-à-vis global institutions. More generally, the creation and strengthening of regional institutions will help increase developing countries' ability to participate in and influence the global financial architecture negotiations.

The history of regional financial cooperation has been particularly rich in post-war Western Europe, from the development of the European Payments

[25] See, for example, Council on Foreign Relations (1999), and Meltzer (chair) (2000).
[26] For a broader discussion of these issues, see ECLAC (2002a, ch. 2), Agosin (2001), Ocampo (1999, 2002) and Park and Wang (2000).

Union and the European Investment Bank, to a series of arrangements for macroeconomic coordination and cooperation that eventually led to the current monetary union of most members of the European Union. To a lesser extent, financial cooperation has been present in the developing world over several decades. Two remarkable examples are the institutions designed in the context of Arab and Andean cooperation. The first includes the Arab Monetary Fund, which plays an essential role in financing intra-regional trade and structural adjustment; the Arab Fund for Social and Economic Development, which supports infrastructure projects, with priority for regional projects; and the Arab Investment Guarantee Fund, which supports intra-regional investment. The second includes the Andean Development Corporation, which provides development finance to both public and private sectors in several Latin American countries, and the Latin American Reserve Fund, which includes Andean countries and Costa Rica, and has provided emergency liquidity financing to all Andean countries over the past decades. There are other institutions in the developing world, including several sub-regional development banks in the Latin American and Caribbean region.

The major advances in this area in recent years have taken place in Asia. They include, first, the May 2000 Chiang Mai Agreement between ASEAN countries, China, the Republic of Korea and Japan, to create a swap arrangement among central banks.[27] This initiative followed the Japanese suggestion to create an Asian Monetary Fund, which generated major opposition by the International Monetary Fund during its 1997 Hong Kong annual meetings. The second was the creation of the ASEAN Surveillance Process, for exchanging macroeconomic and financial information, and providing early warning signals and peer review among ASEAN countries. In Latin America and the Caribbean, there have been some steps towards developing mechanisms for macroeconomic coordination in the context of the four sub-regional integration schemes[28] and initiatives to strengthen the Latin American Reserve Fund.[29]

All these experiences indicate that regional bodies can be very effective in providing liquidity, facilitating development finance and sustaining trade links. They can also contribute to macroeconomic policy peer review and coordination. Nonetheless, these institutions remain limited in their scope so far, and are not recognised as central to the international financial architecture. This would require formal links between the International Monetary Fund and regional reserve funds and swap arrangements, which could eventually transform the former into a network of regional reserve

[27] Park and Wang (2000).
[28] See ECLAC (2002b, ch. 5).
[29] Agosin (2001) and ECLAC (2002a, ch. 2).

funds.[30] It also requires an explicit policy by the World Bank to support regional development banks, including new institutions exclusively owned by developing countries.

An institutional framework such as that suggested would have two positive features. First of all, it may bring more stability to the world economy by supplying essential services that can hardly be provided by a few global institutions, particularly in the face of a dynamic process of open regionalism. Secondly, from the point of view of the equilibrium of world relations, it would be more balanced than a system based on a few world organisations. This would increase the commitment of less powerful players to abide by rules that contribute to world and regional stability.

[30] United Nations Executive Committee on Economic and Social Affairs (1999), Section 9; Ocampo (1999, 2002).

5. Political Economy

As we have seen in this paper, progress on international financial reform has been uneven and asymmetrical; more progress has been achieved in areas implemented nationally by developing countries (e.g. Codes and Standards) than in the equally important and complementary international measures (e.g. provision of sufficient official liquidity and development finance, and design of international debt workout procedures). What are the main reasons for this uneven progress? More importantly, what strategy and bargaining tactics could be most productive for achieving a more symmetrical process?

Clearly, the asymmetries in the international financial reform process reflect certain political and political economy characteristics of the world. The most powerful governments – and especially their financial authorities – have not thrown their weight consistently behind a deep international financial reform, even though they were more enthusiastic about it after the 1997–1998 Asian and Russian crises, largely due to the brief credit crunch these generated in the industrialised world.

An important reason for the lack of consistent developed country support for the reform process may be that some powerful actors in those countries (e.g. major financial agents) do not see it in their interest to support or promote major changes in the international financial architecture. Another problem is that those who would benefit most from such changes in developed countries (e.g. shareholders and workers of companies trading and investing long-term in developing economies, or who support development in poor countries) are not represented properly in financial decision-making processes.

As a result, the main impulse for international financial reform could potentially come from developing countries. However, developing countries have their own restrictions. Firstly, and most important, they have relatively limited power, as reflected in their exclusion or limited participation in key bodies. Secondly, developing countries have seen their ability to generate strong coalitions weakened; this may be linked to the "policy competition" to attract foreign capital, and thus the resulting unwillingness to make or support proposals that could modify their image as friendly to foreign investors. Finally, developing countries – especially but not only the poorest ones – may have insufficient technical capacity and resources to generate complex blueprints for international financial reform, and follow complex negotiation processes.

If conscious and deliberate efforts are not made to overcome the basic asymmetries in global power relations, and the technical as well as other difficulties of generating international coalitions to compensate for these power imbalances, the international financial agenda will continue to be biased towards the views of a limited set of actors in the industrialised countries, and the impact of this agenda and these policies on the rest of the world – including in particular developing countries – will not be fully internalised.

A second reason restricting progress in international financial reform is the reluctance of most (especially industrialised, but also developing) countries to give up economic sovereignty to international organisations. In this sense, regional organisations and mechanisms may be very valuable, both in themselves and as stepping stones towards global organisations and mechanisms, and for improving the bargaining position of developing countries for a better financial architecture. A problem here is that countries (except in the case of the European Union) have been reluctant to give up sovereignty even to regional organisations.

There are however, two very positive elements that may be helpful in the process of genuine international financial reform. One is that all key actors involved share a common objective, which is that they are in favour of – and benefit from – sustained growth in developing countries. As seen in Table 4, for some actors this is more important than others, but all share this objective.

Table 4. Objectives of key actors

	Dominant objectives	**Other objectives**
Developed country governments	Growth in their own economies Profits for their financial sectors Global financial stability No large bail-outs	Growth in developing countries No crises
Developing country governments	Growth in their own economies. Global financial stability Stable and adequate flows	Growth in developed countries
Banking and financial markets	Maximise profits	Global financial stability Growth in developed and developing economies

A second potentially very positive element is the existence of a set of actors in developed countries, who are – and could become even more – important allies of developing countries in building a better international financial system. These include the non-financial part of governments (e.g.

Development Cooperation Ministries), NGOs, political parties and parliamentarians, as well as non-financial corporations. In different ways, and for different reasons, these actors are supportive of more rapid growth in developing countries, and therefore are or could become very supportive of an international financial reform that helps make growth possible. For this purpose, developing countries' governments need to have an active dialogue on international financial reform, not just with financial authorities in developed countries, with market actors and IFIs - International Financial Institutions (who clearly are the main actors in the reform process), but also with other actors in the developed world.

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, both in the public and the private sector, as well as supportive of their own growth and development.

Such a bargain would have two sets of elements. Developing countries could say they would be keen to implement initiatives that are of particular interest to developed economies, such as Codes and Standards on financial regulation and a fuller liberalisation of their capital accounts, if, *and only if*, developed countries start reforming the global financial system in ways that would facilitate larger and more stable capital flows to developing countries, and that would make costly crises in these countries less likely. Whilst such a reformed international financial system did not exist, they would clearly be less able and less willing to open their capital accounts fully, as the potential risks of doing so could outweigh the benefits. Particularly, developing countries could argue that implementing Codes and Standards and a commitment to adopt proper domestic macroeconomic policies should be explicitly linked to some regulation of developed countries' financial markets to help avoid excessive surges of potentially reversible capital flows to developing countries; to mechanisms that encourage long-term flows; to the design of (low-conditionality) international liquidity mechanisms that would significantly protect individual developing countries from crises and stop crises from spreading to other countries; and to fair multilateral debt workout mechanisms that would be used to manage solvency crises (debt overhangs).

Thus, developing countries that followed good macro-economic policies and significantly improved their financial regulation (as certified, for example, in their annual Article 4 IMF consultations) could have virtually automatic access to sufficient IMF lending if hit by a crisis whose origin was not of their own making, but was due to unexpected changes in perceptions of international lenders or investors or due to large terms of trade shocks. Low-income countries that followed good macroeconomic policies and improved financial regulation would have sufficient access not just to international liquidity, but also to development finance. Debt workout mechanisms would only be used when crises faced by developing countries were due to unsustainable debt burdens (and would not be used when they are associated with insufficient international liquidity), and appropriate mechanisms would be designed to guarantee financing in the post-debt restructuring environment to facilitate reinsertion into private capital markets.

Such a bargain would provide incentives for developed countries to make necessary international changes, as they would know that they would ensure the desired changes in developing countries, and vice versa. Collective action problems could thus be overcome if genuine progress was made simultaneously by developed and developing countries. Most importantly, the result would be of great value, not just to developing countries, but also to developed ones.

Developing countries could here draw interesting lessons from both the bargaining tactics used and the vision presented by Keynes in negotiations that led, at Bretton Woods, to the creation of the post-war international financial order (Skidelsky, 2001). As regards bargaining tactics, Keynes presented two clear alternatives: an "ideal" scheme, with key international elements – such as a large IMF – and a "second best" case, wherein the UK would reluctantly follow a far more closed approach in trade and the capital account if the international financial system was not properly developed; there was, he argued, no middle way (though in practice he made some important concessions later).

Suitably adapted to the features of the early 21st century world economy, developing countries can argue that the same two clear options remain:

a) An appropriate international financial system, that would support development and make crises far less likely and less costly, not just for them but particularly for the global economy. Developing countries could contribute to this new IFA by implementing regulatory standards, adopting good macroeconomic policies and by gradually liberalising their capital accord;

or

b) An incomplete and lopsided international financial system that could not guarantee supporting developing country aims, and where they would not be able to open fully their capital accounts, as they would regretfully have to protect their interests by having, as a "second best solution", more rather than less national policy autonomy. Similarly, they may be forced to rely on regional institutions and mechanisms even to perform functions that could be best performed globally, given vacuums in the existing global financial architecture.

Developing countries could draw lessons from Keynes's preparation of a clear vision of the key elements that would need to be included in a "first best" international financial system, and demonstration of how such a superior system would benefit all involved; this system would be superior both because it would support more stable growth in developing countries – of benefit to many actors in the developed world – and, perhaps more importantly, because it would increase financial stability globally. There is here a clear parallel with Keynes's position at Bretton Woods, who in defending the interests of the relatively weaker, debtor countries like the UK, was at the same time defending global prosperity. Furthermore, just as Keynes appealed then to United States internationalism and liberalism to help overcome opposition to his proposals, developing countries should appeal to current United States ideals of supporting and deepening the market economy globally; for this, they should stress how a "first best" international financial system, which would facilitate growth and prosperity for them, would clearly increase their own commitment to the global market economy, and their ownership of policies to integrate further into this globalised market economy.

6. Implications for Aid

As we have seen above, one of the best ways to support progress on an international financial reform that promotes development and poverty reduction is to strengthen the voice of developing countries in that discussion. To do that, it is important not just to increase the participation of developing countries in the key fora (along the lines discussed above), but also to enhance their technical knowledge of increasingly complex issues in relation to the reform of the international financial system, and simultaneously to strengthen their bargaining position.

Two crucial tasks need to be tackled in this field. Firstly, developing countries should develop and attempt to agree jointly clear and precise positions on the main areas outlined above, such as provision of sufficient official liquidity and development finance, appropriate regulation of financial markets and capital flows, international standstills and orderly debt workouts, and participation of developing countries in key institutions. Then, they could agree a strategy on how to best try to achieve such change; this would include preparing and taking specific initiatives to relevant bodies (e.g. IMF and World Bank, the Basel Committees, the G-20, etc.).

Secondly, much of the transformation in the international financial architecture is *de facto* taking place through a fairly large number of small incremental changes – through what Kenen (2001) has aptly called "galloping incrementalism". Because a major overhaul of the international financial system (à la Bretton Woods) unfortunately seems unlikely in the short term, changes in the international financial system are likely to continue to take place in an incremental way. Therefore, riding on this trend seems the best alternative.

In this context, it would be very valuable if a fund or resource centre could be created soon that would help provide systematic, timely and independent support to representatives of developing countries (in particular, but not only, the developing country Executive Directors in the IMF and World Bank boards). Such a resource centre would be particularly, but again not only, valuable to the two Sub-Saharan African Executive Directors who have very large constituencies, representing more than 20 countries each, which implies they have a very heavy load of country work for the countries they represent. In discussions with Executive Directors and their Alternates (both from Africa and Latin America), it has become clear that they would value such an initiative, which they have themselves suggested, given that they – and their governments – do not have sufficient time and resources to undertake the detailed and timely analytical work indispensable for their ability to influence policy debates. This limits both their capacity to analyse and respond to specific documents and initiatives being taken to the IMF and World Bank boards, and even more, their ability to generate their own policy initiatives.

Such a fund or resource centre could have a small core technical secretariat (closely interacting with the G-24) and could draw on a virtual network of think-tanks, academics and other experts (in developed and, particularly, developing countries) in its work. A large part of its activities would imply preparing or helping prepare very brief, focussed papers or memos with reactions to documents on important issues going to the IMF and World Bank boards, where new or alternative proposals could be elaborated. This would have to be a quick response facility, as there is normally a very short period between distribution of policy papers and their discussion.

Because time would be so much of the essence in a large part of this work, the quick response work would require much and creative use of teleconferencing, emailing, etc. Small workshops or meetings (either in person or cybernetic) could play a very helpful role. Donors would fund the centre, but it is essential that its work be independent of donors, and that ownership and accountability of the work belong clearly to developing countries. The independence of the resource centre would clearly benefit developing countries, but it could also be valuable to developed countries that are keen to improve the quality of developing countries' positions and dialogue.

Ideally, several donors would fund such a centre. One major donor is already evaluating the creation of such a centre. Further support from other donors (and in particular Sweden) would be extremely valuable to enlarge the scope of such an initiative. Given that the Monterrey Consensus specifically encourages the IMF and World Bank "to continue to enhance the role of developing countries in their decision-making and deliberative bodies", this proposal could be launched as part of the initiatives to implement that Consensus.

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Counter-Cyclical Prudential and Capital Account Regulations in Developing Countries

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List of acronyms

ADRs	American Depository Receipts
BIS	Bank for International Settlements
ECLAC	Economic Commission for Latin America and the Carribean
FV	Fair Value
FVA	Fair Value Accounting
GDP	Gross Domestic Product
HVA	Historic Value Accounting
IDB	Inter-American Development Bank
IMF	International Monetary Fund
IRB	Internal Rating Based (approach)
MVA	Market Value Accounting
OECD	Organization for Economic Co-operation and Development
SMEs	Small and medium-sized enterprises
UNCTAD	United Nations Conference on Trade and Development

Executive Summary

The association between capital flows and economic activity has been a prominent feature of the developing world and, particularly, emerging markets during the past quarter century. This fact highlights the central role played by the mechanisms by which externally generated boom-bust financial cycles are transmitted. The strength of business cycles in developing countries and, particularly, the devastating effects of new crises are thus related to the strong connections between domestic and international financial markets.

The economic literature has recently explored the dynamics of financial cycles by analyzing the mechanisms by which vulnerability is built up during capital account booms, leading to sudden shifts of expectations that trigger the subsequent busts. The acceleration of economic growth and the reduction of interest rates and spreads that takes place during the upward phase of the business cycle increase both the demand for credit and the rate of return on loans, leading banks to a process of escalating credit expansion. During this stage of buoyant activity, banks usually underestimate the risk of future losses. Additionally, the valuation of risk on the basis of an identified deterioration of assets rather than latent losses reinforces the pro-cyclical behavior of credit markets.

Moreover, changes in the liability structure of both financial and non-financial sectors lead to the accumulation of currency and maturity mismatches that become an additional source of vulnerability to external and domestic shocks. Financial sectors in developing countries have a short-term bias and depend to a significant extent on external credit lines for their local operations. Small and medium-sized enterprises, which finance investment with short-term credit, will be generally unable to avoid maturity mismatches. Large corporations may be able to do so by borrowing long in external markets, but will then develop currency mismatches when they operate in non-tradable sectors. A mix of maturity and currency mismatches is a general structural feature of developing countries.

Furthermore, exchange rates have significant pro-cyclical wealth effects in economies with large net external liabilities and significant currency mismatches. Capital gains generated by appreciation during upswings fuel the spending boom, whereas the capital losses generated by depreciation have the opposite effect in the downturn. This feature may be enhanced by interest and exchange rate policies. This is particularly true when overvaluation of exchange rates is encouraged during booms by the use of the exchange rate as a price anchor. Also, interest rates are often raised to control inflation during the upswing, creating an incentive to borrow abroad. Later, when imbalances become explosive, they are further increased to contain speculative attacks on the currency, a strategy that accelerates banking crises.

The severity of the downward adjustment in domestic spending after a crisis will bear a direct relationship to how excessive spending levels were, as reflected in accumulated liabilities, as well as to balance sheet imbalances. The high fiscal and quasi fiscal costs of crises reveal that private risks assumed by financial intermediaries during economic booms incorporate a substantial component of public sector risk. This fact constitutes a powerful argument for intervening in financial systems in order to prevent the build-up of excessive risks during booms.

This paper explores the role of two complementary policy instruments for managing the effects of boom-bust cycles: counter-cyclical prudential regulations on domestic financial intermediation, and capital account regulations. With respect to the first of these instruments, the paper argues that prudential regulation and supervision should take into account not only microeconomic, but also the *macroeconomic* risks associated with boom-bust cycles. In particular, instruments need to be designed that will introduce a counter-cyclical element into prudential regulation and supervision. To guarantee this, banks' provisions for loan losses should be forward-looking. They should be estimated when loans are disbursed on the basis of *expected* losses, taking into account the full business cycle, rather than on the basis of loan delinquency or short-term expectations of future loan losses. This means, in fact, that provisioning should approach the criteria traditionally followed by the insurance rather than the banking industry.

Traditional accounting practices, which determine the way banks calculate provisions or reserves for losses, tend to enhance rather than mitigate the cyclical performance of bank lending. In view of the fact that asset impairment tends to decline during booms, provisions usually underestimate the true inherent credit risk of the loan portfolio. This method constitutes an incentive to overlend during booms and delays the process by which banks realize the gradual deterioration of their loan portfolio and protect themselves against subsequent losses. In turn, the lagged recognition of effective asset impairment when the recession is already in progress reduces banks' capital at a time when it is most difficult to raise new capital, thus reinforcing the credit crunch that usually takes place during downswings.

This paper argues in particular for a regulatory approach that involves a mix of: (a) forward-looking provisions for latent risks, with provisions made when credit is granted on the basis of the credit risks expected in the course of the full business cycle; and (b) more discrete counter-cyclical prudential provisions decreed by the regulatory authority for the financial system as a whole, or by the supervisory authority for special financial institutions, on the basis of objective criteria (e.g., the rate of growth of credit, or the growth of credit for specific risky activities). Specific provisions should be managed together with forward-looking provisions. Voluntary prudential provisions can also be encouraged. The combination of these measures would make provisions a powerful instrument for banks to manage the effects of business cycles. To achieve this purpose, it is essential that tax deductibility be granted to provisions, and that accounting and prudential rules on capital/asset ratios should support their counter-cyclical role. In any case, this prudential approach is a complement to counter-cyclical macroeconomic policies, and prudential policies are not a substitute for the risks that pro-cyclical macroeconomic policies may generate.

According to this reasoning, capital adequacy requirements should focus on long-term solvency criteria rather than on cyclical performance. Insofar as developing countries are more likely to face more macroeconomic volatility, there may be an argument for requiring higher capital/asset ratios, but there is none for requiring that such capital adequacy ratios be, as such, counter-cyclical.

Prudential regulation should also prevent currency and maturity mismatches. Prohibitions could be established to prevent firms in non-tradable sectors from borrowing in foreign currency, unless adequate instruments of protection against currency risk are provided. Alternatively, higher provisions and/or risk weights should be set for loans to firms operating in non-tradable sectors that have a direct exposure in foreign currency. Also, liquidity requirements should be established to manage imbalances in the maturities of assets and liabilities in banks' balance sheets, as well as limits on loan-to-collateral value ratios and rules to adjust the values of collateral to reflect long-term market trends in asset values rather than cyclical variations.

As the major source of boom-bust cycles in developing countries is capital account volatility, an alternative to this prudential banking approach is direct capital account regulations. In fact, due to the limitations of both approaches, a mix between the two is advisable. In this view, capital account regulations have a dual role: as a macroeconomic policy tool, which provides some room for counter-cyclical monetary policies, and as a "liability policy", to improve private sector external debt profiles. The emphasis on *liability structures* rather than national balance sheets recognizes the fact that they play the essential role when countries face liquidity constraints.

The paper highlights that innovative experiences with capital account regulations in the 1990s indicate that they can provide useful instruments, in terms of both improving debt profiles and facilitating the adoption of (possibly temporary) counter-cyclical macroeconomic policies. The basic advantages of the price-based instrument pioneered by Chile and Colombia are its simplicity, non-discretionary character and neutral effect on corporate borrowing decisions. The more quantitative-type Malaysian systems have proven to have stronger short-term macroeconomic effects. Traditional exchange controls (e.g., prohibitions on short-term foreign borrowing, except trade credit lines) may be superior if the objective of macroeconomic policy is to significantly reduce the domestic macroeconomic sensitivity to international capital flows.

Direct regulations on capital flows can be partly substituted by prudential regulation and supervision. The main problem with these options is that they have, at best, indirect effects on the foreign currency liabilities of non-financial agents and may encourage them to borrow more abroad. Accordingly, they need to be complemented with other disincentives for external borrowing by firms, such as restrictions on the class of firms that can borrow abroad (including possibly, as indicated, a prohibition on such borrowing by firms operating in non-tradable sectors), restrictions on the terms of corporate debts that can be contracted abroad, public disclosure rules, and tax provisions that raise the cost of direct borrowing in foreign markets. Price-based capital account regulations may thus be a superior alternative and simpler to administer than an equivalent system based on prudential regulations plus additional policies aimed at non-financial firms.

Finally, the paper argues that more direct liability policies should also be adopted to improve public sector debt profiles. In the case of the public sector, direct control by the Ministry of Finance (in some cases by the central bank) is the most important liability policy, including controls on borrowing by other public sector agencies and autonomous sub-national governments.

1. Introduction

The association between capital flows – and, more particularly, net resource transfer – and economic activity has been a prominent feature of the developing world and, particularly, emerging markets during the past quarter century. This fact highlights the central role played by the mechanisms by which externally generated boom-bust financial cycles are transmitted in the developing world. The strength of business cycles in developing countries is thus related to the close connections between domestic and international financial markets.

This paper explores the role of counter-cyclical prudential and capital account regulations for managing the effects of boom-bust cycles. It is divided into four sections. The first explores the macroeconomics and the role played by the domestic financial sector in boom-bust cycles. The second takes a close look at prudential regulations. The third analyzes the role played by capital account regulations. The fourth draws conclusions.

2. Business Cycles and Banking Crises

2.1 The macroeconomics of boom-bust cycles

Private external financing cycles to developing countries are generated by shifts in the availability of external financing and the pro-cyclical patterns of interest rate spreads for what the market considers risky assets. Availability and spreads are associated, in turn, with significant asymmetries in the risk evaluation of macroeconomic conditions in developing countries during booms and crises, which involves a shift from "appetite for risk" to "flight to quality" (risk aversion). In Mexico, East Asia and many other emerging economies, capital inflows amounted to more than 5 percent of GDP (gross domestic product) during the three years preceding their respective financial crises (Mishkin, 2001a). In turn, sudden stops in external financing generate shocks that may amount to 5 to 10 percent of GDP.

The analysis of the effects of financial crises has concentrated in recent years on the mechanisms by which vulnerability is built up during capital account booms, leading to sudden shifts of expectations that trigger the subsequent bust. Thus, Dornbush (2001), among others, compares the high speed and costs of the "new-style crises" with the slow speed, contained crises typical of financially repressed economies. New sources of vulnerability, associated with currency and maturity mismatches in balance sheets and the accumulation of non-performing loans in banks' portfolios during crises, have been added to the effects of "traditional" shocks generated by terms of trade fluctuations and fiscal imbalances. As in the past, exchange rate misalignments play an essential role, but their flow effects are now mixed with, and even dominated by, wealth effects. Changes in expectations and the credibility of domestic macroeconomic authorities and the domestic financial system play a key role in triggering crises.

Among traditional factors, terms of trade booms have been associated with spending booms in developing countries, particularly those with less diversified economies. In turn, drops in export prices have strong effects on spending and economic activity, and frequently impair the ability of firms and ultimately countries to service external debt. As mentioned by Goldstein and Turner (1996), three quarters of the countries that experienced banking crises had previously faced a strong decline the in terms of trade.

Also, during an externally generated upswing associated to either a trade or a capital account boom, temporary public sector revenues and readily accessible external credit tend to generate an expansion of public sector spending, which will be followed by a severe adjustment later on, when those conditions are no longer present. A public sector deficit, especially when funded by short-term debt (external or internal), will be an important source of vulnerability during the subsequent downswing. An internal event such as a change in growth prospects, or an external shock like a rise in international or domestic interest rates, may undermine confidence in the capacity of the government to service the debt.

Nonetheless, the particular feature of "new-style crises" is the sharp fluctuation in *private* spending associated with the boom-bust cycles in external financing. As we will see below, the domestic financial sector plays an essential role in this process, facilitating domestic credit expansion during booms, but also a sharp contraction in lending when the deterioration in bank portfolios becomes evident in the downswing. The severity of the downward adjustment in private spending will bear a direct relationship to how excessive spending levels were, as reflected in accumulated liabilities, as well as to balance sheet imbalances, particularly maturity and currency mismatches. Upswings in asset prices during booms will also accentuate the boom in spending, but the reverse will hold when asset prices fall.

The effects of the terms of trade and fiscal balances on the real exchange rate are compounded by those of the capital account cycle. In turn, real exchange rate fluctuations have significant wealth effects in economies with large net external liabilities. In these economies, the capital gains generated by appreciation during an upswing help to fuel the spending boom, whereas the capital losses generated by depreciation have the opposite effect in the downturn. Thus, the wealth effects of exchange rate variations are pro-cyclical in debtor countries. The income effects may have similar signs, at least in the short run, if the more traditional contractionary effects of devaluation prevail (Cooper, 1971; Díaz-Alejandro, 1988, ch. 1; Krugman and Taylor, 1978).

An overvalued exchange rate plays a crucial role in the process leading to a currency crisis. Traditional sources of overvaluation at the end of the boom, and those associated with large capital inflows, will be mixed with those resulting from anti-inflationary policies that use the exchange rate as a price anchor. These policies are facilitated during boom periods by access to external financing. The difficulty of sustaining them will eventually become apparent when the consequent reduction of economic growth and increased current account deficit reach unsustainable proportions. The magnitude of the collapse will depend on the magnitude of overvaluation, as well as on misalignments in the national balance sheet, which includes the government, banks and other financial intermediaries, the corporate sector and small and medium-sized enterprises (SMEs).

Under a flexible exchange rate regime, crises will lead to currency devaluation while under fixed rate regimes they will reduce foreign exchange reserves. If the peg is perceived to be unsustainable, a self-fulfilling crisis may lead to the eventual abandonment of the fixed exchange rate regime. As the recent Argentinian crisis or the collapse of the gold standard in the past indicate, this may be true even under a "hard peg". Under either exchange rate regime, the use of monetary policy to contain speculative attacks on the currency by increasing interest rates may accelerate a banking crisis. Good balance sheets will restrict the financial damage and leave more room for policy adjustments. Conversely, strong wealth effects generated by changes in asset prices or interest or exchange rates may cause explosive shocks. If debt is simply rolled over, the problems will still be hidden in balance sheets. In a historical perspective, the frequency of "twin" external and domestic financial crises is indeed a striking feature of the period that started with the breakdown of the Bretton Woods exchange rate arrangements in the early 1970s (Bordo, *et al.*, 2001).

The most important policy implication of the high costs of externally generated boom-bust cycles is that the developing country authorities need to focus their attention on crisis prevention, i.e., on managing booms, since in most cases crises are the inevitable result of poorly managed booms. Moreover, the concentration on crisis prevention recognizes an obvious fact: that the authorities have greater degrees of freedom during booms than during crises. The way crises are managed is not irrelevant, however. In particular, different policy mixes may have quite different effects on economic activity and employment, and on the domestic financial system.

2.2 Domestic financial instability associated with boom-bust cycles

The domestic financial sector is both a protagonist in and a potential victim of the macroeconomics of boom-bust cycles.[1] The external lending boom facilitates a domestic credit expansion during the upswing but private sector debt overhangs accumulated during the boom will, in turn, trigger a deterioration in bank portfolios and a contraction in lending during the downswing. At the same time, banks operate with high leverage and maturity mismatches that make them particularly vulnerable to changes in market conditions. They are subject to market failures – associated with information asymmetries, adverse selection and moral hazard – that affect their assessment of credit risk and may inhibit the channeling of funds by markets to the best investment opportunities (see, for example, Mishkin, 2001b).

The acceleration of economic growth and the reduction of interest rates and interest rate spreads that usually take place during the upward phase of the business cycle reduce expected project risks and the cost of funding. These conditions increase both the demand for credit and the rate of return on loans, leading banks into a process of escalating credit expansion. During the stage of buoyant activity banks usually underestimate the risk of future losses, a phenomenon the literature refers to as "disaster myopia". The

[1] The literature on the determinants of banking crises is extensive. See, for example, Bell (2000), Berg and Patillo (2000), Eichengreen and Rose (1998), Demirgüc-Kunt and Detragiache (1998), Evan *et al.* (2000), Honohan (1997) and Timmermans (2001).

overestimation of credit quality increases the speed of credit growth, which helps to amplify the cycle. Under the pressure of increased competition, banks often relax their standards of risk appraisal and accept borrowers with lower credit quality (Fernández de Lis, *et al.*, 2001; Clerc, *et al.*, 2001). This strategy is more frequent in the case of new participants in the market, since the older and larger institutions tend to retain the best quality borrowers. The tightening of monetary policy that usually takes place at the end of the boom may also induce more rather than less risk taking for some time, due to problems of adverse selection, since borrowers with riskier projects will be willing to pay higher interest rates.[2]

Changes in the liability structure of both financial and non-financial sectors – as regards both corporations and small and medium-sized enterprises (SMEs) – will lead to the accumulation of currency and maturity mismatches, which become an important source of vulnerability to external and domestic shocks. In particular, financial sectors in developing countries have a short-term bias and depend to a significant extent on external credit lines for their local operations. As a result, domestically financed firms tend to have maturity mismatches in their portfolios, as they may be forced to finance investment with short-term credit. Whereas SMEs are unable to avoid such mismatches, large corporations may borrow long in external markets, but will then develop currency mismatches when they operate in non-tradable sectors. In addition, firms that lack direct access to external capital markets (e.g., smaller corporations and SMEs) may finance their domestic operations by borrowing in foreign currency from domestic banks. Financing strategies that lead to currency mismatches often originate in macroeconomic policies that facilitate the generation of large differentials between local and foreign interest rates during booms, as well as expectations of exchange rate appreciation (Kaminsky and Reinhart, 1996). Generally, due to asymmetries in financial development, a variable mix of maturity and currency mismatches will be a structural feature of non-financial firms' balance sheets in developing countries (Ocampo, 2001).

Excessive leverage of non-financial agents as well as maturity and currency mismatches in their portfolios will turn into banking problems during crises. Deteriorated corporate balance sheets in Indonesia, Korea, the Philippines and Thailand played a crucial role in the development of the Asian crisis. Like Mexico in 1994, most of these countries substantially increased the ratio of foreign debt to external reserves before their respective crises. Some government policies during credit booms generated incentives in this direction. For example, merchant banks in Korea were allowed to borrow short-term external funds freely so long as the loans they extended domestically were also short-term. Also, at the time of the Mexican crisis,

[2] This behavior has been particularly evident in consumer loans and in credit unions.

almost 60 percent of the liabilities of large and medium-scale firms were denominated in foreign currency, while their foreign exchange revenues amounted to less than 10 percent. The high incidence of short-term external debt, plus currency and maturity mismatches, increased the vulnerability of these economies to devaluation (Goldstein and Turner, 1996; Hausmann and Rojas-Suárez, 1996; Mishkin, 2001a; Rojas-Suárez, 2001; Sundararajan and Baliño, 1991).

High interest rates at the end of the boom and the outbreak of the downswing will accelerate the deterioration of non-financial firms' balance sheets and, thus, of credit quality. Moreover, high interest rates reduce the net value of banks, as the present value of assets, which usually have longer duration, falls more than the present value of liabilities. Experience indicates that the subsequent deterioration of banks' balance sheets becomes apparent after a credit boom with a lag of approximately three years (Fernández de Lis, *et al.*, 2001). Under extreme conditions, the protection provided by capital, reserve requirements and loan loss provisions may be insufficient to absorb the impact of strong adverse shocks. In the absence of new capital, which is hard to raise when balances have deteriorated, banks are forced to constrain lending even if borrowers are willing to pay higher interest rates. The severity of the credit crunch that follows will depend on the magnitude of the credit boom.

Confronting the dilemma of defending the currency or allowing for further deterioration of the banking system through the adverse effects of high interest rates on the balance sheets of financial and non-financial firms, the monetary authorities are likely to defend the currency only up to a certain point. Expectations of devaluation will encourage attacks on the currency. Devaluation will then hit banks in three ways: through changes in the value of assets and liabilities, currency mismatches in the balance sheets of banks and borrowers, and the reduced capacity of the latter to service their debts. Once risks have accumulated, however, authorities have little room to avoid the financial effects of devaluation, and indeed must generally choose between these effects and those resulting from falling international reserves and domestic monetary contraction. Thus, the decision to devalue is generally associated with the recognition that the financial costs of devaluation are lower and, more broadly, that this policy decision brings benefits (relative price adjustment) that in the long run will compensate for financial as well as other costs (e.g., inflationary effects) of depreciation.

The domestic asset price dynamics reinforces this boom-bust dynamics. The rapid growth of asset prices during booms, particularly stocks and real estate prices, raises the value of collateral, thus stimulating credit growth. Speculation with price swings will also become an additional source of demand for credit. In turn, the resulting wealth effects accentuate the spending boom. This process is further reinforced by the greater liquidity that characterizes fixed assets during periods of financial euphoria. However, this behavior also increases the vulnerability of the financial system during the subsequent downswing, when it becomes clear that the loans did not have adequate backing. Asset price deflation will be reinforced as debtors strive to cover their financial obligations and creditors seek to liquidate the assets received in payment for outstanding debts, in conditions of reduced asset liquidity.

3. The Role of Counter-Cyclical Prudential Financial Regulation

3.1 The costs of financial crises and the role of prudential policies

One of the painful lessons learned during recent decades in developing countries is how costly financial crises are in terms of duration and cumulative loss of GDP.[3] Some of the largest costs have to do with the sharp reduction in the time horizon of firms experiencing difficulties, which is also associated with the fact that property rights become largely indeterminate during crises (i.e., the proportion of assets which will be finally owned by stock holders vs. lenders is subject to significant uncertainties). The losses are not only of a short-term character, since they involve physical assets of firms as well as intangibles (including human and social capital and firms' business reputation, along with the consequent loss of business contacts) that have taken years to build up. Moreover, these losses are incurred even if firms manage to restructure and survive. Also, the credit system is paralyzed for long periods, thereby slowing the recovery of economic activity.

The fiscal and quasi-fiscal costs of bank rescues are very high: 4 to 5 percent of GDP in relatively small crises; some 15 to 20 percent of GDP in severe ones, such as those that hit Mexico in the mid-1990s or South Korea in the late 1990s; and 35 percent of GDP or even more in full-blown crises, such as those that engulfed Argentina and Chile in the early 1980s or Indonesia in the late 1990s. This means that the private risks assumed by financial intermediaries during economic booms incorporate a substantial component of public sector risk. This fact constitutes a powerful argument for intervening in financial systems in order to prevent the build-up of excessive risks during booms.

The origins of the problems that erupt during financial crises have been surveyed in the previous section. They are associated with both excessive risk taking during booms, as reflected in a rapid increase in lending, and maturity and currency mismatches in financial and non-financial agents' balance sheets. They are also associated with inadequate risk analysis by financial agents, as well as weak prudential regulation and supervision of financial systems. The combination of these factors becomes explosive under conditions of financial liberalization in the midst of a boom in external financing. The underestimation of risks characteristic of environments of economic optimism is then combined with inadequate practices for evaluating risks, both by private agents and by supervisory agencies. Indeed,

[3] See, in particular, IMF (1998), chapter 4. See also Rojas-Suárez and Weisbrod (1996) and ECLAC (2002).

the high demand for credit and the expectations created by domestic financial liberalization may generate the accompanying boom in external financing.

This underscores just how important the sequencing of financial liberalization processes is and, in particular, how necessary it is to make such liberalization contingent upon the prior establishment of appropriate prudential regulation and supervision and the design of satisfactory information systems to guarantee a proper microeconomic functioning of markets. Since the learning process – by financial intermediaries, depositors and the authorities – is not instantaneous, the liberalization process needs to be gradual to guarantee that financial intermediaries have the time they need to learn how to manage higher risks, depositors how to use the new information channels, and the authorities how to supervise the system more strictly and how to modify prudential regulations and reporting requirements on the basis of accumulated experience.

Prudential regulation should, first of all, ensure the solvency of financial institutions by establishing appropriate capital adequacy ratios relative to the risk assumed by lending institutions, strict write-offs of questionable portfolios and adequate standards of risk diversification. Properly regulated and supervised financial systems are structurally superior in terms of risk management, generating incentives for financial intermediaries to avoid assuming unmanageable risks. Indeed, the interpretation of credit risk indicators in developing countries is more difficult because of deficiencies in the assessment and accounting for risk, provisioning for loan losses, inadequate information systems and insufficient rules on information disclosure.[4] These shortcomings obstruct the timely transmission of risk signals that might prompt actions to reduce the vulnerability of banks to economic cycles. Under-provisioning causes an overestimation of bank capital, which consequently increases the difference between the accounting value and real value of capital for each bank and reduces the accuracy of the capital/asset ratio as a synthetic indicator of risk (Goldstein and Turner, 1996; Rojas-Suárez, 2001).

Supervisors in developing countries should thus require banks to use risk assessment techniques and develop a system of signals that will alert bank management to the build-up of risk above certain tolerable limits. Additionally, each bank should monitor and report the concentration of

[4] It should be mentioned that banks in developed countries also face difficulties in risk assessment. However, they are better prepared to improve these conditions. They have a larger percentage of counter parties that are rated by independent agencies; information about corporations and even small industries is more readily available through different data bases and, particularly, they face less instability in the macroeconomic environment. They also have more historical information about loan performance, which allows calculation of the probability of loan default, as recommended in the proposal for a new Basel Accord.

risk in a few economic sectors or borrowers, acknowledge the consequences of this concentration and, when necessary, adopt procedures to compensate for increased risk. Credit monitoring should go beyond the scope of each bank to consider the credit burden of its clients and the performance of the particular markets in which they operate. The authorities should require banks to monitor the frequency distribution of loan losses by different classes of loans such as retail, commercial real estate, housing, and corporate. They should be aware of specific patterns by regions or by sectors that alert them about the build-up of risk. Stress tests should be applied to consider future needs of capital and the results should be reported to the board of directors of each bank. Bank supervisors should conduct their own monitoring and stress testing and meet regularly with bank directors in order to discuss the evolution of risk (see European Central Bank, 2000).

Although the problems related to assessment and accounting of credit risk and under-provisioning of bad loans in developing countries are widely recognized, they have received insufficient attention in the design of regulatory and supervisory schemes. Certain activities such as monitoring of reports and in-situ inspection are typically intensive in professional skills and governments frequently allocate inadequate resources to recruiting, training, organizing and retaining the teams of professionals that are needed to improve the coverage and quality of supervision. Multilateral development banks are increasingly involved in financing and providing technical assistance for this purpose. They, as well as regional associations of banking supervisors, should promote discussions among regulators and supervisors in different countries, circulate information on a regular basis, identify priorities for different regions and countries and organize training programs with extensive coverage.

In this regard, lessons learned from the experience of recent bank crises are particularly relevant for the timely assessment of cyclical changes in risk behavior. Traditional regulatory practices, and even recent innovations included in the new proposed Capital Accord, do not fully take into account the effects of boom-bust cycles on credit risks. This means that prudential regulation and supervision should take into account not only microeconomic, but also *macroeconomic* risks associated with boom-bust cycles. This is particularly true in developing countries, where this dynamics is intense. Due attention should thus be paid to the links between domestic and external financing; between both of these factors, asset prices and economic activity; and between domestic financial risks and variations in interest and exchange rates.

The basic problem in this regard is the inability of individual financial intermediaries to internalize the collective risks assumed during boom periods, which are essentially of a *macroeconomic* character and therefore entail coordination problems that exceed the capabilities of any one agent. Moreover, risk assessment and traditional regulatory tools, including the

Basel standards,[5] have a pro-cyclical bias in the way they operate. The traditional focus on *microeconomic* risk assessment, with inadequate attention to the effects of external financial cycles on domestic financial markets, and exchange and interest rates, further reinforces this bias. In fact, it is during crises that the excess of risk assumed during economic booms becomes evident, and ultimately makes it necessary to write-off loan portfolios. Under a system in which loan loss provisions are tied to loan delinquency, the sharp increase in such delinquency during crises reduces financial institutions' capital and, hence, their lending capacity. This, in conjunction with the greater subjectively perceived level of risk, triggers the "credit squeeze" that characterizes such periods, further reinforcing the downswing in economic activity and asset prices, and thus the quality of the portfolios of financial intermediaries.[6]

This is why instruments need to be designed that will introduce a counter-cyclical element into prudential regulation and supervision. To guarantee this, provisions should be forward-looking. They should be estimated when loans are disbursed on the basis of *expected* losses, taking into account the full business cycle, rather than exclusively on the basis of loan delinquency or short-term expectations of future loan losses, which are highly pro-cyclical. This means, in fact, that provisioning should approach the criteria traditionally followed by the insurance sector (where provisions are made when insurance contracts are issued) rather than the banking industry. This practice may help to smooth the shape of the cycle, by increasing provisions or reserves during booms, thus helping to reduce the credit crunch that takes place during busts. It must be emphasized that, on top of these regulations on provisions, capital should also be adequate to cover the *un*expected losses that banks may incur, particularly during the downswing. This principle is reflected in the new Basel Accord, which proposes that banks should estimate the probability of default on loans when calculating regulatory capital under the Internal Rating Based (IRB) approach.[7] Although this

[5] The Basel Accord on international standards for the regulation and supervision of banks is an agreement among central bankers representing the group of countries affiliated with the Bank of International Settlements (BIS). Although it is designed for the operations of internationally active banks, its guidelines have been adopted by countries all over the world in the regulation of local banks and, indeed, have come to be regarded as a sign of confidence in the operation of domestic financial systems in developing countries. The Basel Committee meets with supervisors from different regions to discuss the main issues related to regulation and supervision. On the basis of these discussions, the Basel Committee has proposed a new Accord, still under discussion, which will modify the present accord that dates from 1988.

[6] For recent analysis of these issues and policy alternatives for managing them, see BIS (2001b), ch. VII; Borio, *et al.* (2001) and Turner (2002).

[7] The proposed new Basel Accord allows banks to choose between two methods for the calculation of regulatory capital. The first is the standardized approach, in which the authorities entirely determine the method of calculation. The second is based on the bank's own internal risk estimation models, subject to previous approval by the supervisory authorities. The latter method includes, in turn, two different cases, one in which only the probability of default is provided by banks, and an "advanced IRB", in which banks also provide the expected losses given default.

implies that capital regulations should be forward-looking, it is unclear whether there would be a counter-cyclical element in the calculation (see below).

It must be emphasized, in any case, that any regulatory approach has clear limits and costs that cannot be overlooked. Prudential regulation involves some non-price signals, and prudential supervision is full of information problems and is a discretionary activity that is susceptible to abuse, indicating that the authorities must be subject to strict limits and controls. Some classic objectives of prudential regulation, such as risk diversification, may be difficult to guarantee when macroeconomic issues are at the root of the difficulties. In particular, experience indicates that even well regulated systems are subject to periodic episodes of euphoria, when risks are underestimated, as the experience of many industrialized countries confirms. The recent crisis in Argentina is a case in point, in which a system of prudential regulations considered to be one of the best in the developing world, with a financial sector characterized by the large-scale presence of multinational banks, was clearly insufficient to avoid the effects of major macroeconomic shocks on the domestic financial system. Moreover, being able to separate cyclical from long-term trends is always an elusive task, as any process that involves learning will always generate path-dependent processes in which short and long-term dynamics are interconnected. These learning processes include those associated with forming expectations of future macroeconomic events, a particularly difficult task in developing economies facing substantial shocks (Heyman, 2000).

Moreover, to some extent, regulatory practices aimed at correcting risky practices on the part of financial intermediaries shift the underlying risks to non-financial agents, thus generating additional credit risks to domestic financial intermediaries. The net effect of regulation on banks' vulnerabilities is thus partial. Thus, regulatory standards establishing a lower risk rating for short-term credits and reducing mismatches between banks' deposits and lending maturities, will reduce direct banking risks but will also reinforce the short-term bias in lending in countries where deposits tend to have short maturities. Maturity mismatches are thus displaced to non-financial agents. Indeed, in this case, a net positive effect of this type of regulation on banking risk will be associated with either reduced fixed capital investment due to an inadequate supply of long-term domestic lending or a higher proportion of external financing of fixed capital investment. Also, prudential regulations forbidding banks from holding currency mismatches in their portfolio will reduce their direct risk, but may encourage non-financial agents to borrow directly abroad. The risks incurred by corporations, particularly those operating in non-tradable sectors, will eventually be reflected in the credit risk of domestic financial institutions that are also their creditors. Similar effects will result from higher spreads on domestic financial intermediation resulting from more stringent domestic vis-à-vis international regulatory practices. In all these cases, the reduced direct vulnerability of the domestic financial sector will have as its counterpart maturity and currency mismatches for non-financial agents (as well as suboptimal fixed capital investment) that may become credit risks for domestic financial agents during the downturn.

It is interesting to note that similar effects – the shifting rather than elimination of risks – are obtained by Basel regulatory standards that generate incentives for OECD banks to provide short-term loans to non-OECD countries. In this case, the reduction in the risks incurred by those institutions will have as a counterpart a higher risk for borrowing countries, a fact that became evident in several financial crises in the past decade.

This means that improved prudential regulation, including the introduction of strong counter-cyclical components that take into account the macroeconomics of boom-bust cycles, is a complement but not a substitute for appropriate policies in other areas. Two types of policies are essential in this regard: counter-cyclical macroeconomic policies that reduce the intensity of boom-bust cycles, and policies aimed at deepening domestic financial development (Ocampo, 2002).

3.2 Different views of risk measurement

There are two basic approaches to financial accounting: the traditional Historic Value Accounting (HVA), which considers assets at their historic value, and the more functional Market Value Accounting (MVA). Under the traditional method, which stresses the registration of past or present events, the accounting of credit risk is performed by means of provisions for loan losses on the basis of confirmed asset deterioration. MVA, in contrast, registers assets and liabilities at their market value, considering as income or expenses the positive or negative variations in their values (Beatie, *et al.*, 1995; Borio, *et al.*, 2001).

The price (market value) of a financial asset is equivalent to the discounted value of the future net earnings that it generates. In principle, this value thus incorporates income and losses, hypothetically eliminating the need for credit risk provisions under MVA. One of the problems with this method is the lack of market prices for some assets and more specifically for loans. However, in the absence of market prices, estimations of the fair value (FV) of the net present value of estimated future flows of income may be a substitute for the price. However, although Fair Value Accounting (FVA) could solve the problem of risk assessment for assets held by banks, it would introduce significant instability, due to fluctuations in the interest rates used in discounting the net flows of income. There is an intermediate approach that restricts the use of FVA methods to support the estimation of provisions and which avoids additional instability. Several banks have already adopted this procedure. A significant problem with all these estimates is, nonetheless, that income and losses are based on *expectations*, and thus vary with the whims of optimism and pessimism that affect markets, particularly financial markets, through the business cycle.

Accounting practices determine the way banks protect their value against risk through different types of provisions. Traditional HVA practices reinforce the pro-cyclical behavior of credit markets because risk is accounted for on the basis of identified deterioration of assets instead of considering latent losses due to cyclical activity. This means that, under this accounting method, risk is considered to decrease during booms and increase during recessions. As Clerc, *et al.* (2001) point out, the accounting effects of risk are often perceptible too late, a short time before charging off loans. In this sense, provisions do not reflect the true inherent credit risk of the loan portfolio. The alternative approach considers that risk increases during booms and materializes during recessions, as indicated by the previous analysis of the macroeconomics of boom-bust cycles.

Since the 1970s, and more markedly since the 1990s, the discussion about accounting for credit risk has been evolving towards a more dynamic approach. Concepts such as Market Value Accounting have to some extent permeated regulations. The prevalent rules partially incorporate FVA in the valuation of assets held for trading. As a consequence, standard methodologies are used in the banking book while assets in the trading book are priced at market or "fair" values (Jackson and Lodge, 2000).

While current practices of accounting for credit risk are subject to the traditional approach, banks are increasingly using models for calculating loan loss provisions based on past experience. Moreover, in some countries the authorities allow the use of discounted values as an instrument to assist these estimations. The combination of methods described can be considered an intermediate approach in the movement towards a more dynamic accounting system. It evidences a search for a balance between the two approaches and definitely breaks the ground for a more forward-looking system of provisions.

However, the pace of these changes has been slow. To some extent, the emphasis on provisioning methods based on evidence of asset impairment rather than a consideration of the expected effects of the business cycle on balance sheets reveals a fiscal bias. This approach is explained by a traditional sensitivity to the possible understatement of income in the financial statements of banks. It can also be defended on the basis of the principles of corporate governance, as the estimation of the net worth of banks based on effective asset impairment eliminates any margin of discretion on the part of managers and is thus a transparent process. However, it is probably clearer to refer to it as the "fiscal view".

This perspective is in open contrast to prudential concerns about the timely recognition of risk – which can be termed the "prudential view". Thus, while the fiscal view emphasizes accuracy in the calculation of income for tax purposes and the prevention of unjustified deductions, the prudential view stresses the accurate assessment of credit risk, based on expected future losses, and the calculation of the corresponding loan valuation allowances. The conflict between the two views arises from the fact that the latter tends to maximize the value of taxable earnings during upswings, while the application of the former would reduce it. However, the impact of risk accumulated during a credit boom will materialize in loan losses during crises. In the long run, both views should thus converge. In fact, the fiscal view will tend to generate pro-cyclical tax revenues. Moreover, if the fiscal costs of bank rescues are taken into account, there may be positive net fiscal effects from adopting the prudential view. A similar analysis can be made from the perspective of transparency in corporate governance: traditional HVA accounting would in fact lead to an overestimation of the net worth of banks during booms and an underestimation during crises.

The omission of long-term considerations, especially cyclical risks, is likely to have serious consequences for the prudent operation of the banking system. It is realistic to expect some experienced banks to anticipate the slowdown of economic activity, especially in a market that has already shown signs of instability. However, whether they make adequate provisions or not depends not only on risk assessment but also on regulatory pressures. In the absence of an incentive or a penalty, market forces will not necessarily correct for this omission. If, in this context, banks charge an interest rate premium for latent losses but, instead of provisioning for such premiums, use the additional income to increase distributed profits, borrowers will be subsidizing bank owners to the detriment of deposit safety. This behavior would be reinforced by expectations of (domestic or international) bailouts or by a generous system of deposit insurance, reinforcing moral hazard concerns. Again, this practice can also be called into question from the point of view of transparent corporate governance.

A final perspective that should be taken into account is the extension to credit risk analysis of concepts widely used by agents operating in stock markets, where risk is recognized as having two components: systematic (beta) and nonsystematic. The first depends on the correlation of price fluctuations of each particular stock with prices on the entire market and arises from exposure to common factors (e.g. economic policy or the business cycle). Nonsystematic risks depend, in contrast, on the individual characteristics of each stock and may be reduced by diversification. Stock market investors use information on betas to assess their risk exposure to market cycles. When these concepts are applied to credit markets, the risk of a borrower with a high beta should be transferred to the loans that banks extend to that borrower. Banks usually measure nonsystematic or specific risk by analyzing projects and borrowers on an individual basis.

In the absence of a deep enough market for loans, banks could use the same information about betas that is available in stock markets. The value of betas provided by stock markets could be used in the estimation of systematic risk for groups of loans, which could be classified according to industry betas. Obviously, this approach is of limited use in countries with underdeveloped stock markets, and in countries or sectors with a large presence of family firms or SMEs.

Understandably, banks and investors will be behaving pro-cyclically if they increase their exposure to industries with high betas during the upward phases of cycles while doing the opposite during downturns. Since they must reduce their exposures before the peak of the cycle, stock market investors rely on indicators such as price-to-value ratios and analysis of time series to predict the length of price cycles. In the absence of a market for loans that provides equivalent signals, bankers are increasingly using models for risk assessment and prediction of market conditions. However, crises differ in length and intensity, which makes it difficult to predict the timing of cycles. Nonetheless, the assessment of cyclical risk should improve by increasing the period of time used for observation of past experience.

3.3 The choice of instruments for protection against credit risk

Considering that banks should adequately protect their value against cyclical fluctuations in economic activity, which instruments should be used and what are the constraints imposed by current regulations and accounting practices? In particular, should banks choose provisions or reserves and what are the available alternatives among them? A quick review of definitions of these concepts as well as their practice in different countries may help to understand the implications of choosing among the alternatives.

Under generally accepted accounting practices, provisions constitute an estimated amount of an expense that has a *certain incidence but uncertain magnitude* and reflect *identifiable asset impairment*. By contrast, reserves are allocations of net (after tax) profits set aside for unexpected problems in future loan repayments. It is also accepted that provisions should cover *expected losses*, and are recorded as expenses, while reserves apply to *unexpected losses* and are part of capital.[8] The principles underlying this practice also imply that banks charge an interest risk premium for expected risk while stockholders should cover unexpected risks. Unexpected losses might threaten solvency, and capital is considered necessary as a reserve for cases of insolvency (Beatie, *et al.*, 1995; Borio, *et al.*, 2001). Provisions also tend to reflect more specific risk than reserves, which are more general. This latter view is reflected in the definition of regulatory capital under the current Basel Accord, which states that "general provisions eligible for inclusion in regulatory capital must be held against presently unidentified

[8] It is important to note that in the United States, provisions are also called loan loss reserves.

losses", and " be freely available to meet losses which subsequently materialize".[9]

Accounting practices differentiate between *general* and *specific* provisions. The latter refer to individual assets or pools of assets defined according to criteria such as industry, country, time of default, etc., and respond to specific signals of loan impairment. In most countries, calculation of specific provisions is made on an individual basis for commercial loans and on a pooled basis for retail loans. However, certain countries require evaluation of all loans on an individual basis. General provisions are estimated on the basis of pools of loans, or of the total portfolio. In some countries, they are treated as *reserves* and, as such, as capital, while in others they are subtracted from assets. The distinction makes an important difference in terms of taxation. Whereas procedures for calculating specific provisions are more similar, there are a variety of practices among countries in the methods used to estimate general provisions. The evidence shows that rules related to general provisions and reserves are more flexible and allow for more forward-oriented approaches in the appraisal of risk.

The proposals by Beatie, *et al.* (1995) follow these criteria and suggest an approach for use in confronting three manifestations of credit risk: (a) expected losses due to identifiable asset impairment, which are observed on an individual basis and should continue to be managed with specific provisions; (b) non-identifiable but expected losses, which do not correspond to observed signals of impairment and require general provisions; and (c) unexpected losses, which include the variability of returns on loans and the possibility of losses exceeding an expected level, which should be covered by a reserve.

Banks use a variety of methods to calculate provisions. In some countries, authorities (governments or central banks) are restrictive to the point of establishing statutory rules that determine the level of provisions. In others, the system varies from a strict formula to statistical approaches, using historical data, information on peer groups and more explicit risk models. The flexibility that authorities allow to banks regarding the use of their own methods or models is also variable.

Internal models used by banks have become very sophisticated. Several OECD countries allow the constitution of forward-looking provisions based on past experience and the expectation of future events. However, most of them are short-term oriented, using a one-year horizon to measure risk. In most of the countries, the application of such methods is voluntary, though sometimes motivated by fiscal incentives. In general, however, they do not account for cyclical variations in economic activity.

[9] See Beatie, *et al.* (1995), ch. 4, p. 38.

The best known exception to this rule is Spain, which recently issued regulations requiring counter-cyclical provisions calculated by statistical methods. The main features of this approach are the estimation of “latent risk” based on past experience (long enough to cover at least one entire business cycle), and a dynamics such that provisions build up during economic expansion, but the corresponding fund is drawn upon during slowdowns and recessions (Poveda, 2001; Fernández de Lis, *et al.*, 2001). The major innovation of this system is the explicit recognition that risks are incurred when credits are approved and disbursed, not when they come due.

More particularly, under this scheme, “statistical” or actuarial provisions for “latent” risks must be estimated for homogenous categories of credit according to the possible loss that a typical asset (loans, guarantees, interbank or fixed income portfolio investments) in this category is expected to have, estimated on the basis of a full business cycle. Either the internal risk management model of the financial institution or the standard model proposed by Banco de España can be used for this purpose. The latter establishes six categories, with annual provisioning ratios that range from 0 to 1.5 percent. These “statistical provisions” must be accumulated in a fund, together with special provisions (traditional provisions for non-performing assets or performing assets of borrowers in financial difficulties) and recoveries of non-performing assets. The maximum amount of the fund is three times the annual statistical provisioning ratio. The fund can be used to cover loan losses, in effect entirely substituting for special provisions if resources are available in adequate amounts. If this is so, provisions actually follow the credit cycle. Additionally, general provisions equivalent to 0, 0.5 and 1.0 percent of assets are required.

Although the accumulation and depletion of the fund made up of statistical and specific provisions has a counter-cyclical dynamics, this only reflects the cyclical pattern of bank lending. In this regard, the system is strictly speaking ”cycle-neutral” rather than counter-cyclical, but it is certainly superior to the traditional pro-cyclical provisioning for loan losses, or forward-looking provisioning based on too short a time horizon to take into account the cyclical performance of lending during the business cycle.

Consequently, a system such as this should be complemented by strictly counter-cyclical ”prudential provisions”, decreed by the regulatory authority for the financial system as a whole, or by the supervisory authority for special financial institutions, on the basis of objective criteria. These criteria could include the rate of growth of lending, the bias in lending towards sectors characterized by systematic risks or the growth of foreign-currency denominated loans to non-tradable sectors. Voluntary prudential provisions can also be encouraged. This would make provisions a powerful instrument for use by banks in managing the effects of business cycles.

To achieve this purpose, it is essential that tax deductibility be granted to provisions. Indeed, accounting and taxation rules contribute to the failures in risk assessment because, in general, they require the registering of events that have already occurred.[10] As we have emphasized, this traditional criterion disregards the fact that risk is present in the loan portfolio *before* the occurrence of loan impairment – the basic principle underlying forward-looking provisioning as well as market and fair value accounting.

The formulas for calculating capital/asset ratios also influence provisioning. Under the current Basel Accord, only provisions and reserves "which are not allocated to an identified deterioration of any asset or group of assets" may be included in capital. However, some countries do not allow general provisions in regulatory capital. There are also differences regarding the value of risk-weighted assets because some countries require banks to subtract general provisions from total assets. This practice tends to increase the value of the capital/asset ratio, an effect that would be reinforced by inclusion of general provisions in regulatory capital. It is also important to note that the rules for calculation of the capital/asset ratio under the current Basel Accord assign the same weight to all commercial loans regardless of their individual risk. Even the rules proposed by the new Basel Accord for calculating capital requirements under the "standardized" approach, which is the method that most likely will be applied in developing countries, disregard the differences in credit risk among non-rated corporations and small businesses, as they receive the same weight in the denominator of the capital/asset ratio. This homogeneous treatment of risk calls for more caution in the calculation of loan provisions on an individual or group basis.

It might be considered that reserves and provisions could work interchangeably as protection against future losses. However, the choice between the two is not immaterial. Provisions reduce profits, providing a better assessment of the real value of assets. The overestimation of profits that takes place when banks are short of provisions delivers inaccurate information to the markets, a fact that amplifies cyclical variations of credit and delivers non-transparent information to investors in bank stocks.

The combination of tax, accounting and prudential rules thus influences provisioning policies. For example, in a country where reserves are counted as regulatory capital and provisions are not tax deductible, banks may be more inclined to protect their value from risk via reserves. As we have indicated, an inadequate tax treatment will reduce the advantages of forward-looking provisioning. Also, as stated, an inadequate accounting for risk may

[10] The treatment of provisions for tax purposes varies among countries, from the extreme and exceptional case of the United States, where they are not deductible, to cases of full deductibility. Most of the countries allow for deduction of specific provisions while the treatment of general provisions is more variable. In some cases, there is no deductibility for provisions but write-offs are deductible. Finally, for some types of debts certain countries require provisions to be spread over a number of years (Beatie, *et al.*, 1995).

lead to overstatement of profits, generating a strong pressure to distribute dividends.

The problems related to asymmetries of information that are inherent in the banking business also deserve some consideration. The capacity of banks to assess the risk of loans correctly depends on the information available about borrowers and their ability to service their obligations. However, developing countries often lack appropriate data on the credit records of their bank clients (except, obviously, on their business with them). Medium-sized countries in Latin America, such as Chile and Colombia, provide examples of privately managed systems for gathering this type of information that can be replicated in other developing countries, assigning priority to records for the largest bank clients. However, even in these systems, there are still shortcomings in the assessment of risk for SMEs that increase the probability of adverse selection. Countries should try to improve information regarding these firms. This is an issue that merits government intervention, perhaps by sharing the costs of gathering and standardizing information on SMEs.

Furthermore, considering that the risk of loans initially increases the net income of banks via the risk premiums they charge, it may be necessary to compensate this perverse incentive by developing market instruments that raise the cost of excessive risk taking. Certainly, this is the purpose of provisions. However, the effectiveness of this instrument is limited by information asymmetries about the quality of loans. It is thus worth exploring other market instruments that directly affect the costs of risk taking and increase transparency of information on the quality of loans. Developing a secondary market for loans, where the price would be set by auctions, would serve this purpose.

The foregoing analysis indicates that an appropriate policy for managing the macroeconomic effects of boom-bust cycles in developing countries should involve a mix of: (a) forward-looking provisions for latent risks that force financial intermediaries to take into account the risks they incur throughout the whole business cycle, with provision being made when credit is granted; and (b) more discrete counter-cyclical prudential provisions. Specific provisions should be managed together with forward-looking provisions, as in the Spanish system. As we will see in the following sections, they should be complemented by regulations in other areas. Reserves or general provisions play a less clear role, and in fact are not distinguishable from the role of capital as the essential coverage against unexpected losses.

A system of provisions such as this is certainly superior to the possible use of capital adequacy ratios to manage cyclical variations. This means that capital adequacy requirements should focus on long-term criteria rather than on cyclical performance. Insofar as developing countries are more likely to face greater macroeconomic volatility, there is an argument for requiring higher capital/asset ratios, but there is none for requiring that such capital adequacy ratios should not be, as such, counter-cyclical. Provisions have a clear advantage in this regard.

It should also, in any case, be borne in mind that stricter standards for managing macroeconomic risks in developing countries – in terms of provisions, capital or other areas – increase the costs of financial intermediation, reducing international competitiveness and creating arbitrage incentives to use international financial intermediation as an alternative. As indicated in Section 3.1 above, counter-cyclical macroeconomic policies are an essential complement, and prudential policies are certainly not a substitute for the risks that pro-cyclical macroeconomic policies may generate.

It is important to emphasize that the proposal for the proposed new Basel Accord constitutes an advance in the concept of risk applied in banking regulation as well as the alignment of capital with risk. It would require banks to calculate regulatory capital as a function of credit, market and operational risk.[11] Pillar II of the proposal, which is concerned with the supervisory review process,[12] also recommends checking that banks "evaluate the level and trend of their material risks and their effect on their capital level". It also requires that each of them "assess its future capital requirements based on the bank's reported risk profile and make necessary adjustments to the bank's strategic plan accordingly". Regarding the internal reviews performed by the banks, it recommends analyzing "the validity of scenarios used in the assessment process" as well as the "stress testing analysis of the assumptions and inputs". Certainly simulation of scenarios and stress testing require consideration of the macroeconomic context in which banks operate as well as changes in macroeconomic variables that affect their performance.

However, it is unclear whether the new Basel Accord would make the regulatory system less pro-cyclical. This is true even in the Internal-Ratings Based (IRB) approach, under which banks are supposed to estimate the probability of loan defaults based on historical experience, as this concept may be applied for too short a time horizon, which does not encompass a whole business cycle. This has been the experience with advances in forward-looking provisioning in recent years (see above). Furthermore, credit may turn out to be more pro-cyclical under the IRB approach, due to the implicit shape of the functions that estimate the probability of default and the expected loss given default under the IRB approach. Some simulations indicate that, due to the implicit shape of these functions, lending to firms and countries with intermediate ratings could become more pro-cyclical.

[11] Operational risk is defined as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems and from external events".

[12] The proposal for a new Basel Capital Accord is divided into three pillars. Pillar I refers to the calculation of minimum capital requirements according to the risk incurred by each bank. Pillar II proposes guidelines for bank supervisors in the process of reviewing the activities of banks. Pillar III is concerned with market discipline in the banking activity.

The incentives to use risk evaluations by specialized rating agencies may have the same effect, given the pro-cyclical bias that these ratings have shown in recent years. The high concentration of the rating industry is an additional argument against adopting this recommendation. Moreover, it would be difficult to apply this practice in developing countries due to the absence of adequate credit ratings for most firms.[13]

3.4 Prudential treatment of currency and maturity risks and volatile asset prices

As has been pointed out, experience indicates that currency and maturity mismatches are essential aspects of financial crises in developing countries. Prudential regulation should thus establish strict rules to prevent currency mismatches (including those associated with hedging and related operations), to reduce imbalances in the maturities of assets and liabilities of financial intermediaries, and to establish liquidity regulations to manage such imbalances.[14]

The strict prohibition of currency mismatches in banks' portfolios is the best rule in this regard. Additionally, authorities should closely monitor the intermediation of short-term external credits. At the macroeconomic level, monitoring the ratio of foreign exchange reserves to total short-term external debts (or the adjusted ratio, which adds the current account deficit to the denominator) constitutes a simple way to establish the financial vulnerability of a country to changes in the exchange rate. Ratios below one, such as those observed in Asian countries on the eve of the 1997 crisis, should alert supervisors to an increased level of currency risk (Rodrik and Velasco, 2000; Rojas-Suárez, 2001; Haldane, *et al.*, 2001).

On the other hand, in order to accomplish the dual objective of protecting the economy against fluctuations in exchange rates and increasing the supply of long-term financing, it is necessary to design instruments that redistribute (if not eliminate) the risk of currency mismatches and keep the amount of exposure within reasonable limits. In the case of foreign-owned corporations, guarantees from parent companies should compensate for such risks. Large local corporations could use hedging instruments to cover currency risk. However, these instruments are unlikely to be available for long maturities, forcing corporations to rotate short-term hedging, a strategy that carries high costs and risks in periods of currency turbulence. Additionally, authorities could require local non-financial firms to make provisions for currency risks when the incidence of foreign loans reaches pre-determined limits.

[13] This has been the claim in relation to the effects of the new accord on bank lending to emerging markets. See Griffith-Jones, Spraat and Segoviano (2002) and Reisen (2001).
[14] For an interesting analysis of the problems created by these mismatches and their effects during recent crises, see Perry and Lederman (1998).

Currency risks are particularly severe for corporations operating in non-tradable sectors. As we have seen, these risks may turn into credit risk for domestic banks even if corporations borrow directly abroad. This fact calls for better monitoring of the currency risks of these firms and, probably, for specific regulations on lending to firms in non-tradable sectors that hold substantial liabilities in foreign currencies. In particular, banks should not be allowed to extend loans in foreign currencies to non-tradable sectors unless adequate instruments of protection against currency risk are provided, which may include investment guarantees against the risk for companies operating in non-tradable sectors. Alternatively, these loans can be given a high risk weighting in the estimation of the capital/asset ratio.

In addition, prudential regulation needs to ensure adequate levels of liquidity for financial intermediaries, so that they can handle the mismatch between average maturities of assets and liabilities related to the financial system's essential function of "transforming maturities", which generates risks associated with volatility of deposits and/or interest rates. This underscores the fact that liquidity and solvency problems are far more interrelated than traditionally assumed, particularly in the face of macroeconomic shocks. Reserve requirements, which are strictly an instrument of monetary policy, provide the required liquidity in many countries, but their declining importance makes it necessary to design new tools. Moreover, their traditional structure is not geared to the specific objective of ensuring financial intermediaries' liquidity. An important innovation in this area is undoubtedly the Argentine system created in 1995, which set liquidity requirements based on the residual maturity of financial institutions' liabilities (i.e., the number of days remaining before reaching maturity).[15] These liquidity requirements – or a system of reserve requirements with similar characteristics – have the additional advantage that they offer a direct incentive to the financial system to maintain a better time-liability structure. The quality of the assets in which liquidity requirements are kept is obviously essential. In this regard, it must be pointed out that allowing them to be invested in public sector bonds was an essential weakness of the Argentine system, as it increased the vulnerability of the financial system to public sector debt restructuring.

The decline of asset prices during the downward phase of the business cycle constitutes a major source of distress for banks that may lead to crises. The main source of fragility is credit risk, which increases defaults on the part of customers that have taken leveraged positions in real estate and/or stock markets. A secondary source of problems is the economic slowdown related to the price slump, which also affects debt service.

[15] Banco Central de la República Argentina (1995), pp. 11–12.

According to current Basel rules, the risk weight for loans to real estate corporations in the denominator of the capital/asset ratio is higher than the weight for household loans. However, recent experience of several emerging markets suggests the need for complementary rules to provide stronger protection against an asset price drop. Increasing the risk weight for loans to real estate companies in the denominator of the capital/asset ratio should improve protection for banks when real estate prices rise beyond a previously defined threshold. Although it may be difficult to realize when prices are close to the peak, historical data on previous cycles should be helpful. Other issues to be considered are specific market and regional factors, as well as credit concentration. Price fluctuations are often larger in particular regions. A large concentration of loans to or specialization of financial intermediaries in real estate lending is also a factor increasing risk.[16]

The valuation of collateral also presents problems because, in several cases, ex-ante assessments may be significantly higher than ex-post prices. Limits on loan-to-value ratios and rules to adjust the values of collateral to take into account cyclical price variations should be adopted. One approach in this direction is the "mortgage lending value", a valuation procedure applied in some European countries (Denmark, Germany, Luxembourg and Austria), which reflects long-term market trends in real estate prices based on past experience. The main purpose of this approach is to calculate asset values that are sustainable in the long run.[17]

Other relevant regulatory and supervisory practices are alert signals, including indicators that address the fragility of customers, avoiding credit concentration and the timely write-off of due loans. Indicators of customers' debt burdens, such as the level of debt servicing as a percentage of disposable income or as a percentage of operating profits for firms, should be frequently monitored. Banks (and other financial institutions that supply loans to this market) should be especially cautious about marginal borrowers who enter the market when prices are approaching the peak of the cycle and supervisors should monitor these loans more closely. Supervisors should conduct their own monitoring and stress testing. Other advisable practices include public communication of concerns by supervisory authorities and central banks (whether they play the supervisory role or not), meetings with bank managers and directors and sensitivity analysis of banks' balance sheets (for an extended discussion of these topics see European Central Bank, 2000).

Some analysts have proposed higher capital/asset ratios for developing countries to compensate for poor provisioning practices (Rojas-Suárez,

[16] The Savings and Loans crisis in the US and the case of "Jusen" in Japan exemplify the consequences of this fragility.

[17] Valuation procedures identified by the European Mortgage Federation (European Central Bank, 2000).

2001). In order to induce the adoption of adequate standards for the assessment, monitoring and provisioning of credit risk, it would be advisable to adopt a general but conditional increase in the capital/asset ratio. Individual banks would be allowed to reduce the requirement if they demonstrate appropriate risk control procedures and adequate accounting and provisioning practices.

As Rojas-Suárez (2001) has pointed out, there has been an increase in the preference of banks for local government bonds, even when the spreads of public debt securities are rising . The zero risk weights that regulations allow for this type of investment generate incentives of this sort. The proposed new Basel Accord requires the assignment of risk weights according to country ratings; however, it allows for zero or low risk weight for sovereigns issued in countries where each bank is incorporated, provided that the claims are issued in the currency of the sovereign and banks are funded in the same currency (BIS, 2001a). Recent experience with some developing countries (i.e. Argentina) shows that this policy may understate the real risk that banks face.

It should finally be pointed out that, during financial crises, authorities must adopt clearly defined rules to restore confidence. However, the application of stronger standards should be gradual, to avert a credit squeeze. Of course, in order to avoid moral hazard problems, authorities must never bail out the owners of financial institutions, guaranteeing that their losses are written off up to the value of the net worth of the bank that is the object of intervention.

4. Capital Account Regulations

4.1 The dual role of capital account regulations

As the major source of boom-bust cycles in developing countries is capital account volatility, an alternative to the prudential approach analyzed in part 3 of this paper is direct capital account regulations. In fact, due to the limitations of both approaches, a mix between the two is probably advisable. The characteristics of macroeconomic policies and, more broadly, the regulatory tradition will also determine the nature of the mix.

In macroeconomic terms, the accumulation of risks during booms will depend not only on the magnitude of domestic and private debts but also on their maturity structure. Capital account regulations thus have a dual role: as a macroeconomic policy tool, which provides some room for counter-cyclical monetary policies, and as a "liability policy", to improve private sector external debt profiles. More direct liability policies should also be adopted to improve public sector debt profiles. The emphasis on *liability structures* rather than national balance sheets recognizes the fact that together with liquid assets (particularly, international reserves), they play an essential role when countries face liquidity constraints; other assets play a secondary role in this regard.

Viewed as a macroeconomic policy tool, capital account regulations are aimed at the direct source of boom-bust cycles: unstable capital flows. If they are successful, they will provide some room to "lean against the wind" during periods of financial euphoria, through the adoption of a contractionary monetary policy and reduced appreciation pressures. If effective, they will also reduce or eliminate the quasi-fiscal costs of sterilized foreign exchange accumulation. During a crisis, they may also provide "breathing space" for expansionary monetary policies.

Viewed as a liability policy, capital account regulations recognize the fact that the market generously rewards sound external debt structures (Rodrik and Velasco, 2000). This is because, during times of uncertainty, the market responds to *gross*, rather than merely net financing requirements, which means that the rollover of short-term liabilities is not financially neutral. Under these circumstances, a time profile that leans towards longer-term obligations will considerably reduce the level of risk. This indicates that an essential component of economic policy management during booms should be measures to improve maturity structures, in both the private and the public sector, and for both external and domestic liabilities.

4.2 Innovations in capital account regulations in the 1990s

A great innovation in this sphere during the 1990s was unquestionably the establishment of reserve requirements for foreign currency liabilities in Chile and Colombia. The advantage of this system is that it creates a simple, non-discretionary and *preventive* (prudential) price incentive that penalizes short-term foreign-currency liabilities more heavily and has neutral effects on corporate borrowing decisions (see below). The corresponding levy has been significantly higher than the level suggested for an international Tobin tax: about 3 percent in the Chilean system for one-year loans, and an average of 13.6 percent for one-year loans and 6.4 percent for three-year loans in Colombia in 1994–1998. As a result of a drastic change in international capital markets, the system was phased out in both countries in 1999–2000. Other capital account regulations complemented reserve requirements, particularly one-year minimum stay requirements for portfolio capital (lifted in May 2000) and direct approval for the issuance of American Depository Receipts (ADRs) (and similar operations) in Chile, and direct regulation of all portfolio flows in Colombia.

The effectiveness of reserve requirements has been subject to a great deal of controversy.[18] There is fairly broad agreement on their effectiveness as a liability policy. In this regard, there is clear evidence that both countries maintained above-average external debt profiles. On the other hand, there is heated controversy about their effectiveness as a macroeconomic policy tool. This issue has been made more complex by the fact that neither country has been free from pro-cyclical macroeconomic policy patterns.

However, judging from the solid evidence that exists with respect to the sensitivity of capital flows to interest rate spreads in both countries, reserve requirements do influence the volume of capital flows at given interest rates. This may reflect the fact that the *access* of national firms to external funds is not independent from their maturities – i.e., that the substitution effect between short- and long-term finance is imperfect – and that available mechanisms for evading or eluding regulations are costly.[19] Alternatively, if higher reserve requirements induce new flows by their effects on domestic interest rates, their ability to affect the latter should be seen as an indication

[18] For documents that support the effectiveness of these regulations, see Agosin (1998), Agosin and Ffrench-Davis (2001), Le Fort and Budnevich (1997), Le Fort and Lehman (2000), Ocampo and Tovar (1998, 1999, 2001), Palma (2002), Rodrik and Velasco (2000) and Villar and Rincón (2000). For a more skeptical view, particularly on the macroeconomic effects of control, see Cárdenas and Barrera (1997), de Gregorio, Edwards and Valdés (2000) and Valdés-Prieto and Soto (1998). There have also been explicit taxes on foreign currency borrowing in other countries, notably Brazil.

[19] Some of these mechanisms, such as the use of hedging, enable investors to cover some of the effects of these regulations, though in large part by transferring risks (and, more specifically, the risks associated with long-term financing) to other agents.

that they are a useful macroeconomic policy tool. In Colombia, where these regulations were modified more extensively in the course of the 1990s, there is strong evidence that increases in reserve requirements have reduced flows (Ocampo and Tovar, 1999 and 2001) or, alternatively, been effective, when tightened, in raising domestic interest rates (Villar and Rincón, 2000). Similar evidence is available for Chile (see Agosin and Ffrench-Davis, 2001, and LeFort and Lehman, 2000). Moreover, according to the analysis presented in the previous section, there is evidence that the strengthening of capital account regulation improved the exchange rate/monetary policy mix that authorities could choose in the face of pressures from booming capital markets. These effects were only temporary, however, operating as "speed bumps" rather than permanent restrictions, to use Palma's (2002) expressions.

Some problems in the management of these regulations were associated with changes in the relevant policy parameters. The difficulties experienced by the two countries in this connection differed. In Chile, the basic problem was the variability of the rules pertaining to the exchange rate, since the upper and lower limits of the exchange rate bands (in pesos per dollar) were changed on numerous occasions until abandoned in 1998. During capital account booms, this gave rise to a "safe bet" for agents bringing in capital, since when the exchange rate neared the floor of the band, the probability that the floor would be adjusted downward was high. In Colombia, the main problem was the frequency of the changes in reserve requirements. Changes foreseen by the market sparked speculation, thereby diminishing the effectiveness of such measures for some time following the modification of the requirements. It is interesting to note that in both countries reserve requirements were seen as a complement to, rather than as a substitute for, other macroeconomic policies, which were certainly superior in Chile. In particular, the expansionary and contractionary phases of monetary policy were much more marked in Colombia, and this country's fiscal position deteriorated through the decade.

Malaysia also offered major innovations in the area of capital account regulations in the 1990s. In January 1994, this country prohibited non-residents from buying a wide range of short-term securities; these restrictions were lifted later in the year. These restrictions also had a preventive focus, but the basic instruments used were quantitative restrictions. As a "speed bump", they proved highly effective, indeed superior in terms of reducing capital flows and asset prices to the Chilean regulations that had been adopted in previous years (Palma, 2002). They also improved the country's debt profile (Rodrik and Velasco, 2000). However, after they were lifted, a new wave of debt accumulation and asset price increases developed, though the debt profile was kept at a more prudential level than in other Asian countries that ran into a crisis in 1997 (Kaplan and Rodrik, 2001; Palma, 2002).

The other innovation came with the Asian crisis. In September 1998, strong restrictions were imposed on capital outflows. The regulations were basically aimed at eliminating offshore trading of the national currency. Ringgit deposits abroad were made illegal, and it was determined that such deposits held abroad by nationals had to be repatriated. Trade transactions had to be settled in foreign currency, with no control on the corresponding current account transaction. It was also determined that ringgit deposits in the domestic financial system held by non-residents would not be convertible into foreign currency for a year. In February 1999, this regulation was replaced by an exit tax, with a decreasing rate if deposits were held for a longer period and no tax on deposits held for more than a year. An exit profit tax was then established for future foreign capital flows, with a high rate for capital that stayed less than a year (30 percent; 10 percent otherwise); the higher tax rate was eliminated later in the year and in January 2001 it was determined that the tax would apply only to deposits held for less than a year.

Significant discussions have taken place on the effects of these controls. Kaplan and Rodrik (2001) have recently provided the strongest defense of the effectiveness of these regulations. Following previous studies, they show that they were highly and very rapidly effective in reversing financial market pressure, as reflected in the evolution of foreign exchange reserves, the exchange rate and offshore interest rates for ringgit deposits. The removal of financial uncertainties, together with the additional room provided for expansionary monetary and fiscal policies, led to a speedier recovery of economic activity, lower inflation and better employment and real wage performance than comparable IMF-type programs during the Asian crisis. This is true even adjusting for the improved external environment characteristic of the time when Malaysian controls were imposed. Moreover, the country did not receive large injections of capital and, indeed, temporarily cut itself off from external capital markets, a fact that does not seem to have had perceptible long-term effects in terms of access to these markets.

Overall, innovative experiences with capital account regulations in the 1990s indicate that they can provide useful instruments, both in terms of improving debt profiles (liability policy) and in facilitating the adoption of (possibly temporary) counter-cyclical macroeconomic policies. They have thus shown that it is possible to design preventive policy instruments that avoid part of the costs of boom-bust cycles in international finance. The basic advantages of the Chilean-Colombian price-based instrument are its simplicity, non-discretionary character and neutral effect on corporate borrowing decisions. The more quantitative-type Malaysian systems have proven to have stronger short-term macroeconomic effects.

At any event, all these systems have been designed in countries that chose to be *integrated* in international capital markets. In fact, in the case of Colombia, the transition from the old type of exchange controls to price-based capital account regulations represented an effective liberalization of the capital account, as reflected in the increased sensitivity of capital flows to interest arbitrage incentives (Ocampo and Tovar, 1998). Traditional exchange controls may be superior if an objective of macroeconomic policy is to significantly reduce the domestic macroeconomic sensitivity to international capital flows (see Nayyar, 2002, for an analysis of the Indian experience). Simple quantitative restrictions that rule out certain forms of indebtedness (e.g., short-term foreign borrowing, except trade credit lines) are also preventive in character and easy to administer.

Furthermore, the experience of many developing countries in recent decades strongly indicates that capital account liberalization in countries with underdeveloped prudential regulation of domestic financial systems has a high probability of leading to a twin (macroeconomic and domestic financial) crisis (see, for example, IMF, 1998). Moreover, these experiences also show that crisis-driven quantitative controls generate serious credibility issues and may be ineffective, since a tradition of regulation and efficient management of controls is necessary to make any regulatory regime effective. Therefore, *permanent* regulatory regimes that are tightened or loosened over the cycle are superior to the alternation of different (even contrasting) capital account regimes. Also, traditional quantitative capital account regulations can make perfect sense, if they are not used as a substitute for sensible macroeconomic policies, and if they are well managed to avoid loopholes, evasion, high administrative costs and, particularly, corruption.

4.3 Complementary liability policies

Capital account regulations can be partly substituted by prudential regulation and supervision. In particular, higher liquidity (or reserve) requirements can be established for the financial system's foreign currency liabilities. Also, as we indicated in Section 3.4, domestic lending to firms operating in non-tradable sectors that have substantial foreign currency liabilities can be discouraged through more stringent provisions and/or risk weighting in the calculation of the capital/asset ratio.

The main problem with these options is that they only indirectly affect the foreign-currency liabilities of non-financial agents and, indeed, may encourage them to borrow directly abroad. Accordingly, they need to be complemented by other regulations, including rules on the classes of firms that are allowed to borrow abroad and the prudential ratios that they must meet; restrictions on the terms of corporate debts that can be contracted abroad (minimum maturities and maximum spreads); public disclosure of the short-term external liabilities of firms; regulations requiring rating agencies to give special weight to this factor; and tax provisions applying to foreign currency liabilities (e.g., no or only partial deductions for interest payments on international loans).[20] In this regard, a simple rule that should be contemplated is the Malaysian system prohibiting non-financial firms without income in foreign currency from borrowing in foreign currencies.

Price-based capital account regulations may thus be a superior alternative and simpler to administer than an equivalent system based on prudential regulations plus additional policies aimed at non-financial firms. Among their virtues, vis-à-vis prudential regulation and supervision, we should also include the fact that they are price-based (some prudential regulations, such as prohibitions on certain types of operations, are not), non-discretionary (prudential supervision, in contrast, tends to be discretionary in its operation), and neutral in terms of corporations' choice between foreign currency-denominated borrowing in the domestic vs. the international market. Indeed, equivalent practices are used by private agents, such as the selling fees imposed by mutual funds on investments held for a short period, in order to discourage short-term holdings (J. P. Morgan, 1998, p. 23).

In the case of the public sector, direct control by the Ministry of Finance (in some cases by the central bank) is the most important liability policy, including controls on borrowing by other public-sector agencies and autonomous sub-national governments.[21] Public sector debt profiles that lean too far towards short-term obligations may be manageable during booms, but can become a major destabilizing factor during crises. This remark is equally valid for external and domestic public sector liabilities. The most straightforward reason for this is that residents holding short-term public sector securities have other options besides rolling over the public sector debt, including capital flight. This is even clearer if foreigners are allowed to purchase domestic public sector securities.

Thus, when gross borrowing requirements are high, the interest rate will have to increase to make debt rollovers attractive. Higher interest rates are also immediately reflected in the budget deficit, thereby rapidly changing the trend in the public sector debt. In addition, rollovers may be viable only if risks of devaluation or future interest rate hikes can be passed on to the government, generating additional sources of destabilization. Mexico's widely publicized move in 1994 to replace peso-denominated securities (Treasury Certificates or Cetes) by dollar-denominated bonds (Tesobonos), which was one of the crucial factors in the crisis that hit the country late in that year, was no doubt facilitated by the short-term profile of Cetes.[22] The short-term structure of Brazil's debt is also the reason why, since late 1997, fixed-interest bonds were swiftly replaced by variable rate and dollar-denominated securities, which cancelled out the improvements that had been made in the public debt structure in previous

[20] For an analysis of these issues, see World Bank (1998, p. 151), and Stiglitz and Bhattacharya (2000).

[21] ECLAC (1998), chapter VIII.

[22] See Sachs, Tornell and Velasco (1996) and Ros (2001).

years. It is important to emphasize that, despite its fiscal deterioration, no substitution of similar magnitude was observed in Colombia during the 1998–1999 crisis. This country's tradition of issuing public sector securities with a minimum maturity of one year is a significant part of the explanation.

Thus, in terms of reducing the degree of vulnerability during crises, a sound domestic public sector debt maturity is an essential complement to a sound public and private external debt profile. The improvements in Argentina's and Mexico's external debt profiles since the "Tequila" shock were generally regarded as a strength during the 1998–1999 crisis. Similarly, Colombia's excellent external debt profile and the relatively sound maturity structure of its domestic public sector liabilities, were positively reflected in spreads during the recent crisis, despite its deteriorating fiscal position (except, temporarily in 2000).

The extent to which it proves possible to issue longer-term domestic debt securities will depend on the depth of the local capital market, a characteristic that includes the existence of secondary markets to provide liquidity for these securities. For this reason, measures designed to deepen the countries' credit and capital markets play a crucial role in improving domestic debt profiles. This statement is also valid for an adequate development of long-term private capital markets. However, due to the lower risk levels and the greater homogeneity of the securities it issues, the central government has a vital function to perform in the development of longer-term primary and secondary markets for securities, including the creation of benchmarks for private sector securities.

However, the development of such markets will not eliminate the need for an active external liability policy, as deeper capital markets are also more attractive to volatile portfolio flows. Unfortunately, the tradeoffs are not simple in this regard, as international portfolio flows may actually help to develop domestic capital markets. Thus, the authorities must choose between reducing the volatility of external capital and developing deeper, liquid domestic markets. The Chilean decision in May 2000 to eliminate the one-year minimum maturity for portfolio flows, as well as the Colombian decision in 1996 to allow foreign investment funds to participate in the domestic market for public sector securities, may be understood as a choice in favor of the second of these options at the cost of additional capital volatility. This is, in fact, what happened with portfolio flows in Colombia during the 1998–1999 crisis.

5. Conclusions

The strength of business cycles in developing countries is related to the close links between domestic and international capital markets. A typical approach adopted by the economic literature in recent years in exploring the effects of financial cycles has been to analyze the mechanisms by which vulnerability is built up during capital account booms, leading to sudden shifts of expectations that trigger the subsequent bust. The sharp business cycles associated with capital account volatility have proven costly in both economic and social terms.

The domestic financial sector is both a protagonist in and a potential victim of the macroeconomics of boom-bust cycles. The external lending boom facilitates and finances domestic credit expansion during the upswing but private-sector debt overhangs accumulated during the boom will, in turn, subsequently trigger deterioration in bank portfolios and a sharp contraction in lending during the downswing. At the same time, banks have inherent weaknesses that make them particularly vulnerable to changes in market conditions. They operate with high leverage, maturity mismatches between deposits and lending operations, and are subject to market failures that affect the assessment of credit risk. Moreover, variable mixes of maturity and currency mismatches are a structural feature of non-financial firms' balance sheets in developing countries.

Prudential regulation and supervision should take into account not only microeconomic, but also the *macroeconomic* risks associated with boom-bust cycles. In particular, instruments need to be designed that will introduce a counter-cyclical element into prudential regulation and supervision. To guarantee this, banks' provisions for loan losses should be forward-looking. They should be estimated when loans are disbursed on the basis of expected losses, taking into account the full business cycle, rather than on the basis of loan delinquency or short-term expectations of future loan losses, which are highly pro-cyclical. This means, in fact, that provisioning should approach the criteria traditionally followed by the insurance rather than the banking industry.

In particular, we argue for a regulatory approach that involves a mix of: (a) forward-looking provisions for latent risks, with provisions made when credit is granted on the basis of credit risks that are expected in the course of the full business cycle; this is the approach adopted by the Spanish authorities; and (b) more discrete counter-cyclical prudential provisions decreed by the regulatory authority for the financial system as a whole, or by the supervisory authority for special financial institutions, on the basis of objective criteria (e.g., the rate of growth of credit, or the growth of credit for specific risky activities). Specific provisions should be managed together with forward-looking provisions, as in the Spanish system. Voluntary prudential provisions can also be encouraged. This would make provisions a powerful instrument for use by banks in managing the effects of business cycles. To achieve this purpose, it is essential that tax deductibility be granted to provisions, and that accounting and prudential rules on capital/asset ratios should support the counter-cyclical role of provisions. In any case, this prudential approach is a complement to counter-cyclical macroeconomic policies, and prudential policies are not a substitute for the risks that pro-cyclical macroeconomic policies may generate. It is also important to note that, although the proposed new Basel Accord constitutes an advance in the alignment of capital with risk and in the introduction of principles of forward-looking provisioning for banks using their own internal risk models, it is unclear whether it would make the regulatory system less pro-cyclical and, indeed, it may enhance pro-cyclical lending to firms and countries with intermediate ratings.

Capital adequacy requirements should focus on long-term solvency criteria rather than on cyclical performance. Insofar as developing countries are more likely to face more macroeconomic volatility, there may be an argument for requiring higher capital/asset ratios, but there is none for requiring that such capital adequacy be, as such, counter-cyclical. In any case, stricter macroeconomic risk management standards in developing countries – in terms of provisions, capital or elsewhere – increase the costs of financial intermediation, reducing international competitiveness and creating arbitrage incentives to use international financial intermediation.

A system of counter-cyclical prudential regulations should be complemented by regulations in other areas. In particular, prudential regulation should establish strict rules to prevent currency mismatches; to reduce imbalances in the maturities of assets and liabilities of financial intermediaries and to establish liquidity regulations to manage such imbalances; limits on loan-to-collateral-value ratios and rules to adjust the values of collateral to reflect long-term market trends in asset values rather than cyclical variations. Foreign liabilities of firms operating in non-tradable sectors should also be a particular focus of attention. Thus, higher provisions and/or risk weights should be set for loans to firms operating in non-tradable sectors that have a direct exposure in foreign currencies.

As the major source of boom-bust cycles in developing countries is capital account volatility, an alternative to the prudential approach is direct capital account regulations. In fact, due to the limitations of both approaches, a mix between the two is probably advisable. Overall, innovative experiences with capital account regulations in the 1990s indicate that they can provide useful instruments, both in terms of improving debt profiles and in facilitating the adoption of (possibly temporary) counter-cyclical macroeconomic policies. The basic advantages of the price-based instrument pioneered by Chile and Colombia are its simplicity, non-discretionary character and neutral effect on corporate borrowing decisions. The more quantitative-type Malaysian systems have proven to have stronger short-term macroeconomic effects. Traditional exchange controls (e.g., prohibitions on short-term foreign borrowing, except trade credit lines) may be superior if the objective of macroeconomic policy is to significantly reduce the domestic macroeconomic sensitivity to international capital flows.

Direct regulations on capital flows can be partly substituted by prudential regulation and supervision. The main problem with these options is that they have, at best, indirect effects on the foreign-currency liabilities of non-financial agents and may encourage them to borrow more abroad. Accordingly, they need to be complemented by other disincentives for external borrowing by those firms, such as restrictions on the classes of firms that are allowed to borrow abroad (including a prohibition on such borrowing by firms operating in non-tradable sectors), restrictions on the terms of corporate debts that can be contracted abroad, public disclosure rules, and tax provisions that raise the cost of direct borrowing in foreign markets.

Price-based capital account regulations may thus be a superior alternative and simpler to administer than an equivalent system based on prudential regulations plus additional policies aimed at non-financial firms. In the case of the public sector, direct control by the Ministry of Finance (in some cases by the central bank) is the most important liability policy, including controls on borrowing by other public sector agencies and autonomous sub-national governments.

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THE EXPERT GROUP ON DEVELOPMENT ISSUES (EGDI)

The Expert Group on Development Issues, EGDI, was established by the Swedish Government in 1995 with the objective of contributing to an increased understanding of development issues in a global context and increasing the effectiveness of development co-operation policies.

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The recent financial crises in East Asia, Russia and Latin America 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. In the aftermath of the crises the Expert Group on Development Issues (EGDI) has asked three authors to analyse, in two separate studies, the emerging financial architecture and the role of different policy instruments that developing countries posses for managing the effects of boom-bust cycles.

The study ***What Progress on International Financial Reform? Why so Limited?***, by Stephany Griffith-Jones and José Antonio Ocampo, gives an overview of the emerging international financial architecture. The goals of a new international financial architecture should, according to the authors, be to prevent currency and banking crises and better manage them when they occur, and to support the adequate provision of net private and public flows to developing countries. Progress towards these goals has so far been uneven and suffered serious problems. There has been no agreed international reform agenda. Some advances in the international financial architecture run the risk of reversal. The study also discusses what can be done to overcome the insufficient representation of developing countries in key financial institutions and organisations. A fund or resource centre could be created that would provide independent support to representatives of developing countries in the boards and fora where the international financial reform agenda is being discussed.

The study ***Counter-Cyclical Prudential and Capital Account Regulations in Developing Countries***, by José Antonio Ocampo and Maria Luisa Chiappe, explores the role of two complementary policy instruments for managing the effects of boom-bust cycles in developing countries: counter-cyclical prudential regulations on domestic financial intermediation, and capital account regulations. The study argues that prudential regulation and supervision should take into account not only microeconomic, but also the macroeconomic risks associated with boom-bust cycles. In particular, instruments need to be designed that will introduce a counter-cyclical element into prudential regulation and supervision. To guarantee this, banks' provisions for loan losses should be more forward-looking. As the major source of boom-bust cycles in developing countries is capital account volatility, the authors find that a mix between the prudential banking approach and direct capital account regulations is advisable. The paper also highlights experiences with capital account regulations in the 1990s in Chile, Colombia and Malaysia.

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