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DEVELOPING COUNTRIES AND THE NEW FINANCIAL ARCHITECTURE

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A. WHAT PROGRESS ON INTERNATIONAL FINANCIAL REFORM?

The recent wave of currency and banking crises that began in East Asia, then spread to many other emerging markets, and even threatened briefly to spill over to the US in the wake of Russia and LTCM – generated a broad consensus that fundamental reforms were required in the international financial system. Existing institutions and arrangements were widely seen as inadequate for dealing with very large and extremely volatile capital flows, in which an important part of the volatility was caused by large imperfections in the financial markets themselves.

The seriousness of the situation is underlined by the fact that in the 1990s, out of 120 months, during 40 (that is 33% of the time) there have been important crises. This is particularly problematic for two reasons. Firstly, currency and banking crises – which have recently occurred mainly in emerging markets – have extremely high development and social costs. Indeed, deep and frequent crises in developing countries could undermine achievement of the UN target to half world poverty by 2015. Secondly, there is always the very small – but totally unacceptable – risk that contagion and spillovers in an increasingly interdependent international financial system could lead to global problems. Both these problems implied that urgent action was required to overcome the risk that the important benefits that globalisation offers in other fields could be seriously undermined by international financial developments.

Three years after the Asian crisis, and a few weeks after the Annual IMF/World Bank Meetings in Prague it is a good time to evaluate progress achieved on reforming the international financial system.

Some progress has been made, but it is clearly insufficient. Important changes have been implemented. For example, IMF lending facilities for both crisis prevention and management have been quite usefully expanded and adapted and the Fund's total resources were increased. Adaptations are being continuously made. For example, a week before the Prague Annual Meetings, the Fund's Contingency Credit Line (CCL) a new facility that would help countries fight crises spilling over from other countries has been modified; the changes to the CCL crucially include greater automacity in disbursing such loans once a country is in a crisis resulting from contagion and lower cost of the facility. Such modifications were clearly very necessary, since the CCL-created over a year ago – had not yet been used. This was like having new fire-fighting equipment, but not having made the crucial connections to the water supply!

Important institutional innovations have been introduced, such as 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. As capital and credit markets become increasingly integrated both amongst each other and between countries, it is essential for regulation to be efficient that the domain of the regulator is the same as the domain of the market that is regulated. Given that regulation is still national and sectoral, an institution like the FSF is valuable to help coordinate regulation globally and across sectors. The creation of the G-20, a body to discuss international financial reform, that includes both developed and developing countries – is also a positive development.

Developing countries have been asked to take a number of important measures to make their countries less vulnerable to crises; these include the introduction of a large number of codes and standards. Though introducing standards is very positive, there are however concerns in developing countries that the number of standards (at more than 60) is too large; developing countries also are worried that standards are too uniform, in the assumption that 'one size fits all'. At a recent conference held at the Commonwealth Secretariat, senior policymakers from developing countries called for greater selectivity and flexibility in the standards they are asked to implement. A more inclusive process is also necessary, whereby developing countries could participate in the development of these standards and codes, which at present they are asked to implement without having been involved in their design.

Even though there has been quite significant progress on reform of the financial architecture, it has suffered from two serious problems. Firstly, it has been insufficient, given the magnitude of the changes required to create a financial system that supports – and does not undermine – growth and development in the dramatically changed context of the 21st Century, characterised by very large, but extremely volatile and highly concentrated private capital flows. It is essential to develop a clear vision of an appropriate financial architecture in the new circumstances; drawing parallels from the institutional mechanisms developed nationally as domestic credit and capital markets grew a new international architecture requires: a) appropriate transparency and regulation of international financial loan and capital markets, b) provision of sufficient international official liquidity in distress conditions and c) standstill and orderly debt workout procedures at an international level. The mechanisms that exist and the adaptations made till now, do not fully meet the new requirements.

Secondly, progress made has been asymmetrical in three key aspects, in which a more balanced approach is urgently needed.

A first asymmetry in the reform process is that far more progress has been made on important measures taken by developing countries, which are being asked to introduce a very large number of codes and standards, so as to make them less vulnerable to crises. However, far less progress is being made on equally important and complementary international measures. As many leading economists (such as Stiglitz, Sachs, Rodrik, Bhagwati and others have stressed), crises – such as in Asia – were not just caused by country problems but also by imperfections in international capital markets, such as herding, that lead to rapid surges and reversals of massive private flows. To deal with the problems in the international financial markets, it is essential that international measures both for crisis prevention and management are also taken.

As the G-24 – that represents developing countries – pointed out recently, standards in the area of transparency are being pressed upon developing countries to improve information for markets without equal corresponding obligations for disclosure by financial institutions, including highly leveraged ones, such as hedge funds, who have no reporting obligation. Better information on financial markets would be of great value to policy-makers, especially in developing countries. Transparency should not be a one way street. Furthermore, while valuable progress is being made on attempting to improve regulation of domestic financial systems in developing countries, there is painfully slow progress in filling important gaps in international regulation, of institutions such as mutual funds or hedge funds, or of modifying regulations, as of banks, where current regulations may have contributed-rather than prevented-greater short-termism of flows (as discussed in more detail later). In the field of international regulation, valuable studies have been carried out particularly by the Financial Stability Forum Working Parties, but recommendations made are on the whole yet to be implemented.

Passing from crisis prevention to crisis management, it seems important that the IMF's own resources are large enough to meet the financing needs of a systemic crisis involving several economies simultaneously, while also retaining sufficient liquidity to meet normal demands on the Fund's resources. Michel Camdessus and others-including the influential US Council of Foreign Affairs – have suggested that this expansion of official emergency financing could be funded in part by temporary and self-liquidating issues of SDRs. Such a mechanism would not add to total world liquidity, except in a temporary manner during a crisis situation – when it would be compensating for reductions or reversal of private flows. This proposal deserves serious analysis and consideration and there seems to be considerate merit in the G-24's call for a study of this matter and discussion at the autumn 2001 meeting of the IMFC. More speedy progress on orderly debt work-outs is also urgent.

A second source of asymmetry in the reform process that needs to be urgently overcome is the insufficient participation of developing countries in the key fora and institutions. As regards the international financial institutions, more representative governance needs to be discussed in parallel with a redefinition of their functions. It is particularly urgent that developing countries (which are now only represented in a very limited way in the FSF Working parties) are fully represented in the Financial Stability Forum itself, as the issues discussed there have very profound effects on their economies and as their insights can make an important contribution to the Forum's valuable work. It is important to note that after their recent annual meeting Commonwealth Finance Meetings called for such developing country participation in the Forum. The inclusion of major developing countries in the G-20 is clearly a welcome step, but it might be of value to include also some smaller developing nations, to reflect their specific concerns. Above all, it would also be helpful if the agenda of the G-20 could be broadened, to include more explicitly the key issues of international financial reform.

A third asymmetry that has emerged in recent discussions on reform of the system is that we have all placed excessive focus on crisis prevention and management, mainly for middle-income countries. Important as this is, it may have led us to neglect the equally – if not more important – issues of appropriate liquidity and development finance for low income countries. As regards liquidity, it is important that existing IMF facilities for low-income countries – such as the Compensatory Financing Facility and the Poverty Reduction and Growth Facility – should be made more flexible, in case the present level of oil prices are sustained or if other terms of trade shocks affect such countries. More generally, the role of the IMF in providing liquidity to low-income countries is crucial. As regards development finance, low income countries need sufficient multilateral lending and official flows, as well as speedy debt relief. It is a source of concern that multilateral lending to low-income countries, especially via IDA, has recently fallen sharply. Furthermore, in a world of rapidly increasing private flows, it is important that low-income countries, donors and international organisations collaborate to help attract more significant private flows to them. Mobilizing sufficient and stable development finance, both private and official to low-income countries is an essential pre-condition to help ensure growth and poverty reduction in the poorest countries.

It is important that significant further progress on reforming the international financial system is done quickly, as the risks and potential costs of not doing so are unacceptably large, especially for poor people in developing countrie.

We must overcome any possible complacency on this matter, by remembering the man who neglected to fix his leaking roof in sunny times, and was then unable to do so when stormy weather came.

Given the complexity of the issues, I would like to focus the rest of my presentation on better international information on markets and financial regulation that is on international measures for crisis prevention. This is an area where though action is urgent, there has been very little action, and even relatively little analysis.

B. Better International Information and Financial Regulation

1. *Additional information on markets to developing countries*

As pointed out above, better information to markets on developing countries has to be complemented by better information on international financial markets available to policy-makers, especially but not only in developing countries. Particularly during the crisis that started in Asia, emerging country policy-makers have found important limitations in the essential information available on the functioning of international capital and banking markets. The type of information required is particularly on almost day to day changes in the functioning of markets – and their key actors – globally and regionally.

The IMF has led the way in improving information – and its dissemination – on emerging markets economies, which is of particular use to markets. A parallel symmetric effort needs to be done to gather and provide timely information on market evolution to emerging markets' policy-makers. this task should perhaps be led by the BIS, and co-ordinated by the newly created Financial Stability Forum. (FSF). Inputs from other institutions would be very valuable, for example, the IMF and the private sector (for example, the Institute of International Finance, IIF). Suggestions in the October 1998 G-22 Report of the Working Group on Transparency and Accountability did provide important elements for this task. These suggestions relate not just to better statistics on international banks' exposures, but also on 'compiling data on international exposures of investment banks, hedge funds and other institutional investors'. Furthermore, the growth of financial innovations, such as over-the-counter derivatives, while designed to facilitate the transfer of market risk and therefore enhance financial stability, have also made financial markets more complex and opaque. This has created difficulties in monitoring patterns of activity in these markets and the distribution of risks in the global financial system for market participants, regulators, central banks, and other authorities, including particularly those in developing countries. It would seem appropriate for major Central Banks and the BIS to attempt to improve registration of derivatives and institutions like hedge funds, by making it obligatory. Unfortunately, such initiatives to make reporting obligatory have until now been blocked, especially in the US Congress.

Given the speed with which markets move, it seems particularly important that the frequency with which relevant data is produced is very high (and possibly higher in times of market turbulence, when it becomes particularly crucial), and that dissemination is instant to all countries' Central Banks. Indeed, a special additional service could be provided by the BIS in which it would play the role of clearing house of information. For this purpose, it could draw not just on information it can gather directly from markets, but by collecting and centralising information on their markets that individual Central Banks have, and where the aggregate picture is not easily available to any individual Central Bank. This could possibly include both quantitative and qualitative information. Via the internet, the BIS could standardise the information requirements, collect the information, aggregate it, and disseminate it rapidly to all central banks, as well as to other relevant institutions. Such a service would be of the greatest usefulness to developing country policy-makers, especially immediately before and during crises; however, it would naturally also be very valuable to developed country policy-makers and international institutions (including the BIS itself) in handling crisis prevention and management.

2. *Improved international financial regulation*

2.1 *The case for regulation*

A strong case can be made that international financial regulation is welfare increasing. This is particularly true, if – as we discuss below – such regulation has explicit counter-cyclical elements, to compensate for inherent pro-cyclical behaviour by financial actors, that can also partly characterise traditional financial regulation.

Indeed, there is growing support for a view that the process of international financial intermediation has a second-best element, in which welfare for both source and recipient countries can be increased by regulatory changes (through measures in source and/or recipient countries), which would reduce excessive lending or investing. It is noteworthy that Chairman Alan Greenspan proposed – for the case of interbank lending – that it could be appropriate for either borrowing countries or lending ones to impose reserve requirements to 'deter aberrant borrowing: sovereigns could charge an explicit premium, or could impose reserve requirements, earning low or even zero interest rates, on interbank liabilities. Increasing the capital charge on lending banks, instead of on borrowing banks, might also be effective'.[1]

There is growing recognition that it may often be desirable to regulate excessive surges of potentially reversible capital flows in recipient countries. Indeed, an important part of the responsibility with discouraging excessive reversible inflows – as well as managing them – lies with the recipient countries. However, the experience of the 1990s, with very large scale of international funds – compared to the small size of developing

[1] Remarks by Alan Greenspan before the 34th Annual Conference of the Federal Reserve Bank of Chicago, May 7th, 1998.

country markets – leads to the question whether measures to discourage excessive short-term flows by recipient countries are sufficient to deal with capital surges and the risk of their reversal.

Aizenman and Turnovsky (1999) have formalised such analysis, by developing a rigorous model that analyses the impact via externalities of reserve requirements on international loans (both in lending and recipient countries) on the welfare of both categories of countries. Aizenman and Turnovsky *op. cit.* thus evaluate the macro-economic impact of reserve requirements in a second-best world, where there is moral hazard due to likely bail-outs on the lender's side and sovereign risk on the borrower's side; both generate large negative externalities on welfare. The general conclusion of their model is that the introduction of a reserve requirement in either source or recipient country reduces the risk of default and raises the welfare in both countries.

The aim of such regulatory changes is to help smooth capital flows to emerging markets, without discouraging them excessively. This is in contrast with views based on a belief that crises in emerging markets are due only to moral hazard, and that the appropriate way to combat such moral hazard is by scaling down the role of the IMF in providing financial packages before and during crises. The latter view has acquired some prominence in developed countries, particularly but not only in the US, in particular, the majority Meltzer Report to the US Congress took such views to the extreme. However, such reduction of the role of the IMF could either make crises even more costly and/or lead to a sharp reduction in private flows to developing countries. These are both highly undesirable effects which could significantly diminish welfare, particularly but not only in the developing economies, as well as undermine support for open economies and market-based economic policies in developing economies. Therefore, an approach based on better regulation is clearly better and more welfare-enhancing than one which cuts back the IMF.

2.2 *Filling Gaps*

The broad welfare case for applying reserve requirements in both source and recipient countries can also be applied to institutional investors and in particular to mutual funds, which became increasingly important in relation to banks in the 1990s. This growing importance occurred both within the developed countries, and particularly within the US – where mutual funds receive more than 50% of total deposits in the financial system – and in capital flows from developed to developing countries (see d'Arista and Griffith-Jones, 2000). The narrowing of differences between banks and institutional investors like mutual funds, and the fact that securities markets and thus mutual funds also have access to the lender of last resort – nationally in the US but more importantly in our context also internationally, due to the frequent rescue packages put together by the IMF in recent serious currency crises, suggests the importance of improving prudential standards for institutional investors such as mutual funds.

As regards portfolio flows to emerging markets, there is an important regulatory gap, as at present there is no regulatory framework internationally, for taking account of market or credit risks on flows originating in institutional investors, such as mutual funds (and more broadly for flows originating in non-bank institutions). This important regulatory gap needs to be filled, both to protect retail investors in developed countries and protect developing countries from the negative effects of excessively large and potentially reversible portfolio flows.

Institutional investors, like mutual funds, given the very liquid nature of their investments can play an important role in contributing to developing country currency crises. (For recent evidence, see Kaminsky, Schmukler and Lyon, 2000). It seems important, therefore, to introduce some counter-cyclical regulation to discourage excessive surges of portfolio flows. This could perhaps best be achieved by a variable risk-weighted cash requirement for institutional investors, such as mutual funds. These cash requirements would be placed as interest-bearing deposits in commercial banks. Introducing a dynamic risk-weighted cash requirement for mutual funds (and perhaps other institutional investors) is in the mainstream of current regulatory thinking and would require that standards be provided by relevant regulatory authorities and/or agreed internationally. The guidelines for macro-economic risk, which would determine the cash requirement, would take into account vulnerability variables as defined by the IMF and BIS (for a more detailed discussion of this proposal, see d'Arista and Griffith-Jones, 2000).

The September 1998 Emerging Markets IOSCO Report on *Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets* has in fact described in some detail and evaluated rather positively the above proposal. This report emphasised that 'there appears to be scope – and an urgent need for further work. This is very likely to require a multilateral effort – i.e. by regulators from both source and recipient countries in collaboration with the industry'.

As regards HLIs, the FSF working group on HLIs rightly focussed on two problems: systemic risk linked to high leverage and reduction of market and economic impact of collapse of unregulated HLIs. Particular emphasis was placed on HLI activities in small and medium sized open economies where the potential damage that can be caused by large and concentrated positions can seriously amplify market pressures.

As regards HLIS, the FSF Working Group considered formal direct regulation of currently unregulated institutions. This would include a licensing system, minimum capital and liquidity standards, large exposure limits, minimum standards for risk management, and even an enforcement.

Such regulation was seen to have several very desirable effects, (such as regular oversight over HLIS and reducing likelihood of disruptive market events), but due to what were seen as both philosophical and practical problems, the Working Group did not recommend applying a system of direct regulation to currently unregulated HLIS at this stage, though it did not reject the possibility of establishing such a regime at a later stage. It emphasised that the failure to carry through their recommended measures (see Report *op. cit.*), would prompt such reconsideration.

The philosophical objection relates to the fact that direct regulation would not be aimed at investor protection (as investors are sufficiently wealthy or sophisticated to do their own due diligence), but on the mitigation of systemic risk. However, it could be argued that mitigation of systemic risk is also an increasingly valid regulatory aim. There were also practical objections, including how to avoid leakage through offshore centres. However, current efforts to improve and complete regulation in off-shore centres should help overcome those problems (see discussion of FSF Working Group Report on Offshore Centres). Other practical issues are more technical and more valid, including the need to adapt capital adequacy and large exposure rules to the specific risk profile of HLIS. This should be done in ways that any regulatory capital requirement did not adversely affect the efficiency and liquidity of markets in which HLIs are significant participants. This seems particularly important in a context when several large hedge funds have been wound down, which may diminish some of the negative impacts they had in recent crises, but could according to some observers – deprive markets of countrarian actors, with some useful roles to play in stopping the deepening crises.

2.3 *Removing regulatory distortions and dampening exuberance of bank lending*

As regards bank lending, there has firstly been concern that the 1988 Basle capital accord contributed to the build up of short-term bank lending and its reversal in East Asia and elsewhere, due to significantly lower capital adequacy requirements for short-term lending than for long-term lending. The new proposal published in June 1999 attempts to address this distortion by reducing somewhat (though perhaps not sufficiently) the differential between capital adequacy for short-term and other lending. However, the new Basle recommendations, though including many positive elements (see, for example, Caillous and Griffith-Jones, 1999), also have suggestions that were widely seen as problematic. These included increasing the role of rating agencies to determine country weightings for capital adequacy, which could aggravate the pro-cyclical nature of bank lending, thus encouraging larger surges and larger reversals, – clearly an undesirable outcome.

There is important evidence that rating agencies act in a volatile and, especially, pro cyclical fashion. If that were the case, the reliance on ratings in the new system would exacerbate boom-bust cycles and could undermine the stability of the financial system. Indeed, as pointed by various authors (see for example Turner 2000), rating agencies failed to downgrade the East Asian countries before the crisis but then worsened it because they brought down the ratings as the crisis unfolded. Reisen and von Maltzan (1999) find that sovereign ratings lag rather than lead the market.

These problems should not, however, question the need for reforming the 1988 accord. The current system has fixed weightings which do not adjust with the cycle. In the event of a recession the increased amounts of bad loans (which are usually not fully covered by provisions) will impact upon the lending bank's capital and can lead to decreased lending if the bank is already facing a relatively low capital asset ratio, and – as is likely in a recession – the bank is unable to raise new capital. This reinforces banks' own unwillingness to lend in a downturn. Both elements lower bank lending, which – in aggregate – further deepen the recession, and make banks' financial situation even more fragile.

2.4 *Counter-cyclical elements in regulation*

The answer thus may lie in the implementation of an explicit counter-cyclical mechanism which would, in boom periods, and in contrast to ratings, dampen excess bank lending. Counter-cyclical elements can also be introduced in regulating other actors (see above, for mutual funds). On the contrary, in periods of slowdown and of scarcity of finance the new mechanism should not further accentuate the decline in lending as exemplified by the 1997-1998 Asian crisis but rather encourage it.

There would be two linked objectives for introducing elements of counter-cyclical regulation. One would be to help smooth capital flows and the other would be to smooth the domestic impact of volatile capital flows on the domestic financial system and therefore on the real economy. Introducing counter-cyclical elements into regulation would help build a link between the more micro-economic risks on which regulators have tended to focus till recently and the macro-economic risks which are becoming increasingly important, both nationally and internationally.[2] Counter-cyclical elements in regulation related to bank lending could be applied, either internationally, nationally or at both levels.

Several mechanisms could be used to introduce a counter-cyclical element into regulation of bank lending. One mechanism would be to get the required capital ratio higher in times of boom, and to allow banks to use the additional cushion provided by the higher capital ratio, so they could sustain lending in times of recession at a lower capital asset ratio (when increased bad loans are likely to be reducing their capital). Some practical difficulties may arise in implementing such a mechanism, of which the most serious one may be getting international agreement on a general formula for cyclically adjusted capital asset ratios.

A second mechanism for introducing counter-cyclical elements in bank lending regulation is for regulators to encourage that higher general provisions be made for possible loan losses (i.e. subtracted from equity ca bad times, without affecting reported capital. The way to ensure this would be to maintain higher general provisioning that applies to all loans. The main problem for this mechanism, according to Turner, *op. cit.*, may be that tax laws often limit the tax deductibility of precautionary provisioning; however, it is possible to change such tax laws, as indeed was done in the late eighties in the UK.

A third mechanism, relevant particularly for domestic bank lending, is for regulators to place caps on the value of assets (such as real estate or stocks and shares) to be acceptable as collateral, when the value of such assets has risen sharply in a boom and is at risk of declining sharply in a recession. Rules could be used such as averaging values for the last five years, or accepting only 50% of current prices in the peak period of a boom. The latter mechanism seems to have the least problems of implementation (indeed, reportedly it is already applied in some jurisdictions, e.g. Hong Kong).

A fourth possible counter-cyclical mechanism is that, as suggested by McKinnon and Pill, monetary authorities could monitor and try to limit or dis-

[2] I thank Andrew Crockett for his suggestive remarks on this point.

courage lending for property, construction and personal consumption, as these items tend to increase substantially – and often even be a major factor – in booms. A possible implementation problem would be that it may be difficult to verify final use of credit, and such measures could be partially evaded.

Furthermore, regulators should be flexible in the downturn, particularly to allow banks to easily use cushions (e.g. of capital or of provisioning) in times of recession; it may even be advisable, if a recession is very serious, to allow ratios to fall below normally required levels, (to help sustain lending), in the understanding that they will be rebuilt as soon as the economy starts recovering. A tension may arise here between the regulatory concerns about individual bank liquidity and solvency and the macro-economic externalities of their actions, particularly in recessions.

Specific issues seem to require further study. How best can the distinction between a temporary boom and a permanent increase in growth be made? After what period of 'boom', should regulatory changes be introduced? How large should such changes be? What are the best mechanisms through which counter-cyclical measures should be introduced (flexible capital adequacy ratios, higher provisioning against losses, more 'realistic' pricing of collateral)? Should such measures be introduced for both international and domestic lending, or preferably for one of them? This paper provides only initial thoughts on these important issues.

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