Introduction

Stephany Griffith-Jones and Amar Bhattacharya

Background

As a result of the frequency, severity and high development costs of recent financial crises, the attempt to design a new international financial system, more appropriate for the needs of the twenty-first century, is high on the international agenda.

The Commonwealth Secretariat has been very active in this international discussion. Commonwealth Finance Ministers discussed issues relating to international financial reform at their 1998, 1999 and 2000 Meetings. In 1999, Commonwealth Finance Ministers mandated the Commonwealth Secretariat to monitor the international financial architecture.

To carry out this task, the Commonwealth Secretariat, jointly with the International Monetary Fund (IMF) and the World Bank, organised a high-level Conference on Developing Countries and the Global Financial System, held at Lancaster House, London, 22–23 June 2000.

A special emphasis of this meeting was to highlight the views of developing countries (and especially of their policy-makers) so as to help strengthen their voice in the discussion of a new international financial architecture. This was felt to be important because developing countries' participation in both the discussion and decision-making process of reform has so far been insufficient. A second major concern was to identify and highlight areas where progress on reform has, till now, been too limited.

More broadly, the Conference had the following four objectives, which were felt to have been successfully met:

- To take stock of progress in reforming the international financial architecture, especially from the perspective of developing countries;
- To identify concerns, both on issues currently being taken forward and on implementation, from the perspective of developing countries;
- To identify missing elements and gaps;
- To examine the future role of international financial institutions.

The Report of the Conference was an important input into the 2000 Commonwealth Finance Ministers' Meeting, which in turn contributed to the Commonwealth position at the annual IMF/World Bank meetings.

Given the high quality of both the discussions and of the background papers prepared for the Conference, it seemed that it would be useful to make them more widely available.

This introduction provides an outline of the main areas discussed and the key questions addressed in each session. The Conference Programme is given in Appendix A.

A number of the issues which were discussed in depth at the Conference, together with several of its recommendations, were taken up at the Commonwealth Finance Ministers' Meeting held in Malta in September 2000 and at meetings of the G-24 and G-20.

At their meeting in Malta, Commonwealth Finance Ministers reaffirmed the central role of the International Financial Institutions (IFIs) in supporting growth, financial stability and poverty reduction. They recognised that without IFI support private capital flows can be volatile, concentrated and inadequate for the needs of developing countries.

Commonwealth Finance Ministers also stressed the need for a more inclusive process of shaping the international financial architecture, where developing countries must be allowed a stronger voice and representation in decision-making at all levels. In this context, they welcomed the suggestion for enhanced participation of developing countries in the Financial Stability Forum (FSF).

Both the Commonwealth Finance Ministers and the G-24, at their meeting in Prague in September 2000, were encouraged by recent modifications in the IMF's Contingent Credit Line (CCL) which simplified its review procedure, increased the amount of resources that can be released without additional conditionality and lowered its cost. Commonwealth Finance Ministers further emphasised that the Fund's credibility as the principal crisis manager in the system required that it should have access to sufficient resources. The G-24 went further, calling for the study of a systemic emergency facility that could decisively underpin confidence in the face of severe market crises; this facility could be funded through the temporary creation of Special Drawing Rights (SDRs), which could be withdrawn when the need for them had passed.

The G-24 also emphasised the traditional responsibility of the IMF to stand ready to support balance of payments adjustment of all its members, including the poorest among them. They also stressed the need for flexibility in Fund facilities to meet the diverse requirements of the Fund's heterogeneous membership, given their different stages of development and the variety of shocks affecting them. The G-24 also emphasised the need for a larger voice for developing economies in the decision-making process of the Fund.

As regards the World Bank, Commonwealth Finance Ministers saw important continuing roles for three of its functions: advice and channelling longer-term concessional assistance (through the International Development Association (IDA)) to low-income countries; a combination of policy advice and non-concessional lending to middle-income countries, complementing private finance; and support for the provision of a range of global public goods. Commonwealth Finance Ministers emphasised that the Bank's role in providing knowledge about development was most effective when combined with finance. In this context, Commonwealth Finance Ministers regarded as disturbing developments the recent decline in the volume of Bank non-concessional lending (especially if crisis-related lending was excluded) and the decline in net IDA lending; they considered that these trends needed to be reversed.

Commonwealth Finance Ministers welcomed the report of the Commonwealth Secretariat/World Bank/IMF joint conference on Developing Countries and the International Financial Architecture and called for the continued collaboration of these institutions in monitoring developments and arranging a second conference in a year's time to take stock of progress achieved in reform of the global system.

The G-24 welcomed the efforts being made by the IMF Managing Director and the World Bank President to move away from micro-management in their conditionalities to emphasise country ownership and to invoke a more participatory approach.

The G-24 Ministers recognised the positive aspects of international standards and codes, noted that participation of developing countries in discussions on the development of these standards and codes has been limited, and called for a more inclusive process. They underlined the voluntary nature of the implementation of such codes and standards, taking into account countries' institutional capacities and stages of development. Echoing the analysis made at the joint Conference, the G-24 meeting stressed the highly asymmetric application of codes and standards. Standards in the area of transparency are pressed on developing countries without corresponding obligations for disclosure by financial institutions, including highly-leveraged institutions. The G-24 therefore insisted that any monitoring of standards and codes by the Bretton Woods Institutions should be done on a strictly symmetric basis.

The G-20 Finance Ministers and Central Bank Governors emphasised, amongst other important aspects, that emerging market economies should be supported with technical assistance and policy advice in opening their capital accounts in a well-sequenced manner to benefit from international capital flows while minimising potential risks.

This book contains an analytical report of the discussions at the Conference, together with the main background papers. It is intended as a contribution to the important discussion within the international community of reform of the international financial system.

Issues for Discussion

To facilitate and focus discussion at the Conference, key questions for each of the Conference sessions were prepared and distributed in advance.

1. International standards and domestic regulation

The financial crises of the late 1990s underscored the importance of having in place a well-designed national financial framework which can both regulate the private financial sector, and reduce the need for public sector action at times of crisis and the associated costs. This shift in emphasis – from crisis resolution to crisis prevention and mitigation – has led to an agenda in which risk management and strengthening market underpinnings at the national level represent two important complementary aspects.

In this regard, the development and implementation of international standards represents an important aspect of the ongoing international effort to assist countries in addressing the challenges posed by increasing global integration. To be effective, however, standards need to be implemented and observed. The appropriate standards and implementation strategy will vary depending on the stage of development and policy objectives of each country. Therefore, standards should be assessed with respect to their effectiveness and in the context of a country's development strategy

Over the past three years, the international community has made good progress in developing and implementing standards. The standard-setting bodies and the IFIs have put forward a variety of standards, and are in various stages of developing detailed methodologies for assessing how far they are being observed. The World Bank/IMF experimental Reports on Observance of Standards and Codes (ROSCs) provide an organising framework for conducting these assessments, including the evidence drawn from the assessments conducted through the Bank/Fund Financial Sector Assessment Program (FSAP).

Questions

- What role can standards play in strengthening economic and financial systems in developing countries? What other steps are needed to strengthen policy-making and financial systems?
- Which standards are most important in this regard? Those being assessed by the Bank/Fund in their experimental reports on observance? The 12 standards proposed by the FSF? How should these standards be applied to developing country circumstances?
- What are the constraints that developing countries face in implementing international standards? What steps are needed (including technical assistance) to ensure that developing countries move towards observance of internationally recognised standards?
- What role should the official sector play in encouraging the adoption of standards?
- Should market incentives be used to encourage the adoption of standards? Or is this premature, given the limited experience with them which could give misleading signals to the market?

As noted by the FSF taskforce on implementation of standards, the experience gained through these efforts points to three key factors for fostering implementation of standards: (a) promoting country *ownership*; (b) providing a judicious blend of market and official *incentives*; and (c) mobilising *resources*, both nationally and internationally, through enhanced partnerships.

The taskforce has also proposed a five-stage strategy for the implementation of standards: (a) identifying and forging international consensus on key standards; (b) prioritising standards for implementation, taking into account country circumstances; (c) designing and effecting an action plan to implement standards; (d) assessing progress in observance of standards on an ongoing basis; and (e) disseminating information on progress in observance of standards.

2. International regulation

Since the East Asian crisis, there has been considerable discussion of the need for, and issues related to, international financial regulation as a complement to the strengthening of domestic financial systems.

One outcome has been the creation of new fora such as the Financial Stability Forum and the G-20 in order to provide additional institutional mechanisms for identification and ongoing discussion of systemic issues. An explicit objective has been to broaden participation, but the inclusion of developing countries in some of the discussions, such as those carried on in the FSF, is still extremely limited.

As regards international regulation, a number of studies and proposals have emerged, including from the FSF Working Groups and the Basle Committee, on subjects such as bank lending, hedge funds, mutual funds and offshore centres, with the aim either of modifying existing regulations or of introducing new measures where gaps exist. As yet there has been relatively limited progress in implementation.

As a result of the Asian and other crises, an interesting new question has arisen as to whether regulation, both national and international, should have explicit counter-cyclical elements in an attempt to compensate for pro-cyclical tendencies in private behaviour.

Questions

- What are the best institutional arrangements for international co-operation on systemic issues?
- In relation to which actors and sectors should international regulation most urgently be modified or introduced to reduce the likelihood of future crises? What type of measures should be introduced? How would such measures affect both the stability and level of capital flows to developing countries?
- Should explicit counter-cyclical elements be introduced into international regulation? How could this best be done?
- In what areas is it particularly important, especially for policy-makers in developing countries, to improve timely information on international capital markets? How can this best be achieved?

3. Private sector involvement

The involvement of the private sector is critical to forestall and resolve financial crises; prevention remains the first line of defence against crises. In this regard, several measures have been identified, including the adoption of collective action clauses in sovereign bonds, call options in interbank loans, private sector contingency financing and the setting up of creditor committees.

The most difficult issue remains how to involve the private sector in face of, or in the aftermath of a crisis. The need to secure appropriate private sector involvement now seems reasonably well accepted, including by the private financial community, and the experience with some recent cases has been encouraging.

There is also broad consensus on the underlying principles that were put forward by the G-7. IMF staff have proposed an operational framework based on these principles.

With this approach, private sector involvement could be ensured primarily through reliance on the IMF's traditional catalytic role:

- if the member's financing requirements are moderate; or
- if the member has good prospects of rapidly regaining market access on appropriate terms, even in cases in which the financing requirements are large.

More concerted forms of private sector involvement could be required:

- if the financing requirement is large and the member has poor prospects of regaining market access in the near future; or
- if the member has an unsustainable medium-term debt burden.

Although this framework provides a useful start, making it operational requires an assessment of the appropriate means and timing in individual cases and raises difficult analytical and market judgements.

Questions

- The IMF has been developing experience with the concerted involvement of the private sector in the resolution of financial crises for two and a half years. Has any success been achieved? Has it damaged the ability of a wide range of emerging market and developing countries to attract private capital?
- Would there be merit, as we move forward, in providing greater clarity about the circumstances in which concerted private sector involvement should be required? What should be the role of the IMF in this regard? Should we move towards a more mechanical rule-based system?
- Are the tools available to the international community for securing concerted private sector involvement able to handle the wide range of future cases that might arise? If outflows are broad based – and extend beyond a withdrawal of interbank lines from foreign com-

mercial banks and payments in respect of international sovereign bonds – how could concerted private sector involvement be secured? Would there be a case, under certain circumstances, for countries experiencing such outflows to use temporary standstill?

- What pre-emptive measures can be taken to reduce the likelihood and costs of private sector-related payment difficulties? What are the views on the recent steps taken by some industrial countries to encourage wider use of collective action clauses? Is this a useful precedent for developing countries to adopt, and are they now more likely to do so?

4. Capital account liberalisation and its critique

Since the East Asian crisis, there has been fairly broad agreement that capital account liberalisation should be very gradual and properly sequenced. Furthermore, there is agreement that liberalisation of potentially more reversible flows should proceed very carefully, and not take place till significant macro-economic imbalances have been reduced and till domestic financial systems are strong and well regulated, so as to help avoid costly currency and banking crises.

Questions

- What is the most appropriate pace of liberalisation of the capital account for different categories of countries that have not yet embarked on liberalisation? For example, what is the appropriate pace for small and large countries, for low-income and middle-income countries? Is it advisable and feasible for countries that have significantly liberalised to somewhat reverse this process?
- What types of controls are most effective in different country circumstances, in the light of recent experience? What problems arise in their implementation, and how can they be overcome?
- Given that countries suffer the effects of crises, and that a new international financial architecture is not yet in place, should developing countries have full autonomy to decide on their capital account liberalisation? How can they best benefit from systematic evaluation on international experience of capital account liberalisation?
- What are the linkages between capital controls, lender of last resort and orderly debt work-outs?

5. The role of IFIs in the new architecture

There is a growing consensus that the role of IFIs needs to be adapted to help developing and transition economies meet two major challenges: (a) how to integrate into the world economic and financial system in such a way that they can maximise the benefits of globalisation, while minimising the costs; and (b) how to help developing countries with the broader challenge of development and, especially, poverty reduction. The first challenge implies helping developing countries to attract sufficient sustained private capital flows, whilst strengthening measures for crisis prevention and better crisis management. The second implies supporting policies and structural reforms that facilitate development, and helping countries to secure sufficient external funding, both official and, more especially, private funding, to sustain growth and reduce poverty.

To fulfil, as far as possible, these two major roles, it is important to define: (a) the key tasks that need to be fulfilled by respective IFIs, especially the World Bank and the IMF; (b) the mechanisms to be used (for example, lending facilities); (c) the division of labour among the IFIs, as well as collaborative arrangements; and (d) appropriate governance of the IFIs, including appropriate participation by developing countries. Although there is broad consensus on the overarching objectives that the IFIs have collectively to meet, there has been renewed and intense debate on the specific mandates and division of responsibilities, given the changing global context, and especially the substantial increase and potential volatility of private capital flows.

Questions

- What are the main changes in the global context that have a bearing on the role of international institutions? What are the gaps that have been identified in the aftermath of the East Asian crisis? What are the other challenges that international financial institutions need to respond to?

- What do these new challenges imply for the role of the international financial institutions, notably the Bank and Fund? What do they suggest for the delineation of responsibilities between the Bank and the Fund? How can we preserve clarity of mandates and accountability, and yet ensure coherence in what is now an increasingly interconnected agenda?

- In what ways do instruments of the two institutions need to adapt to changing circumstances? What are the implications for the content, design and co-ordination of conditionality?

- What are the implications of this evolving agenda for the modalities of collaboration between the Bank and the Fund, and the involvement of other institutions such as the regional development banks? In what way can regional arrangements complement efforts at the global level?