PART 1

REPORT OF THE CONFERENCE

Developing Countries and the Global Financial System[1]

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Introduction

On 22 and 23 June 2000 a major Conference on Developing Countries and the Global Financial System was held in London; it was jointly organised by the Commonwealth Secretariat, the World Bank and the IMF. The Conference brought together senior policy-makers from the International Financial Institutions (IFIs), and from developed and developing countries, as well as private sector representatives and academics. One of the key aims of the Conference was to provide a forum for senior policy-makers from developing countries to define and express their views on the future roles of the IFIs, facilitating a stronger voice for them in this important debate. The results of this Conference have been useful in preparing inputs for the Commonwealth Finance Ministers' Meeting in Malta, and may also be of interest to the next G-20 meeting and the Annual Meetings of the IMF/World Bank.

The following were the main issues discussed:

- International standards and domestic regulation
- International regulatory challenges
- Private sector involvement in crisis resolution
- The role of the IFIs in the new financial architecture
- Issues of global governance
- Capital account liberalisation and its critique.

On all these issues, the aim was to have a candid exchange of views, to try to narrow differences and to explore new technical challenges. One important theme was the future role of the IFIs in the context of the debate that began after the publication of several reports, including that by Meltzer. A summary of the various presentations and discussions at the Conference follows. It does not give full details of all views expressed as the discussion was extremely rich. The list of participants is given in Appendix B.

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Overview

Opening the Conference, Dame Veronica Sutherland, Deputy Secretary-General (Economic and Social Affairs), Commonwealth Secretariat noted that the design of a new international financial system was high on the international agenda, as a result of the frequency, severity and high development costs of recent financial crises. She said that what was needed was to identify a new system appropriate for the needs of the twenty-first century.

There had been progress in a number of areas. The lending facilities of the IMF for crisis prevention and management had been usefully expanded and adapted, and there had been some modification of conditionality. Institutional innovations had been introduced, such as the creation of the Financial Stability Forum (FSF), and the creation first of the G-22 and, more recently, of the G-20. A more flexible approach had also been adopted on capital account liberalisation. Developing countries which were recipients of private capital flows had introduced some important measures including, for example, the provision of better information to international financial markets and better regulation and supervision of their domestic financial systems. Other measures were designed to make these countries less vulnerable to currency and financial crises.

Even though the progress made so far on designing a new international financial architecture had been important, it was somewhat asymmetrical. In particular, there were three aspects where a broader approach would be beneficial. The first was the issue of capital flows. Crises such as those in East Asia were caused not just by problems in the East Asian countries themselves, but to a large extent by imperfections in international capital markets, which led to rapid surges and reversals of massive private flows. To deal with the problems of very large and potentially reversible capital flows, there was a clear need for better international regulation of private capital flows. It was also arguable that there was a need for sufficiently large international provision of official liquidity to control crises within countries and to prevent them from spreading to other countries. Progress in these two areas had taken place, although it was fairly limited. The FSF had produced very good working party reports on hedge funds and on off-shore centres, but their recommendations were only now beginning to be implemented and important regulatory gaps continued to exist. The Basle Accord on Capital Adequacy was being revised, but action had yet to be taken to reduce excessive regulatory bias which seemed to encourage short-term bank lending to developing countries.

Broader issues of the further expansion of IMF resources for times of crises needed to be explored, including the possibility raised by Michael

Camdessus, in one of his last speeches as Managing Director of the IMF, of funding a facility like the Contingent Credit Line (CCL) with a temporary creation of Special Drawing Rights (SDRs); these would be self-liquidating as the crises receded and loans were paid back.

A second source of asymmetry in the process of international financial reform had been the limited participation of developing countries, including the main emerging market countries, in the process, especially in the decision-making fora. Clearly the participation of developing countries in the G-22 and now the G-20 was a useful step, though these fora were mainly of a consultative nature. However, it would be a major step forward if developing countries and development concerns were represented in key fora such as the FSF. Indeed, when the FSF was created, it was announced that its membership could be broadened.

A third and final source of asymmetry had been the undue focus 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 external financing for low-income countries. These required development finance in the form of multilateral lending, official aid and debt relief. They also needed official and other assistance to catalyse more significant private capital flows.

Finally, it was a serious source of concern for developing countries and for all those concerned with development that views were now emerging, mainly from the industrialised countries, for a significant scaling down of lending by the IMF and the World Bank. As several of the papers prepared for the Conference point out, these proposals are exactly the opposite of what developing countries, and indeed the world economy, need. Amongst the crucial roles of the Bretton Woods Institutions were the provision of liquidity and of longer-term development finance. In both cases, the IFIs filled gaps not covered, or not yet covered, by private flows, either because private lenders or investors had temporarily withdrawn or because they were not willing to finance certain countries, sectors or projects.

Not only was it important to reaffirm the value of IFIs in today's and tomorrow's world, it was also crucial to make suggestions on how best to adapt their lending facilities, as well as the conditionality attached to them, so as to maximise the effectiveness of IFIs' contribution to development.

In his opening remarks, Kemal Dervis, Vice-President, Poverty Reduction and Economic Management Network, World Bank, emphasised that in the debate about globalisation and its management the challenge went beyond just economic or financial aspects. The real debate in international finance, as in other areas, was which levels of sovereignty were responsible for what actions?

The Asian crisis had encouraged ongoing discussion on a new financial architecture. There was a risk that the rapid recovery of growth – in the crisis countries and the world economy – could reduce the sense of urgency of this debate.

There were two good and two bad elements associated with globalisation. The two good ones were that overall growth was robust and developing countries were increasingly participating in the process; and that, as recent World Bank studies had confirmed, growth was good for the poor. As a reflection of these developments, human indicators showed massive progress in the last decade. The overall conclusion, therefore, was that globalisation was good for poverty reduction.

The two bad elements, however, were that the severity and frequency of crises had increased over time, and that volatility seemed to be a phenomenon that was here to stay. There were surges of capital flows before World War I, and again in the 1920s and the 1970s, all of which ended with major dislocations in the world economy. Comparatively, the recent crises were not the worst. Given the regularity and high cost of crises, there was an urgent need to continue efforts to reduce such problems.

Secondly, there was a group of the poorest countries which were not benefiting from globalisation; their per capita income had not grown and their share of world trade was falling. They were being left out and this was a major challenge.

As regards the role of the IFIs, the depression of the 1930s and World War II had provided a rationale for the creation of the Bretton Woods Institutions. The Cold War had provided initial justification for aid and multilateral lending. Today, however, aid was justified in terms of poverty reduction.

In the current Heavily Indebted Poor Countries (HIPC) initiative, debt reduction was seen as being linked to growth and poverty-reduction policies. In that context, strategies to be pursued had to be designed by the affected country, but the IFIs' staff had to assess the programmes which would need the approval of the IFIs' boards of directors. In poor countries macro and structural policies were intertwined, and this made close co-operation with the IMF and the World Bank essential. This was also true for middle-income countries. In country programmes, there was a multitude of agencies and actors to be co-ordinated, but ultimately success would depend upon the dynamics of the country itself.

In the debate, a significant point was made that it was important not to overlook the different sizes of developing countries. Though the economies of small countries had been growing, their growth was both more vulnerable and more volatile.

International Standards and Domestic Regulation

There was broad agreement amongst participants about the importance of international standards. The significance of standards for building up sound financial systems and for promoting stability of the international financial system was particularly emphasised. Two key objectives of standards were highlighted: (i) to help policy-makers in developing countries, by providing a benchmark; and (ii) to provide more and better information to markets so that they could price risks more appropriately; this, in turn, would hopefully provide feed-back mechanisms for policy-makers.

The need for standards was caused by several elements. Globalisation meant that countries were increasingly linked, and as a consequence externalities were significantly increased. Indeed, the rapid growth of capital flows, and the increased emphasis on private markets, had speeded up the international transmission of shocks. Recent experience had shown the significance of contagion. In this context, some participants stressed the value of implementing consistent and uniform standards across countries; facilitating comparability of information would hopefully reduce the likelihood of crises and their contagion. Other participants stressed the need for adapting standards to country circumstances.

A number of concerns were expressed by developing country participants about the relevance, scale and nature of standards, and the legitimacy of the process involved in designing them. These concerns were perhaps best summarised in the question of whether standards were a runaway juggernaut or a desirable reform.

As regards the reason why so much emphasis had been placed on implementation of standards by developing countries, the argument was put forward that standards were the lowest common denominator of agreement among key players regarding measures leading to the setting up of a new financial architecture. It was far more difficult to reach agreement on more radical and international measures, such as the various alternatives of 'lender of last resort' and involving the private sector in crisis resolution. This was linked to the fact that implementing standards required little effort from G-7 countries, which were the key decision-makers in the international arena.

A number of general concerns were raised by developing country participants, several of which were widely shared. Firstly, the question was raised as to whether standards could really play such a large role in preventing crises, given the importance of other factors, such as exchange rate policies. Indeed, the fear was expressed that the micro-rationality of standards (especially in the financial sector) could be overwhelmed by the large macro-economic shocks that tended to be important features of crises. The concern was even raised that implementation of standards could distract policy-makers from dealing with the main potential causes of crises. Secondly, it was stressed that the number of standards (more than 60) was clearly excessive and that implementing them simultaneously would be very costly. A call was made for a cost-benefit analysis of different standards. This would allow a prioritisation of core standards. Thirdly, the advocacy of uniform standards assumed that 'one size fits all', and did not allow for the variety of institutional structures in different countries. Fourthly, given the absence of a sound analytical basis, it certainly seemed premature to incorporate standards as part of routine IMF conditionality. Furthermore, the fear was expressed that even if, during surveillance, countries had their standard implementation easily approved, during crises perceived lack of implementation of standards could be an obstacle to obtaining adequate emergency official finance.

Doubts were also expressed about the process of defining standards. Firstly, the question was asked whether the process of definition of standards was legitimate; should standards be set by international organisations, with so little participation by developing countries? Or should there be negotiation about which standards should be complied with? Secondly, the need to involve more of the private sector in both the design and implementation of standards was emphasised, given that the primary motive for standards was to encourage more (and stable) private capital flows.

Important differences between developing countries also emerged on what types of standards they regarded as more appropriate, especially in the financial sector. This led to the question of whether the same Basle capital adequacy standard should be applied to countries in different stages of development and degrees of opening of the capital account. The Basle capital adequacy standard was seen as too high for some developing countries, where banks were especially crucial to financial growth due to the limited development of capital markets, the high cost of raising additional capital and smaller perceived risks of crises due to more limited opening of the capital account. The fear was also expressed that in countries with large unregulated sectors, stringent capital adequacy standards and regulation could lead to an undesirable expansion of unregulated financial institutions. On the other hand, for developing countries with more open capital accounts, a clear need was seen for higher capital adequacy requirements than those specified under the Basle Accord, so as to reduce vulnerability to costly crises in a context of large and volatile capital flows.

Indeed, the high development cost of bank failures was stressed by several participants as an important reason for higher capital adequacy requirements and other prudential measures in developing countries than the minimum required by the Basle Accord. However, the need for more stringent capital adequacy requirements for developing country banks did pose a serious problem in that this would make them less competitive with the large international banks, whose capital adequacy requirements would be lower; this could lead to large international banks displacing developing country banks, which some saw as undesirable. The need to implement cross-border regulation, together with national regulation, was also stressed; this would go beyond the Basle tradition.

There was broad agreement amongst all participants on several important issues. Some standards clearly needed to be given priority over others. There should be adequate transition phases. Standards should be voluntary and, in particular, the timing and sequencing of standards should be left to individual countries. Developing country concerns should be appropriately reflected in the development of standards. For this purpose, it was crucial that developing country representatives should speak out even more than they had done so far in relevant fora, such as the IMF Board and the G-20.

International Regulatory Challenges

In this session there was broad consensus on the diagnosis of problems but some differences were expressed on remedial measures.

A key problem in international financial markets was that because of externalities markets could not price risk efficiently. This required a regulatory structure to deal with market imperfections. For this regulation to be efficient, the regulator needed to cover the whole domain where these externalities occurred. With today's globalised private financial markets, this required global modalities of regulation.

Two key elements had a bearing on these international regulatory challenges, specifically in relation to financial markets in emerging markets. One was the weakness of domestic financial institutions and infrastructure revealed in recent crises; the second was the pressures arising from 'global consolidation', that is, the emergence of internationally fewer and bigger banks, the concentration of securities trading, etc. In the case of banking, consolidation raised questions about the weakening of competition.

Lessons were drawn from recent crises. The most obvious one was that capital flows were volatile; this volatility resulted in large swings in capital movements and/or sizeable changes in asset prices. Small open economies – especially emerging ones – were, and are likely to remain, particularly vulnerable to disruption by large flows of international capital. Unfortunately it seemed that this volatility was not just transitional, as it had persisted through the 1990s; indeed, it was reported that during the 1990s the financial system had been in crisis for 40 out of the 120 months, or for 33 per cent of the time. These crises had a large impact on real economies, especially in developing countries. Volatility was probably intrinsic to modern financial markets, and could arise even in countries that were well-managed. Indeed, market participants (especially in the short run) found it hard to discern between the good and the unsustainable; they would often herd and contagion was common.

As a consequence, it was argued that the process of international financial intermediation had a second-best element, in which welfare for both source and recipient countries could be increased by regulatory changes – in source and/or recipient countries – to reduce excessive lending or investing. Such regulatory changes could help smooth capital flows to emerging markets without discouraging them excessively. There was growing recognition that it may often be desirable to regulate excessive surges of potentially reversible capital flows in recipient emerging countries. However, the experience of the 1990s, with very large movements of international funds compared to the small size of developing country markets, implied a strong case for complementary regulation in the source countries. Indeed, in a second-best world, where there was moral hazard due to likely bail-outs on the lender's side and sovereign risk on the borrower's side, large negative externalities on welfare were generated. The introduction of regulatory measures in both source and recipient countries reduced the risk of defaults and crises, as well as raising welfare in both countries.

On the basis of the above diagnosis, several of the speakers argued for better international financial regulation, though there were some differences on how best to proceed. On one side of the spectrum was the proposal for a World Financial Authority; if this should prove impossible, the assignment of the responsibilities to be performed by such an authority could be allocated to existing institutions. The economic challenges for such an international regulator would be to: (a) keep pace with the rapid changes in markets; (b) develop a theory of regulation, which linked regulation of micro-economic risk to the macro-economic cycle; and (c) harmonise global risk management with different structures in different economies.

Some participants argued for a looser approach, on the grounds that a single global regulator was not practical, given different legal regimes; this approach would imply further developing existing co-operation (especially on information) between regulators, consolidated supervision and technical assistance to non-G-10 countries.

A number of important new technical issues were raised. One was the interaction between herding, risk management and transparency in bank lending which, it was argued, actually made markets more prone to crisis. This was linked to the models used by banks to manage risks, for limiting their daily earnings at risk; when this limit was exceeded, the banks automatically reduced exposure by switching into what they believed were less volatile assets. However, individual banks underestimated the impact on prices, volatility and correlations when many investors herded and sold the same asset at the same time. A key reason why investors and bankers herded was that, in a world of uncertainty, the best way of exploiting the information of others was by copying what they were doing. The problem was that while market participants behaved strategically in relation to one another, the risk models measured risk statically, without taking these strategic interactions into account. In other words, risk models had limited value in measuring exposure to rare extreme market events.

It was further argued that herding behaviour might actually increase if the frequency of dissemination of information increased significantly (for example, if foreign exchange reserves were published daily), as this would further accentuate herding. Furthermore, a paradox was pointed out: if all banks used similar models, these might contribute to volatility and systemic risk. A partial answer to this type of problem was to provide incentives for banks to adopt broad risk management, not relying on models alone; this would include rigorous stress-testing, to take account of extreme events, which may have not occurred recently, but could take place in the future. Such stress tests should make financial institutions more careful and less prone to herding. It was reported that after the Asian crisis financial institutions had increased resources for stress tests.

A second area of concern was how to fill disclosure and regulatory gaps, such as possible regulation of portfolio flows to emerging markets, originating in institutional investors, like mutual funds, with the aim of smoothing flows to help avoid surges and crises. This could perhaps best be achieved by a variable risk-weighted cash requirement for institutional investors; this would vary with emerging market countries' performance.

As regards disclosure, important gaps existed in relation to aggregate exposures of financial institutions, especially highly-leveraged institutions (such as hedge funds) and banks, which should be urgently remedied. Efforts here needed to be accelerated, including by mandatory requirements for disclosure. It was very important for policy-makers to have far better information on markets, in the same way that information provided to markets on countries had been significantly improved. Transparency should not be a one-way street.

Valuable insights emerging from the FSF report on capital flow volatility (the Draghi Report) were discussed. The first was the need to assess risks and exposures created by capital inflows, emphasising foreign currency liquidity risks; this applied not only to government risks, but also to banks. The Draghi Report argued that the liquidity and foreign exchange exposures of banks in some emerging markets could, as an interim measure, be subject to explicit regulation. In particular, banks' gross foreign currency positions might need to be regulated, as banks use foreign currency borrowing to fund domestic loans. Though the banks' net foreign currency exposure may be small (as they 'balance' foreign assets and liabilities), they remain exposed to credit risk from their borrowers' foreign exchange risks. The Draghi Report listed different possibilities for the limitation of banks' liquidity and foreign exchange exposure, such as minimum holdings of liquid foreign assets, tiered by maturity of borrowing and reserve requirements, with or without remuneration, to discourage foreign currency funding.

The rapidly increased market share of foreign banks in several major emerging markets posed new supervisory challenges. Simple regulations seemed to be useful in some emerging markets. But the trend in supervising big international banks was allowing use of their own risk-management procedures (subject to supervisory verification). Concern was also expressed about this trend and whether regulators were not putting too much faith in the markets. Other banks, especially in developing countries, would still be subject to standardised rules. Applying different standards to domestic and foreign banks in the same country was problematic, raising level playing field issues. In the future, these differences may narrow in some developing countries, whose banks, due to their perceived increased sophistication, may also be allowed by regulators to use their own risk models.

Broader questions were also asked about the willingness of foreign banks to lend to small businesses, and about whether foreign banks were more likely to curtail credit in a crisis. Evidence from South Korea seemed to confirm the latter point.

A final issue raised was the need to remove regulatory distortions, such as those in the 1988 Basle Accord, that may have contributed to the build-up of short-term international debt, due to lower capital adequacy requirements for short-term lending. Rating agencies were also critically assessed, given their pro-cyclical impact; their possible increased role in the proposed new Basle Accord regulations was a source of concern.

The view was expressed that a broader response to pro-cyclical trends in lending itself, and even in regulation, could be the implementation of explicit counter-cyclical elements in bank regulation, to help smooth capital flows and their impact on the domestic financial system, as well as on the real economy. This would better link micro-economic risks, that regulators had, until recently, focused on, and macro-economic risks. Different mechanisms could be used for such counter-cyclical regulation of banks: variable capital ratios, higher general provisions for possible loan losses built up in good times to be used in bad times, caps for the value of collateral in times of boom, and/or discouragement of categories of lending – such as for property or personal consumption – that increased more in booms. Furthermore, regulators should be flexible in the downturn, particularly to allow banks to cushion themselves in times of recession, even possibly allowing ratios to fall below normally required levels, to help sustain lending. Tension may arise between regulatory concerns about individual banks and macro-externalities of such actions. Further analysis is required about practical issues on the best timing and mechanisms to implement counter-cyclical regulatory measures, and whether such measures should be introduced nationally, internationally, or both.

Private Sector Involvement in Crisis Resolution

There was broad consensus on some issues on private sector involvement at a general level. All actors, including the private sector, had accepted the need for collective action and the idea of their own involvement in crises. There was, especially, consensus on the need for collective action clauses in bonds. Furthermore, there had been significant progress in understanding the issues, but far less progress on implementation. This was partly because the issues were rather complex, but also because there were fairly important differences between the different actors involved on what were the best modalities to use.

It was stressed that private sector involvement encompassed several stages. The first, and most important, was crisis prevention. If prevention was managed correctly, there would be no need for crisis management. A key element in prevention was liquidity risk management, for banks, corporates and the government. Private sector contingent credit lines could also play a positive role here. The other two stages occurred during a crisis. At one level, there could be market disruption without default. Agreements were voluntary, and there was differential treatment for creditors. If this second stage was not successful, the country entered a potential default stage, where reactions were involuntary. The decision involved was crucial for the country which would bear very severe costs; developing country participants expressed the view that the decision should be left to the country and that the IMF should not be involved. Furthermore, the intervention of the Fund at this stage could weaken its future influence. In this stage, debtors seemed to prefer a more rule-based, mechanical procedure, and one in which all creditors should be equally treated. It was argued that the negotiations should be left to creditors and debtors, as this would allow for a faster solution.

The exchange rate regime was stressed as crucial, because it determined the burden-sharing between domestic currency denominated debt and foreign currency denominated debt. More broadly, according to some participants, certain exchange rate regimes (such as floating or very strong pegs) could reduce the probability of crises.

From an IMF perspective, it was also stressed that the Fund should not try to become a party in the negotiations. However, the Fund's analysis of debt sustainability in the medium term should be the basis for discussion. Broadly, the Fund distinguished two situations. In one it would rely on its traditional catalytic approach. This was when the finance problem of the country was moderate, could be sorted out with limited official finance and the country had good prospects of recovering market access. The second situation was the one that required private sector involvement. This was when the financial requirement was large and the country had no prospect of re-accessing the capital markets or, if it had, there was an unsustainable medium-term debt burden.

Generally a criterion could be that if funds required exceeded a certain percentage of the country's IMF quota, then private sector involvement would be required. However, from the IMF perspective, moving towards mechanical rules was seen as problematic, because of the complexity of individual cases; this differed from developing country positions, which preferred a more rule-based approach. Emphasis was put on the difficulty of knowing *ex ante* if the situation would go into a crisis, as information was scarce when markets were disturbed.

The decision on whether or not to involve the private sector needed to be based on a cost-benefit analysis. The main benefits of involvement were: (a) relative predictability of rules; and (b) limiting the risk of large-scale official lending that allowed the private sector to exit and created moral hazard. The main costs were: (a) an adverse effect on prospects of resumption of spontaneous market access by the country concerned; and (b) the range of undesirable effects on international capital markets.

The decision for concerted action depended on the expectation of success; the better the instruments the more likely a positive solution.

The private sector representatives stressed that, from the perspective of the private sector, the framework for involvement should be voluntary, transparent and without a fixed set of rules. Comparability of treatment, better information on burden-sharing, as well as respect for bond-holder majority votes, were stressed as desirable features. It was seen as important to avoid situations where investors feared purchasing bonds; indeed, from the private sector's perspective, the optimum situation was one where debt was very difficult (but not impossible) to restructure and the mechanism was pre-established and not arbitrary.

From a private sector perspective, there were three main principles to be followed by the IMF in its involvement in debt restructuring and crisis management: (a) acceptance of free negotiations for restructuring; (b) verifying that countries really did need debt restructuring; and (c) consultation first with the private sector to assess the magnitude of the problem.

It was emphasised that investors and countries both benefited from quick solutions to crises. For the lender, the longer the default, the lower the recovery rate; for the borrower, unresolved debt claims precluded further access to capital markets.

In relation to criteria for private sector involvement, some participants argued for three elements to be considered: (i) whether the crisis was national or systemic; (ii) whether the crisis was one of liquidity or of solvency (it was, however noted that the distinction between illiquidity and insolvency was difficult in practice); and (iii) in the case of illiquidity, whether official lenders had enough resources to meet the outflows without private sector adjustment. If a crisis was clearly systemic, official money should be provided and the private sector should be involved. The case of national crises is more complicated, as there was a trade-off between the cost of the crisis for the country concerned and moral hazard for the lenders; however, a bias towards lending was seen as desirable. As regards a national crisis, a clear criterion for establishing whether it was a liquidity crisis was whether governments could pay back once the panic was over; if this was the case – as in countries like Mexico in 1995 or Korea in 1997 – then it seemed clearly to be a liquidity crisis. In genuine cases of insolvency, new lending by official creditors should only be made on condition that agreement on a write down of debts was also achieved. Collective action clauses could help ensure this.

The issue of standstills was also discussed. South Korea in 1997 was seen as a successful case of a voluntary standstill, once it was implemented (though the delay in implementing it had led to large bank outflows which deepened the crisis); however, the success of the Korean standstill may be partly explained by the fact that banks were the main creditors, which was not the case in other countries, where creditors were more heterogeneous (for example, bond-holders). As regards unilateral standstills, the question was raised about how comprehensive such a measure should be, and whether it could effectively deter capital flight by residents in an open economy. Indeed, it was argued that standstills needed to be combined with capital controls to make them effective and to prevent capital flight undermining the effectiveness of the standstills.

The Role of the IFIs in the New Financial Architecture

The main themes emerging from this discussion were as follows.

The changing global environment posed a double challenge of crisis mitigation and inclusion of developing countries in the globalisation process. Globalisation had led to increasing growth for selected developing countries, but also to greater vulnerability, stemming increasingly from capital rather than trade shocks, which tended to be dramatic relative to GDP. Information asymmetries increased the risk of herd behaviour by investors and contagion affecting middle-income countries. At the same time, least developed countries had been virtually excluded from the benefits of globalisation, and the number of poor in the world continued to rise. This posed a double challenge: (i) to prevent and mitigate crises in middle-income countries; as well as (ii) to ensure that the poorest and currently excluded countries were not left behind, and that global targets on poverty reduction could be met.

The principal recommendations of the Meltzer Commission, however, did not help the IMF and World Bank to better address these challenges. The discussants unanimously rejected the emphasis of the Meltzer Commission on 'moral hazard' issues in defining the role of the Fund, the assumption that access to private capital flows eliminated any role for the World Bank in middle-income countries and the confidence that the donor community would mobilise sufficient financing to replace IDA loans with grants in low-income countries. Accordingly, they did not think that the Meltzer Commission Report provided an adequate blueprint to guide Bank/Fund reform. The IFIs should continue to pursue the aims for which they were created – supporting stability, growth and development – but they should adapt to the needs of the twenty-first century. Equitable income distribution was also an important policy objective.

Bank/Fund collaboration needed to be improved and strengthened, but there could be no simple delineation of roles and responsibilities in an increasingly complex environment. The two institutions needed to work flexibly together – with each acting as the lead institution on different issues. However, the goal should not be to set artificial boundaries or eliminate any 'overlap' in the work programme of the two institutions. There were important synergies which could only be realised if both institutions retained capacity in critical areas. This applied in particular to the nexus of growth-oriented policies, financial sector development and structural reforms in support of poverty alleviation. This was illustrated by recent initiatives such as enhanced collaboration in crisis countries, Poverty Reduction Strategy Papers (PRSPs), Reports on Observance of Standards and Codes (ROSCs), and Financial Sector Assessment Programmes (FSAPs).

The Fund needed to avoid mission creep, but it needed to retain its facilities for low-income countries. In this context, Fund representatives stressed that the naming of the Poverty Reduction and Growth Facility (PRGF) should not be misinterpreted as an attempt to broaden the Fund's mandate. At the same time, Fund approaches needed to reflect the insight from the Asian crisis that a narrow focus on macro-fundamentals without regard to structural, social and institutional factors was inadequate. There was also strong support for retaining the Fund's facilities for low-income countries, especially to provide liquidity and evoke the discipline which was associated with the combination of surveillance and lending. It was seen as appropriate that the PRGF remained in the Fund, as any change would risk losing already approved resources, and because stabilisation was an essential element of growth and poverty reduction, but continued collaboration with the Bank was desirable.

The Bank had an important role to play in middle-income countries. Access to private capital markets was not a sufficient criterion for withdrawal of Bank support, as countries might not be able to raise necessary finance in the markets, especially for longer maturities and for activities where social returns were higher than market returns. In addition, Bank lending provided stable, counter-cyclical access to funds. It could improve asset-liability management by extending duration, and play an important role as a catalyst for private lending, in particular for capital-intensive investments with long gestation and pay-off terms. In support of policy dialogue, it could also have an important impact on expenditure composition to the benefit of the poor. Bank lending added special value due to its technical contribution. Finally, while discussants expressed concern about the use of Bank resources in crisis situations, it was also acknowledged that the availability of timely and adequate crisis lending could have important development pay-offs (for example, in helping to support social safety nets or helping to strengthen banking systems, when they were under extreme pressure).

It was still felt, however, that the Bank lacked focus and efficiency. In the perception of most discussants, the welcome emphasis by the Bank on dialogue with all stakeholders had unfortunately resulted in an unwarranted effort to be 'all things to all people'. Efficiency had suffered as competencies and resources were stretched thin. In particular, there was an apparent disconnection between initiatives supported by senior management and operational priorities at the country level, with country units frequently complaining about a multitude of 'unfunded mandates'. At the same time, from a client's perspective, desirable safeguard policies tended to translate into administrative hurdles for project approval, further increasing already lengthy preparation cycles. Finally, discussants expressed concern that programming of staff time had created perverse incentives (for example frequent over-commitments), effectively reducing management's ability to mobilise staff. To summarise, although there was extremely strong support for the World Bank's mission, there was a lot of criticism of how the Bank implemented it.

The World Bank still needed to play its original role in financing projects crucial for development in health, education and transport. In particular, but not only from a low-income country perspective, the World Bank should not give up on its role of lending for traditional projects.

In defining its mission, the World Bank should recognise that it did not necessarily have a comparative advantage in the provision of all global public goods. The Bank had an important role to play in the provision of global public goods. However, as was imperative in Bank/Fund collaboration, the Bank should increase its efforts to co-ordinate with other global and regional organisations. In many instances, other global organisations appeared to have a comparative advantage and should take the lead in facilitating the provision of global public goods. Moreover, there often were distinct regional externalities which suggested a critical responsibility of regional organisations; regional institutions may also respond better to the needs of smaller countries.

There remained a tension between conditionality and ownership. There was broad consensus that successful policy reform required country ownership of programmes, and genuine partnerships between countries and IFIs. Nonetheless, some participants underlined the usefulness of conditionality to focus policy dialogue and to express government commitment. However, other discussants voiced concern about the legitimacy of conditionality, which at times still appeared to replace, rather than reflect, government ownership, and thus raised issues of democratic legitimacy and accountability. The view was also expressed that there had been an excessive expansion of conditionality, especially linked to HIPC debt relief. Greater humility by the IFIs was also to be encouraged.

Reforms of Bank/Fund governance would strengthen effectiveness and legitimacy. There was a widespread perception that current arrangements in the international financial architecture did not provide sufficient voice for developing countries (see below). This was also deemed to apply to the governance structure of the Bank and the Fund. Even within the parameters of capital-based representation, the current arrangements in establishing the Board of Directors (with, for example, grouping of OECD and developing countries under one chair, or alphabet-based rotation of shared seats for developing countries) were deemed inadequate. Moreover, there was strong support for further focusing the role of the respective Boards on issues of strategic importance, and enhancing the 'deliberative' nature of these bodies – a shift which should be reflected in the stature and mandate of Board representatives.

The meeting provided evidence that the discussions on the role of Bank and Fund were beginning to yield concrete results, and that a variety of reform proposals were emerging which were not confined by the ideological underpinnings of the Meltzer Commission. For the Bank, these included (as well as those mentioned above):

- strengthening the Bank's role in support of trade liberalisation;
- enhancing the capacity of developing countries to conduct WTO negotiations;
- rebuilding sectoral competency;
- enhancing Bank/International Finance Corporation collaboration.

On a more conceptual level, there was also a discussion about the division of labour between global, regional (and national) development agencies, and a vision of their collaboration in a multi-level network where regional agencies were not just perceived as a replica of global institutions.

Issues of Global Governance

Global governance had resurfaced as a major issue as a result of the Asian crisis. The view was presented that it was desirable that governance of institutions should be discussed in parallel with a redefinition of the functions of institutions.

In the depths of the last crisis (around September 1998) calls began to be made by the G-7 for 'reform of the global financial architecture'. The discussions at the Conference focused on whether the progress made had been sufficient to help prevent and respond better to future crises and make them far less damaging and whether the reform process and, more generally, global governance had been inclusive enough.

The view was expressed by several participants that progress on reform had moved in the right direction, but had suffered from two linked problems. Firstly, progress made, though important and clearly valuable, was insufficient, given the magnitude of the changes required; there was the risk that complacency could set in, as the global economy and the crisis-hit countries had recovered so well. Secondly, progress had been asymmetrical. Though significant and useful efforts had been, and were being, made to ensure institutional reforms at the national level in developing countries, it was argued that insufficient progress had been made in the area of international reform. The latter should include provision of adequate official emergency financing, possibly funded by anti-cyclical issues of SDRs to countries experiencing crisis, to be extinguished as they were repaid. It should also include some mechanism for 'standstill' provision to be incorporated into international lending, as well as for strengthening regional and sub-regional organisations so that they could play a greater role in preventing and managing crises. The role of regional institutions was debated but was seen as particularly valuable for smaller countries; it also contributed to valuable diversity of ideas, relevant in a pluralistic world.

As regards the representation of developing countries in global governance and, specifically, in the reform process itself, some positive steps had been taken, but a number of participants saw them as insufficient. The two new vehicles crafted by the G-7 in 1999 to take the reform process forward were the FSF and the G-20; they had now become important actors in the process of international financial reform. Though the creation of the FSF was seen as valuable, concern was expressed that, until now, the FSF had not included developing countries as formal members of the Forum; their inclusion in working groups was not enough. The view was expressed that although the work of the FSF was very valuable, more of its efforts seemed to be geared towards reducing the vulnerability of countries to increasing volatility in the capital markets, rather than influencing the behaviour of the international market actors who played a large role in generating the problem.

In contrast to the mainly G-7 FSF, the G-20 comprised different categories of countries, including major developing ones; this was a welcome feature. However, the absence of smaller countries was noted. The focus of G-20 work was seen as rather narrow. Indeed, the prevailing focus of the G-20 was far more on addressing developing countries' domestic vulnerability to financial crises, rather than the broader international issue of how to reform the global financial architecture.

The view was expressed that the G-20 had so far acted more as a sounding-board for reforms endorsed by the G-7. However, the G-20 was still in its infancy, and the possibility existed of a broadening of its agenda, for example through initiatives taken by non-G-7 members. The statement by the Canadian Finance Minister, Paul Martin, the G-20's first Chairman, was highly encouraging. He said: 'There is virtually no major aspect of the global economy or international financial system that will be outside of the group's purview.' One area suggested for discussion in the G-20 was the role of the IFIs.

Capital Account Liberalisation and its Critique

After the Asian crisis the international consensus moved towards far greater caution on liberalisation of the capital account. This was based on the well-recognised view that although global capital flows had a potential for improving efficiency and growth prospects, especially through the development and deepening of national financial markets, they could also trigger very significant instability, which was particularly costly and painful for developing countries, especially the poorer ones. As a consequence, capital account liberalisation had to be actively managed by national authorities, continuously assessing the costs and benefits of liberalisation vis-à-vis controls or regulation. There was also a broad consensus that such liberalisation, though desirable, needed to be gradual and well-sequenced.

Both external and internal factors were needed to influence the pace and order of liberalisation. Progress on an effective international financial architecture (relating to global arrangements for preventing crises as well as provision of rapid and sufficient official international liquidity and adequate arrangements for burden-sharing) was a major factor determining the desirable pace and sequencing of countries' capital account liberalisation.

As regards the management of the capital account, flexibility in the liberalisation of the capital account, depending on domestic and international developments, was stressed. Some participants argued for a permanent system of controls that could be strengthened or loosened throughout the business cycle, as controls created only in a crisis might be less effective due to the non-existence of institutional mechanisms for putting them into practice.

Several participants stressed the need (even in the liberalised framework of the capital account) to retain an option for the re-imposition of controls, given the fact that capital account liberalisation may have proceeded too fast. Indeed, should the IMF not, for example, recommend to countries which have fully liberalised, and which receive large surges of inflows, that they use Chilean-style capital controls or other measures to discourage these large inflows? It was reported that the IMF has not yet done so, partly due to concerns over the market impact of such a step.

A number of linkages between different policies was stressed. For example, some restrictions on the current account may be needed during transition to a liberalised capital account, to avoid leakages. Capital controls should never be a substitute for an appropriate exchange rate and were ineffective if the exchange rate was unrealistic.

The complex issue of optimal levels of foreign exchange reserves in the new context of large and volatile capital flows was also discussed, with emphasis on the need for significant additional foreign exchange reserves to allow not only for covering current account needs and maturing debt, but also possible reversals of flows, such as portfolio capital and potential domestic capital flight. High forex reserves had the virtue of diminishing risks of crises, but implied significant high net costs.

The linkages between prudent domestic regulation and capital account liberalisation were stressed. Whilst borrowing in foreign markets created forex mismatch, borrowing domestically could lead to maturity mismatches. Indeed, countries like India were able to avoid the Asian type crisis facilitated not only by a relatively closed capital account, but also because of a good regulatory framework of the domestic financial system.

As regards types of capital controls, a distinction was made between price-based and quantitative controls. As regards the former, the Chilean experience indicated that price-based measures could be clearly effective in improving the maturity structure of the debt; there was also empirical evidence that, in Chile, unremunerated reserve requirements provided greater autonomy for monetary policy. Indeed, they helped slow down excessive capital inflows in a time of major surges, which led to less rapid growth of private domestic expenditure and of current account deficit.

Price-based controls were also seen to be better, as they were market-based and non-discriminatory. However, if adequate institutional back-up was not available, it might be necessary to use quantitative controls.

A number of central issues were raised. Was a closed capital account a deterrent to needed reforms? Did it reduce growth? Did it discourage desirable capital flows? The Chinese experience suggested that a closed capital account was not a deterrent to broader reforms and that it could be consistent with very rapid growth. However, it was pointed out by some participants that China, as well as India, were countries with particularly large domestic markets, so that they were not necessarily replicable. But there seemed to be broad agreement that a closed capital account did not discourage desirable capital inflows, as demonstrated by the Chinese experience with very high foreign direct investment. 'Having a door in your house does not imply you are a hermit.'

Several participants stressed that liberalisation of the capital account could aid the process of development and the deepening of national financial and debt markets.

Conclusions

Given the range of views expressed, it was difficult to draw simple conclusions. However, a number of areas of consensus could be discerned. As regards standards, it was seen as urgent to prioritise them, so that countries were not excessively overburdened. The possibility of a negotiated agreement between IFIs and developing countries was emphasised.

Domestic financial regulation was important; however, if large macroeconomic shocks occurred, as happened in the lead-up to or during crises, micro-standards of regulation might not be sufficient to help the financial system to withstand such shocks.

Private sector involvement was broadly accepted. Emphasis was placed on the need for countries to decide standstills. There was a need to clarify what sort of transactions would be subjected to standstills and whether such measures had to be accompanied by capital controls.

As regards the role of IFIs, there had been too much emphasis in the architecture discussions on preventive issues; more emphasis should be placed on their role in crisis management.

The issue of development finance for small and poor countries had also not been sufficiently addressed in current debates. In this context the importance of regional institutions was highlighted.

It was important to define changes in governance of the IFIs simultaneously with any changes to their role, and not, as some argued, afterwards.

A key point was that the IFIs should return to basics. However, this should not imply, as the majority Meltzer Report had argued, a decrease of moral hazard, but rather putting financial stability and, above all, growth and development, as the key objectives of the IFIs. The latter would be consistent with the aims with which the IFIs were created at Bretton Woods.

Finally, the agenda of reform of the IFIs and of the financial system would be here for some time. It would be important for developing countries to participate systematically in this process.