

Chapter VI

Systemic issues

The systemic agenda addressed by the Monterrey Consensus of the International Conference on Financing for Development (United Nations, 2002, annex) covers two broad groups of issues. The first relates to the structural features of the international monetary system, and the possible vulnerabilities that they pose for the world economy or for specific groups of countries. The second relates to the institutional design of the current international financial system.

With respect to the first set of issues, the analysis undertaken in the present chapter starts with the major macroeconomic imbalances that characterize the world economy today, which many observers fear may become unsustainable. This issue relates, at least in part, to the design of the international reserve system, particularly to the role of the United States dollar as the major international currency. The following section looks at the evolving structure of private international financial markets and its potential vulnerability to systemic risk. A particular source of concern is the potential interaction between the macroeconomic risks associated with the current global imbalances and the potential vulnerabilities generated by the financial innovations and consolidation that are taking place. A third issue relates to the asymmetries that characterize the international financial system which not only subject developing countries to pro-cyclical private capital flows but also limit their room for manoeuvre in adopting counter-cyclical macroeconomic policies. The major implications of this problem were dealt with in chapter III; this chapter considers its implications for the role of the international financial institutions in crisis prevention and resolution.

The analysis of these problems includes some issues relating to institutional design, such as the role of multilateral surveillance, the possible role of the International Monetary Fund (IMF) in the coordination of macroeconomic policies among major industrialized nations, the surveillance of domestic policies and emergency financing during crises. The last three sections deal with a selected set of additional institutional issues: the role of special drawing rights (SDRs), the only genuinely international reserve currency in the current system; the role of regional reserve funds and other regional monetary arrangements; and the voice and representation of developing countries in decision-making in the international financial system.

Global macroeconomic imbalances and the international reserve system

The global economy has large and widening imbalances across regions, reflected in a large current-account deficit in the United States of America which is matched by an aggregate of surpluses in a number of other countries, mainly in Asia and Europe, and including a group of oil-exporting countries. These imbalances are continuing to widen and policymakers worldwide are increasingly concerned about their sustainability, about the risks associated with various adjustment processes and, ultimately, about their implications for global financial stability and the growth of the world economy. Even if the imbalances are

The Monterrey Consensus addresses two broad systemic issues

The first comprises the international monetary system's vulnerabilities, one current example of which are the global macroeconomic imbalances

The second is institutional design, including different aspects of the role of the International Monetary Fund

Policymakers are increasingly concerned about the sustainability of current-account imbalances

sustainable or if there is a smooth adjustment, questions remain whether such large and skewed imbalances constitute an efficient and equitable allocation of global resources across countries.

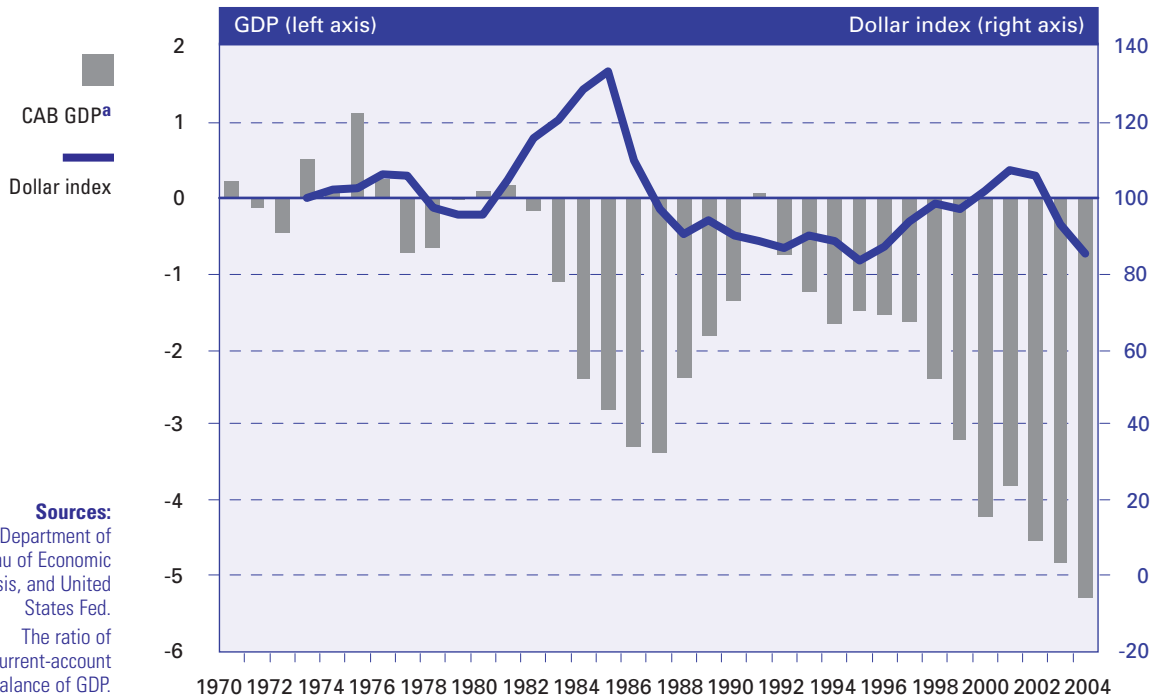
The current-account deficits of the United States have been the rule for most of the past three decades, with only a brief period of balance (see figure VI.1), and have risen rapidly since 2000 to a record high of more than \$600 billion. As a result, the United States, the world's largest economy, has accumulated net international debts of about \$3 trillion, making it the world's largest debtor. These changes in national holdings of international assets are both a counterpart to the current-account imbalances and their mirror image, as reflected in national differences between savings and investment. The external deficit of the United States corresponds to a shortfall of its savings in relation to its investment and surpluses of savings over investment elsewhere, with the United States absorbing at least 80 per cent of the savings that other countries do not invest domestically. The solution to the problem of the global imbalances can therefore be seen either from the trade perspective or from the point of view of rebalancing savings and investment across countries.

These chronic large United States imbalances are closely related to the nature of the current international reserve system and international monetary arrangements. A central feature of the international reserve system is the use of the national currency of the United States as the major reserve money and instrument for international payments. Other major currencies, the euro and the yen, play a supplementary and slightly larger role than in the past, with the exchange rates among the three major currencies being subject to supply and demand, or "floating".

The United States current-account deficit has risen rapidly since 2000

Chronic United States deficits are related to the use of the dollar as the major reserve currency

Figure VI.1.
United States current-account deficit, 1970-2004



Sources:
United States Department of Commerce, Bureau of Economic Analysis, and United States Fed.
a The ratio of current-account balance of GDP.

As early as the 1960s, Robert Triffin (1960) focused on a dilemma facing the international reserve system. He pointed out that the rest of the world needed the United States to run balance-of-payment deficits in order to provide the additional liquidity necessary to fuel continued world economic growth. However, when the deficit of the United States rose, the excess supply of dollars eroded confidence in the value of the dollar, weakening its foundation as the world's reserve currency. This inconsistency would lead to a perpetual cycle of expansion and contraction in the external deficit of the United States, along with instability in exchange rates and in the growth of the world economy.

Although the dilemma posed by Triffin was set in the context of the Bretton Woods system and presaged its collapse, it remains broadly relevant to the current international monetary arrangements. One important difference is that the origin of the external imbalances of the United States has changed. In the 1960s, they were the counterpart of the global investment activities of large United States firms, whereas now they are the consequence of low domestic savings within the United States.

As the issuer of international reserve money, the United States is able to have persistent external deficits and to finance them in its own currency, with virtually no need for foreign-exchange reserves. Facing external constraints that are more limited than those of other countries, the United States can, if it deems necessary, adopt policies that are more stimulatory than those of other countries. In contrast, most other, particularly developing, countries have to use the dollar and other international currencies, rather than their own national currencies, in their international transactions and as a medium for accumulating foreign-exchange reserves; their capacity to run external deficits is constrained by their supply of foreign exchange and their access to global credit markets, both of which are limited.

The United States also profits more concretely from its role as the world's banker. A large part of its liabilities are the foreign-exchange reserves accumulated by other countries, usually held in a combination of cash, and short-term and liquid longer-term securities paying a relatively low interest rate, while its assets consist mostly of its long-term loans and equity investment in foreign countries, which yield higher returns. Thus, and despite its position as a net international debtor, the United States continues to have a positive net inflow of investment income from abroad.

Historically, adjustments to the large external deficits of the United States have involved considerable volatility in foreign exchange and world financial markets and a contractionary effect on both the United States and the global economy. In the early 1970s, adjustment led to the collapse of the Bretton Woods system and the transition to a floating exchange-rate system among major currencies, including a major downward correction of the dollar (see figure VI.1). It was also one of the factors that contributed to the end of the "golden age" of post-war economic growth in the developed countries.

During the 1980s, when the United States faced "twin" fiscal and external deficits, the adjustment had involved, in 1985, a sharp fall in the value of the dollar. Until the current account was rebalanced in 1991, the dollar declined by about 40 per cent against a basket of other major currencies, despite many efforts at international policy coordination among the major developed countries, such as the Plaza Accord of 1985 and the Louvre Accord of 1987.¹ Meanwhile, the equity market in the United States had tumbled in 1987 and, in addition to the correction of the deficit, there was a slowdown

Historically, adjustments to the large external deficits of the United States have had contractionary effects on both the United States and the global economy

in growth of gross domestic product (GDP) in the United States, culminating in a recession in 1990. The United States recession led, in turn, to a global economic slowdown in 1989-1991.

The rebalancing of the deficit in the United States during the late 1980s was matched by a rebalancing of surpluses in Germany and a few other developed countries, a number of developing countries in Asia and some oil-exporting developing countries. In contrast, Japan's large external surplus declined only marginally and rebounded in the following years, even though the yen had appreciated significantly against the dollar since the mid-1980s. The experience of Japan during the 1980s and the 1990s shows that currency revaluation in a surplus country may not necessarily result in the necessary adjustment in the external imbalance; this is contrary to the conventional wisdom, which relies exclusively on exchange rates to adjust current-account imbalances and still underpins some analyses.

The global imbalances today have become larger and lasted longer than in the 1980s

Today's global imbalances have become larger and lasted longer than in the 1980s. Some analysts argue that increasing global economic integration, particularly deepening global financial integration, have made current imbalances different from those of the 1970s and 1980s in terms of their sustainability and their implications for the world economy. The difference, however, can be only in quantity, not in quality. As the imbalances continue to increase, the risks of an abrupt and disorderly reversal also rise, suggesting risks of larger adjustment costs for the world economy in the future.

As the imbalances continue to rise, the risk of an abrupt adjustment increases

Other analysts have argued that current imbalances could be sustained for a long time (see Dooley, Folkerts-Landau and Garber, 2003; 2004a; 2004b). This school of thought contends that the intervention required to prevent Asian currencies from appreciating will continue to provide an important part of the financing needed by the United States to continue its current-account deficits. According to this point of view, for many developing countries, the economic benefits of stable and weak exchange rates exceed the costs of reserve accumulation.² In turn, continued reserve accumulation by some Asian and other central banks allows the United States to rely on domestic demand to drive its growth and to run the resulting large current-account deficits. After a decline from 70 per cent in the 1960s to almost 50 per cent in the early 1990s, the share of United States dollar assets in total world official holdings of foreign exchange has since rebounded, to about 64 per cent (see table VI.1); the share of the euro remains less than 20 per cent and that of the Japanese yen less than 5 per cent.³

Many observers fear that the United States current-account deficit is unsustainable because it finances mainly consumption, because United States investment is shifting towards non-tradables and because the deficit is increasingly funded by short-term flows, including by central banks

However, an increasing number of observers fear that three features may cause the rising United States current-account deficit to become unsustainable in the next few years. First, the deficit is financing consumption rather than investment; second, United States investment is shifting towards non-tradable sectors; and third, the deficit is increasingly being funded by short-term flows (Summers, 2004). It is such factors that have made current-account deficits less likely to be sustainable than in the past, in both developed and developing countries. In addition, the financing needed by the United States to sustain its deficits has been provided by the world's central banks, not by private investors, during certain recent periods (Higgins and Klitgaard, 2004).

For these reasons, many argue that the value of the dollar could fall significantly: the financing required to sustain United States current-account deficits may be increasing faster than the dollar reserves of the world's central banks inasmuch as their willingness to continue to build up those reserves is affected by the many potential sources of instability built into the system (see, for instance, Williamson, 2004; International

Table VI.1.
Share of national currencies in identified official
holdings of foreign exchange, end of year,^a 1994-2003

Percentage										
Currency	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
All countries										
United States dollar	53.1	53.4	56.8	59.1	62.6	64.9	66.6	66.9	63.5	63.8
Japanese yen	7.8	6.7	6	5.1	5.4	5.4	6.2	5.5	5.2	4.8
Pound sterling	2.8	2.8	3	3.3	3.5	3.6	3.8	4	4.4	4.4
Swiss franc	0.6	0.5	0.5	0.5	0.5	0.4	0.5	0.5	0.6	0.4
Euro ^b	..	..	..	..	13.5	16.3	16.7	19.3	19.7	..
Deutsche mark	15.3	14.7	14	13.7	13.1	..	..	..	..	..
French franc	2.5	2.4	1.9	1.5	1.7	..	..	..	..	..
Netherlands guilder	0.7	0.5	0.4	0.5	0.5	..	..	..	..	..
European currency units (ECU) ^c	6.8	5.9	5	0.8	..	..	..	..	..	..
Unspecified ^d	9.5	12.1	11.5	11.3	12	12.1	6.6	6.4	7.1	6.8

Source: International Monetary Fund, Annual Report of the Executive Board for the financial year ended 30 April 2004.

- a** Including only IMF member countries that report their official holdings of foreign exchange.
- b** Not comparable with the combined share of euro legacy currencies in previous years because amounts exclude the euros received by euro area members when their previous holdings of other euro area members' legacy currencies were converted into euros on 1 January 1999.
- c** In the calculation of currency shares, the ECU is treated as a separate currency. ECU reserves held by the monetary authorities existed in the form of claims on both the private sector and the European Monetary Institute (EMI), which issued official ECUs to European Union central banks through revolving swaps against the contribution of 20 per cent of their gross gold holdings and United States dollar reserves. On 31 December 1998, the official ECUs were unwound into gold and United States dollars; hence, the share of ECUs at the end of 1998 was sharply lower than a year earlier. The remaining ECU holdings reported for 1998 consisted of ECUs issued by the private sector, usually in the form of ECU deposits and bonds. On 1 January 1999, these bonds were automatically converted into euros.
- d** Difference between total foreign exchange reserves of IMF member countries and the sum of the reserves held in the currencies listed in the table.

Monetary Fund, 2005a; Roubini and Setser, 2005). One of these sources of instability is the tension between the growing need of the United States for financing to cover its current-account and fiscal deficits and the losses that those lending to the United States in dollars are almost certain to incur. There are also concerns that rising trade deficits will lead to protectionist pressures, especially against Chinese products; signs of a new burst of protectionism are already apparent. These growing signs that the system is under stress raise doubts that the present massive rate of reserve accumulation will continue for an extended period.

Globally, owing to the particular role that the dollar plays in the world economy, the income and wealth effects that the devaluation of the dollar generates tend to run counter to the relative price effects, resulting in limited overall adjustment. Dollar depreciation may therefore counteract the more fundamental rebalancing of growth rates among major economies which is required to correct the global imbalances (United Nations, 2005). In particular, appreciation of their currencies is likely to lead to reduced investment demand and growth in Europe and the economies of Asia, thus increasing, rather than reducing, the savings surplus of these regions. The fact that the wealth effects of dollar

There are tensions between the growing need to fund the United States current account and the losses that those lending in dollars are likely to incur

depreciation are also adverse for those holding dollar assets is likely to reduce their spending, particularly where those assets are held by private agents (as is the case in Europe). Appreciation of the yen may also slow the effort of Japan to overcome price deflation and a large-scale appreciation of other currencies could eventually generate deflation in the economies concerned.

The problem could be accentuated if declines in the value of the dollar were accompanied by falls in the prices of bonds and stocks

So far, concerns about the deficit of the United States have been reflected mainly in foreign exchange markets but not in bond and equity markets. The decline of the dollar in the foreign-exchange market in the past few years has not been accompanied by major sales of the foreign holdings of United States government bonds or stocks during the same period (as indicated, respectively, by the flat yield curve and narrow spreads in the market for United States government securities and the relatively stable equity market). The risk is that this dichotomy between the foreign-exchange market and the capital market may be a short-run anomaly and that there will eventually be a large movement away from dollar-denominated securities by foreign holders. This could increase interest rates in the United States, as well as in the global capital market; this, in turn, could have negative effects on the United States economy and on the rest of the world, particularly on the developing countries.

There is agreement on the measures to be taken, both by major deficit and by major surplus countries, but implementation has been limited

This highlights the need to mitigate the risks of an abrupt adjustment of the global economy. In this regard, there is a large degree of agreement that measures should be taken simultaneously in two broad areas (see, for example, International Monetary Fund, 2005a, 2005b; United Nations, 2005). First, the United States should reduce its fiscal deficit; and second, the surplus countries in Europe and Asia should adopt more expansionary policies to stimulate their aggregate demand. Despite the growing consensus on these priorities, implementation has been very limited. Further delay could cut short the present period of improved widespread global growth.

Smooth global rebalancing requires more international policy cooperation and coordination. Given the systemic risks associated with global imbalances, purely national approaches to the macroeconomic policies of major economies are inadequate. In choosing their policy stance, national policymakers should take into account the interdependence and spillover effects of their policies on others. Consequently, their domestic policies should at least be based on mutually consistent assumptions and preferably be designed in a cooperative manner that recognizes global interdependence.

IMF could have a larger role in policy coordination among major economies ...

The establishment of the roles of IMF in surveillance of major economies and in surveillance of developments in the international financial system—one of the most important innovations introduced during the Asian crisis—are as important as ever. These roles could be complemented by its more prominent role as an honest broker in policy coordination among major economies (Ocampo, 2001). Despite the problems of representation addressed below, IMF is the only institution where developing countries have a voice on macroeconomic imbalances of major economies and could eventually have a voice on global macroeconomic policy consistency.

... and thereby play a more active role in supporting the management of the world economy

It has thus been suggested that there is a need to rethink the role of the Fund in the management of the international monetary system (King, 2005). With the advent of financial globalization, surveillance should focus not only on crisis-prone countries but, increasingly, on the stability of the system as a whole and on major economic challenges that require a global cooperative approach (de Rato, 2004). Consequently, rather than be confined to occasional lending to middle-income countries hit by financial crises and balance-of-payments financing for low-income countries, the Fund should play a more active role in supporting the management of the world economy.

Compared with the Bretton Woods system, the current international reserve system has the merit of flexibility. However, such a system can hardly be considered efficient if it consistently fails to correct large balance-of-payments disequilibria across countries. Nor can the arrangement be deemed equitable when adjustment of the global imbalances often places heavy burdens asymmetrically on many developing countries. The international community should begin to address the long-term and ultimate goal of the reform of the international reserve and international monetary system so as to overcome these systemic weaknesses. More urgent and decisive cooperative action is required to ensure that the imbalances do not result in the derailment of global growth in the short term, an occurrence that itself would have substantial adverse long-term effects.

Urgent and decisive action is required to ensure that the imbalances do not derail global growth

Changes in the structure of global financial markets

Risk implications of changes in global financial markets

The global financial system has undergone a profound transformation over the past decades. Many of the impediments to the free flow of capital across borders have been dismantled and domestic financial markets deregulated. The collapse of the Bretton Woods system of fixed parities among major currencies has brought increased volatility to exchange rates. This, together with interest-rate fluctuations, has generated a rapid expansion of new financial instruments aimed at managing the risks to specific financial institutions or investors dealing in these instruments. This has resulted in greater risk diversification but it has also led to the transfer of risk across segments of the financial system. Advances in data processing and telecommunications technologies have radically reduced costs of financial transactions. As a result of all of these factors, financial activity now represents a much larger share of aggregate economic activity than it did 20 or 30 years ago.

Technological innovation and deregulation have led to a profound transformation of the global financial system

The increase in securitization—brought about, in part, by efforts to introduce risk-based capital requirements—has moved many financial assets off the balance sheets of regulated financial institutions, reducing the monitoring functions of these institutions and increasing the monitoring of the performance of debt relationships by the capital market. This process has led to the growing role of non-bank institutional investors as well as to an increase in trading activities of all financial institutions. It has also made the debt relationships more anonymous, and increased the sensitivity of all market agents to short-term variations in the valuation of assets.

The increase in securitization has resulted in a growing role of non-bank financial institutions and in a rise in trading activities

Another important change has been the consolidation of the financial industry. In the United States, this has resulted from a liberalization of financial regulation that has encouraged branch banking and eliminated the segmentation of commercial and investment banking. For instance, the top five United States domestic bank holding companies now hold about 45 per cent of banking assets, almost twice the share that they held 20 years ago. At the same time, as a result of increased securitization, and despite their increased size and scale, depository institutions now hold only about one fifth of all assets held by United States financial institutions, or less than half the share that they held in 1984. The reduction in their traditional deposit business, along with the reduced restric-

The consolidation in the financial industry and its globalization have resulted in the formation of a small group of global financial conglomerates

tions on their activities, has led to expansion in other areas such as derivatives. The notional value of outstanding derivatives held by the five largest United States banks is more than half of the global total and 95 per cent of the total held by all United States banks. The degree of concentration in the market for credit derivatives—the newest and fastest growing segment—is even greater, with one bank holding more than half of total United States holdings. As a result, there has been a sharp increase in the share of assets that are intermediated by institutions that are not subject to consolidated risk-based capital frameworks (Geithner, 2004).

Increasing concentration has been observed in all regions, including emerging market countries. At the same time, the diminishing obstacles to capital flows and foreign establishment, as well as improved communication and information, have facilitated the expansion of these financial conglomerates across borders. Given the size and reach of such institutions into national markets and financial systems around the globe, the phrase “too big to fail” has acquired a stronger and more urgent connotation than in the past decade.

Alongside these changes, there has also been substantial convergence in the type of financial transactions performed by bank-centred and non-bank affiliated financial intermediaries. With the growing marketability of assets produced by increased securitization and the development of secondary markets, portfolio investors, such as insurance companies and pension funds, have diversified into areas that used to be the exclusive domain of banks. For their part, commercial banks have increased their involvement in the securities business.

The trends towards consolidation and a broadening of the range of activities performed by any given player have culminated in the formation of a rather small group of dominant global financial institutions. In addition to being engaged in different forms of intermediation in many countries, these firms are the main trading partners of, and most important providers of leverage to, so-called highly leveraged institutions (HLIs). These institutions have been largely unregulated in the past but are coming within the purview of regulatory authorities.⁴

These structural trends have manifested themselves in greater convergence and growing linkages among different segments of the global financial system—between financial institutions and markets, among different types of financial institutions, and among different countries. They have important implications for the transformation of financial risk. The fact that a much larger, more complex and interlinked financial sphere has emerged, in which the market has replaced government regulators, means that problems in the financial system can have larger consequences for the real economy than in the past.

The growing size of large financial institutions and the diversity of their activities probably make them less vulnerable to shocks. However, the combining by financial firms of commercial and investment banking operations, and insurance and brokerage services raises potential concentration risks. In these large, internationally active financial institutions, a common capital base underpins an increasing number of activities such as on-balance sheet intermediation, capital market services and market-making functions. Losses in one activity could put pressure on other activities of the firm, and a failure of one of them could have a broader impact than in the past and be considerably more difficult to resolve. In sum, the systemically significant financial institutions are larger and stronger than in the past, but they are not invulnerable and the impact of a failure would be greater.

With growing concentration, a failure of one financial institution could have a broader impact than in the past

Also, numerous new financial instruments, including derivatives, tailored to a broader set of investors, have permitted the independent pricing of risk factors that were previously bundled together in the same instrument (see chap. III). As a result, risk transfer mechanisms have become more efficient at the microeconomic level. To the extent that new financial instruments have improved the technology of risk management, they improve the climate for real and financial investment.

However, the unbundling process does not necessarily eliminate or reduce risk, and may simply transform and redistribute it among different holders. The development of risk transfer markets has strengthened the links between different types of risk. For the same reasons, the similarities of underlying risks are becoming more apparent, regardless of the type of financial firm incurring them. Owing to the layering of direct and indirect links through the markets, assessment of true underlying risks becomes difficult (Knight, 2004b). Besides, the increased opportunities for risk transfer mean that more risk may end up in parts of the financial system where supervision and disclosure are weaker, or in parts of the economy less able to manage it. Despite the positive effects of financial innovations, it is necessary to ask whether they could have the same destabilizing impact in the present cycle that deregulation had in earlier ones (*Financial Times*, 2005).

Recent macroeconomic events have also introduced specific implications for financial risk. While the extent of leverage is now lower than in 1998, when its perils became obvious amid the collapse of a large United States hedge fund, increases in liquidity in response to the recent recession have provided more funds to borrow. Indeed, the search for yield in the low interest rate environment characteristic of recent years resembles the period after the recession of the early 1990s and has prompted a yield famine that has led financial institutions and their customers to take positions in swaps and options in derivatives markets for the purpose of making bets on changes in interest and exchange rates. As the spread between short- and long-term interest rates narrowed, institutions borrowed more in order to take the larger positions needed to bolster shrinking profit margins.

In their 2004 reports, both the Bank for International Settlements (BIS) and IMF pointed out that increased speculation had made the financial sector more vulnerable to unexpected shifts in economic activity or interest rates. IMF also noted that hedge fund assets had grown by 20 per cent globally in 2004 as large banks and brokers, as well as institutional investors increased their presence in the hedge fund business (International Monetary Fund, 2005h, pp. 50-51). This movement of regulated entities into less regulated hedge fund activities suggests that leveraged risk-taking has expanded and may continue to expand over time.

Implications for prudential regulation and supervision

The evolution of the financial system and the changing nature of financial risk have had profound implications for prudential regulation and supervision. The major trend in this area has been towards improving risk sensitivity of regulatory arrangements at both the national and the international level. Risk-focused supervision implies that supervisors are expected to concentrate their efforts on ensuring that financial institutions use the processes necessary to identify, measure, monitor and control risk exposures. The first Basel Capital Accord (Basel I) and the New Basel Capital Accord (Basel II) are considered to constitute a major step in that direction. It is still unclear, however, whether improvements in

New financial instruments have resulted in more efficient risk transfer mechanisms ...

... but assessment of true underlying risks becomes very complicated

More risk may end up in parts of the financial system where supervision is weaker

The regulatory response to the changing nature of financial risk has been a move to risk-based supervision ...

risk management practices can more than compensate for the dangers implicit in the changes in the financial structure. Furthermore, most regulation applies to financial institutions, but not to the markets in which they trade. This is especially true of over-the-counter derivatives.

... to an indirect approach to financial regulation ...

Another important development has been the move towards an indirect approach to financial regulation, which is considered to be more consistent with the evolving financial environment. This involves the establishment of a framework of rules and guidelines intended to set minimum standards of prudent conduct within which financial institutions should be freer to take commercial decisions. In other words, there has been a move away from codified regulation and towards supervision, that is to say, towards an assessment of the overall management of a financial firm's business and the multiple sources of risk that it is likely to confront (Crockett, 2001a).

Within this approach, special attention is being paid to large, systemically important financial firms. It has been argued that large financial firms should maintain capital cushions over and above those stipulated by regulatory standards. Also, the internal risk management regime needs to meet a more exacting standard (Geithner, 2004). However, it is hard to know what constitutes an adequate cushion when so much financial activity that could pose a systemic threat is outside the banking system, and the degree of leverage in finance is so hard to gauge.

... and to greater convergence in prudential frameworks across financial lines and national jurisdictions

Another notable development is the convergence in prudential frameworks across functional lines. The growing similarities of underlying risks call for greater consistency in the supervisory treatment of financial risk across functional segments of the industry. For instance, by now, capital adequacy, supervisory review of risk management processes, and enhanced public disclosure are all emerging as common elements of regulation in both the banking and insurance industries (Knight, 2004a). Also, the United States Securities and Exchange Commission (SEC) has outlined a framework that provides a form of consolidated supervision of the major investment banks with a risk-based capital framework based on Basel II. The proposed new regime will add a consolidated approach to risk-based capital and an intensified focus on the risk management regime to the traditional SEC focus on enforcement for investor protection and market integrity. This will be similar to the European Union (EU) implementation of Basel II, which will be applied to all financial institutions.

The trend towards convergence has also manifested itself in the consolidation of financial sector supervision into a single agency in over 30 countries. Internationally, this trend has led to the creation of the Joint Forum, which brings together representatives of regulatory authorities in banking, securities and insurance. With globalization of financial activity, the pressure to adopt similar regulatory and financial reporting arrangements across countries has also intensified (Knight, 2004a).

The liberalization of the financial sector has resulted in greater pro-cyclicality ...

It is also worth noting that, with the advent of liberalization, the financial sector, at both the national and the international level, has tended to become much more pro-cyclical. Having realized this, supervisors are searching for techniques that can help make financial systems more resilient to the financial cycle.

... and this has increased the likelihood of boom-bust cycles, with the "endogenous" component of risk becoming more prominent

The transformation of the financial system has increased the likelihood of boom-bust cycles. Those cycles have common features. Credit and debt levels rise in the upturn, with lenders and investors becoming increasingly vulnerable to the same shocks owing to common risk exposures. As a result, the "endogenous" component of risk, which reflects the impact of the collective actions of market participants on prices and

liquidity of financial assets, and on system-wide leverage, becomes more prominent. In the downswing, this process goes into reverse with significant and long-lasting costs to the economy.

In this regard, it has been argued that, at least in part, the financial problems of the past 15 years or so are the result of the sustained period of credit expansion and increasing asset prices in the industrialized countries in the 1990s (White, 2003). An important development in this respect is that, while inflation in the prices of goods and services has become less of a problem in the developed countries, increases in liquidity tend to be reflected in increases in asset prices. These excesses, combined with overvalued exchange rates and currency mismatches in many emerging market economies, have contributed to the financial crises both in developed and in developing economies.

Consequently, policymakers in developed countries should pay more attention to preventing harmful feedback effects of financial excesses. The existing tools, however, are not very useful for that purpose. Indeed, regulators rarely consider the probability of shocks generated endogenously in the system. The risk assessments of rating agencies are highly pro-cyclical (Reisen, 2003) and tend to react to the materialization of risks rather than to their build-up, in relation to both sovereign and corporate risk. Most risk models rely heavily on market-determined variables like equity prices and credit spreads that may be biased towards excessive optimism when imbalances are emerging. Furthermore, the use of similar market-sensitive risk models, together with other features of financial markets (for example, benchmarking and evaluation of managers against competitors), may increase herding behaviour (Persaud, 2000).

Improving the safeguards against instability for a financial system that is larger and more interconnected, and whose endogenous component of risk is more prominent, calls for a modified approach to prudential regulation with a system-wide perspective and a focus on endogenous components of risk. This systemic or macro orientation of prudential regulation requires a shift away from the notion that the stability of the financial system is simply a consequence of the soundness of its individual components.

The importance of this macroprudential perspective as a complement to the more traditional microprudential focus is widely recognized (see, for instance, Crockett, 2000, 2001a; Knight, 2004b; Ocampo, 2003). Its objective is to limit the risk of episodes of financial distress with significant losses in terms of real output for the economy as a whole. Consequently, it stresses the need to establish cushions as financial imbalances build up during the upswing in order to both restrain excesses and give more scope to supporting losses in the downturn. This implies introducing some counter-cyclicality into financial regulation, which would compensate for the tendency of financial markets to behave in a pro-cyclical manner (see chap. I).

An important impediment to implementing macroprudential policies in practice is uncertainty about the significance of potential systemic problems. Relevant analyses are now carried out in various forums, including IMF, the World Bank, the Financial Stability Forum (FSF) and the Bank for International Settlements. The process of convergence within the global financial system across markets, institutions and national jurisdictions makes it very important to have appropriate institutions for this purpose.

Among existing institutions, the Financial Stability Forum stands out in its capacity to ensure macroprudential monitoring and appropriate policy response. However, the Forum has no power to propose or to sanction, and insights gained from its deliberations may not necessarily be turned into policy actions. The need for stronger internation-

Most risk models rely heavily on market-determined variables, which may increase herding

The rising importance of the endogenous component of risk calls for the strengthening of macroprudential regulation

al governance in the area of financial regulation has been suggested by several analysts (see, for instance, Eatwell and Taylor, 2000), but these proposals face constraints associated to the desire of major countries to retain sovereignty over national financial regulations and supervisory systems.

There are concerns that Basel II may increase the pro-cyclicality of lending

The regulatory approach will be seriously tested for the first time during and after the implementation of the New Basel Capital Accord (Basel II), which, according to many observers, may increase pro-cyclicality of bank lending especially for developing countries, because of its increased risk-sensitivity (see chap. III). To alleviate these concerns, the architects of Basel II have noted that supervisory oversight and market discipline should reinforce the incentive for banks to maintain a cushion of capital above the minimum so as to have a margin of protection in downturns. They are also urging financial institutions to adopt risk management practices that take better account of the evolution of risk over time (thus taking better account of the full business cycle) and that are not excessively vulnerable to short-term revisions. It has also been argued that because of greater disclosure built into Pillar 3 of Basel II, markets may become less tolerant and more suspicious of risk assessments that are too volatile and lead to substantial upgrades in good times (Borio, 2003). However, as noted above, rating agencies and other market actors themselves often have strong pro-cyclical biases. More broadly, the regulators' success in dealing with the problem of the pro-cyclicality of the New Accord remains an issue of serious concern.

Crisis prevention and resolution

Avoiding financial crises is crucial to ensuring that the benefits of capital inflows create permanent increases in national welfare. Since the Asian crisis, increased attention has been given to the design of measures at the national and international levels aimed at better managing external shocks and preventing financial crises.

Domestic macroeconomic policies

Many developing countries have better control overinflation and are pursuing more prudent fiscal policies

Developing countries have the primary responsibility for their own macroeconomic policies and thus for crisis prevention. In this regard, important progress has been made since the Asian crisis. Inflation rates have tended to fall and stabilize at historically low levels in all developing-country regions. Also, despite setbacks and variations across countries, fiscal policy has become more prudent in its general thrust. Strong external accounts have led to a reduction in external debt ratios and the accumulation of foreign-exchange reserves. Greater global liquidity and reduced risk aversion have contributed to declining spreads between emerging market sovereign borrowing rates and developed-country benchmark interest rates. All these factors, together with strong growth in world trade and high commodity prices, have led to rapid economic growth in all developing-country regions in 2004 and 2005, for the first time in three decades (United Nations, 2005).

Nevertheless, their budgets are more vulnerable to shocks than those of developed countries

However, owing to higher and more volatile interest rates paid by emerging market Governments, their budgets are more vulnerable to interest rate shocks than those of developed countries. Also, many developing countries depend heavily on commodity exports and thus are much more vulnerable to risks of sharp external price swings. Indeed, improved terms of trade due to high commodity and energy prices of recent years might

have made underlying fiscal and external positions in some countries look healthier than they actually are.

There has also been a gradual shift of developing countries towards more flexible exchange rates. Greater exchange-rate flexibility is considered by some observers to have contributed the most to the reduction of the risk of future crises (Fischer, 2002) but it also carries the risk of exchange-rate instability in the face of volatile capital flows.

In this regard, there is now strong evidence that capital-account liberalization has increased growth volatility, without clear benefits in terms of more rapid growth (Prasad and others, 2003). Vulnerability to capital-account shocks is compounded by the tendency to adopt pro-cyclical macroeconomic policies that reinforce rather than mitigate the effects of external financial cycles (Kaminsky and others, 2004). Despite some advances (for example, the introduction of structural benchmarks for fiscal policy and the design of fiscal stabilization funds by some countries), limited progress has been made in introducing explicit objectives of counter-cyclical management of macroeconomic (that is to say, fiscal, monetary and exchange rate) policies, or in designing instruments that cushion developing borrowers against adverse economic developments by linking debt payments more directly to the borrower's ability to pay (see chap. III).

Given the evidence that capital-account liberalization increases macroeconomic volatility, many developing countries have continued to use capital controls. The evidence shows that there has been a slowdown in the removal of capital controls in developing countries since 1998 (International Monetary Fund, 2003a). To reduce currency mismatches, which have been a prominent feature of every major emerging market financial crisis of the past decade, local currency bond markets have expanded in developing countries. At the same time, lending by foreign banks has shifted from largely dollar-denominated cross-border loans to local currency loans through local affiliates. As a result, in many emerging economies, currency mismatches were reduced (see also chap. III).

There has also been progress in strengthening financial regulation and supervision. Supervisory and regulatory regimes of many developing countries have been brought in line with international practices as codified in the Basel Core Principles for Effective Banking Supervision. Also, in spite of the fact that there is no implementation timetable for non-Group of Ten (G10) members, many developing and emerging market countries have already begun to deal with implementation of the new capital adequacy framework (Basel II). It is expected that, by 2010, almost 75 per cent of banking assets in the developing world will be covered by Basel II arrangements (Bank for International Settlements, 2004).

Irrespective of the exchange-rate regime adopted, to ensure themselves against sudden shifts in market sentiment, most emerging economies have kept increasingly high stocks of international reserves. This "self-insurance" option entails significant costs and could constrain global growth as it reduces global aggregate demand. Nevertheless, in the absence of efficient market-based private alternatives or appropriate international official facilities, and given the enormous costs of financial crises, reserve accumulation remains a reliable, although costly, option for coping with volatility.

To reduce external vulnerabilities, many developing countries have moved towards more flexible exchange rates ...

... have taken a more cautious stance on capital-account liberalization, have reduced currency mismatches ...

... and have strengthened financial regulation and supervision

In the absence of satisfactory alternatives, most emerging economies have had to increase their holdings of reserves, as "self-insurance"

Multilateral surveillance

Surveillance of national macroeconomic and, since the Asian crisis, financial policies remains at the centre of IMF crisis prevention efforts. It has been argued, however, that increasing complexity of financial markets may have rendered the existing instruments of surveillance such as the Article IV consultations, the Financial Sector Stability Assessments and programmes, and the reviews of the observance of international codes and standards, less effective than assumed so far in identifying and preventing crises (Commonwealth Secretariat, 2004).

In July 2004, the IMF Executive Board concluded the latest biennial review of the surveillance activities. The review identified key priorities for further strengthening surveillance. It has been agreed that surveillance activities should be focused on improving analytical tools for early identification of vulnerabilities, including more rigorous assessments of balance-sheet weaknesses and stress-testing in regard to possible macroeconomic shocks.

To raise the effectiveness of surveillance, increased focus on country-specific areas of vulnerability is considered necessary. This requires surveillance that is tailor-made for addressing mainly those macroeconomic issues that are relevant in each member country. In addition, there is a need to better understand the constraints on a country's ability to take certain actions. It is therefore necessary to consider institutional, social and political realities in order to offer realistic policy advice.

As in the case of national efforts, more attention should be given to increasing the room for manoeuvre to enable countries to adopt counter-cyclical macroeconomic policies in the face of trade and, particularly, capital-account shocks. Greater attention within IMF surveillance on ways to enhance such room for manoeuvre would improve the effectiveness of crisis prevention efforts and financial support.

To increase the transparency of surveillance, IMF moved from voluntary to presumed publication of Article IV surveillance reports and programme documents. Increased transparency is thought to help improve both countries' policies and the quality of the Fund's work. However, there could be a potential tension between greater transparency and the Fund's role as a provider of candid and frank advice. Hence, in the handling of sensitive topics during surveillance exercises, there is a need for an appropriate balance between candour and confidentiality.

The Fund's ability to influence policies through surveillance is most limited with regard to large non-borrowing, mostly developed countries. At the same time, some of those countries have the greatest global impact. As was emphasized in the first section of this chapter, the role of IMF in macroeconomic surveillance of major economies and as an honest broker in policy coordination among these countries thus deserves special attention.

The role of emergency financing and precautionary financial arrangements

At the country level, central banks have acted for many decades as lenders of last resort, to prevent systematic banking or other financial crises, and to prevent their deepening when they do occur. Equivalent international mechanisms are still at an embryonic stage, with the current IMF arrangements operating more under the principle of the "emergency financier", which is a function different from that of the lender of last resort as performed at

More effective surveillance requires increased focus on a country-specific approach ...

... and on ways to enhance the room for economic policy manoeuvre

The Fund's ability to influence policies is most limited with regard to large non-borrowing countries

International emergency financing is essential to reducing the burden of adjustment

the national level, since there is no automaticity in the availability of financing during crises (Ocampo, 2002a). Enhanced provision of emergency financing at the international level in response to external shocks is essential to lowering unnecessary burdens of adjustment. Appropriate facilities should include a liquidity provision to cover volatility in export earnings—particularly that caused by fluctuations in commodity prices—sudden stops in external financing and, as recently emphasized, natural disasters.

The evidence of the adverse effects of terms-of-trade shocks on economic growth is strong. Particularly important is the finding that their negative effects on growth and poverty reduction can be very large (Collier and Dehn, 2001). However, the major IMF facility designed to compensate for terms-of-trade shocks, the Compensatory Financing Facility (CFF), has become increasingly ineffective. Since its modification in early 2000, which basically tightened conditionality for access, the CFF has not been used, in spite of the additional shocks affecting developing countries (International Monetary Fund, 2003a).

During the 1990s, capital-account liberalization and large capital-account volatility greatly increased the need for official liquidity to deal with sudden and large reversals of flows. There is an increasing consensus that many of the recent crises in emerging markets have been triggered by self-fulfilling liquidity runs, rather than by fundamental disequilibria or incorrect policies (see, for instance, Hausmann and Velasco, 2004). Indeed, capital outflows could be provoked by many factors not related to countries' policies. Among those factors are changes in financial conditions in industrialized countries and the pro-cyclical behaviour of capital markets, as well as contagion effects.

The enhanced provision of emergency financing in the face of capital-account crises is important not only to manage crises when they occur, but to prevent such crises and to avert contagion (Cordella and Yeyati, 2005; Griffith-Jones and Ocampo, 2003). Indeed, lending of last resort at the national level is basically conceived as a tool for crisis *prevention*, particularly prevention of systemic crises.

To address this obvious need, IMF has made efforts in recent years to improve its lending policy during capital-account crises. In 1997, the Supplemental Reserve Facility (SRF) was established. The SRF provides larger and more front-loaded financing to countries hit by a capital-account crisis, at a higher interest rate than that of other Fund facilities. Also, in some cases, the Fund softened its requirements and accelerated the approval process in the renewal of credits extended under this Facility, as was the case for Brazil in 2003 and 2004.

However, large-scale access by certain emerging economies led to criticism by some IMF members who considered that such large-scale lending should be more strictly limited. To a large measure, these debates have been provoked by cases of exceptional access to Fund resources not accompanied by an agreement on the conditions that should determine eligibility for such special treatment. In February 2003, the IMF Executive Board approved a new framework for exceptional access in capital-account crises, which included the following criteria for eligibility: exceptionally large need; a debt burden that would be sustainable under reasonably conservative assumptions; good prospects of regaining access to private capital markets during the period of the IMF loan; and indications that the country's policies had a strong chance of succeeding.

A major problem of many recent Fund-supported programmes, especially in cases of capital-account crisis, has been the lower-than-expected levels of private financing, resulting in sharper and more abrupt current-account adjustment and steep output declines (International Monetary Fund, 2004a). Past experience has shown that the catalytic effects of

Greater volatility of liberalized capital accounts has increased the need for official liquidity

Enhanced provision of emergency financing is important not only to manage crises better, but to prevent them and their contagion

In many recent Fund-supported programmes, private financing has been lower than expected

IMF financing on private capital flows may work only in rather rare situations when there is no doubt about debt and exchange-rate sustainability. This means that a further analysis of the optimal mix between financing and adjustment, as well as of the catalytic effects of Fund-supported programmes, is required (International Monetary Fund, 2005c).

The evidence that even countries with good macroeconomic fundamentals might be subject to sudden stops of external financing also gave broad support to the idea that a precautionary financial arrangement, closer to the lender-of-last-resort functions of central banks, had to be added to existing IMF facilities. The goal was to create a mechanism to prevent self-fulfilling liquidity crises.

The introduction of the CCL was not successful

In response to these demands, in 1999 the IMF had introduced the Contingent Credit Line (CCL). The facility was never used, however, and was discontinued in November 2003. Among the factors that may have contributed to the fact that countries failed to avail themselves of the CCL, observers have emphasized the “entry” and “exit” problems (Buirá, 2005). Contrary to what was desired, access to the CCL was seen as an announcement of vulnerability that could harm confidence. Another problem was that, even with a CCL, the country had to go back to the IMF Executive Board to secure a loan. There was also a lack of clarity regarding the amount of support that would be available and its timing.

The exploration of precautionary financial mechanisms continues

Since the expiration of the CCL, IMF has been exploring other ways to achieve its basic objectives. Opponents note that precautionary arrangements with exceptional access could potentially increase the risk of moral hazard (Fischer, 2002). The alternative view is that the case made for moral hazard issues associated with IMF lending—particularly moral hazard on the side of IMF borrowers—is exaggerated and lacks adequate empirical evidence. Furthermore, if a country was insured *ex ante* against self-fulfilling runs, such a scheme could prevent the massive real and financial costs associated with crises.

A recent proposal suggests automatic access, with eligibility linked to Maastricht rules

A recent proposal suggests the creation of a country insurance facility (CIF) to help stop and reverse liquidity runs (Cordella and Yeyati, 2005). Through this facility, eligible countries would have automatic access to a line of credit at a predetermined interest rate to cover short-term financing needs. Automaticity, which is essential for pre-empting liquidity runs, would distinguish the CIF (or any similar facility) from the late CCL, which required a pre-qualification process. The eligibility suggested would focus primarily on Maastricht-type rules, with a debt-to-GDP ratio not higher than 60 per cent and a fiscal deficit of 3 per cent or less being natural candidates for eligibility criteria. This has many merits, although the level of reserves should also be included, so that net indebtedness may be considered. Following lender-of-last-resort principles, the proposal envisages short-term lending (up to one year) at a penalty rate relative to pre-crisis levels.

It is assumed that, by replacing the standard *ex post* conditionality with voluntary *ex ante* conditionality, more countries would have the incentive to adopt sustainable policies conducive to solvency and eligibility. Furthermore, a well-designed CIF, or a similar facility designed to prevent liquidity runs, would be used very infrequently or, possibly, never. However, its impact should be visible in an increasing number of eligible countries and lower emerging market risk premiums. Indeed, the essential advantages of such a facility is that, by offering instant liquidity, it “would place a ceiling on rollover costs—thus avoiding debt crises triggered by unsustainable refinancing rates, much in the same way as central banks operate in their role of lenders of last resort” (International Monetary Fund, 2005d).

The additional demand for IMF lending facilities that was evident during the succession of the Asian, Russian and Latin American crises in the late 1990s also made evident the fact that a significant strengthening of the resource base of IMF might be needed, and that the potential loss to the global economy of failing to act was much higher than the opportunity costs of a larger Fund size (Kelkar, Chaudhry and Vanduzer-Snow, 2005). Existing mechanisms, which allow the Fund to borrow from major economies when such exceptional demands arise, may be suboptimal relative to the option of strengthening the resource base of the Fund, via SDRs. This issue is explored below.

A strengthening of the IMF resource base is needed

Strengthening IMF financing of poor countries

In September 1999, the IMF transformed the previously existing Enhanced Structural Adjustment Facility (ESAF) into the Poverty Reduction and Growth Facility (PRGF) for lending operations in its poorest member countries. PRGF-supported programmes are framed around Poverty Reduction Strategy Papers (PRSPs), the major policy instrument of concessional lending from both IMF and the World Bank, as well as of debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. In the case of IMF, PRGF-supported programmes are designed to cover mainly areas that constitute the primary responsibility of the Fund, such as exchange-rate and tax policy, fiscal management, budget execution, fiscal transparency, and tax and customs administration.

Concessional lending under the PRGF is administered by IMF through the PRGF and PRGF-HIPC Trusts. The PRGF Trust borrows resources from official institutions at market-related interest rates. The difference between the market-related interest rate paid to PRGF Trust lenders and the rate of interest of 0.5 per cent per year paid by the eligible borrowing members is financed by contributions from bilateral donors and the International Monetary Fund's own resources. As of March 2005, 78 low-income countries were eligible for PRGF assistance. At end-February 2005, total loan resources provided by PRGF creditors amounted to SDR 15.8 billion, of which SDR 13.3 billion have already been committed and SDR 11.7 billion disbursed.

A major issue under debate is how to improve existing arrangements so as to assist low-income countries in dealing with shocks. One of the most appropriate mechanisms could be to increase significantly access under the PRGF arrangements (called PRGF augmentation in recent IMF analysis) and diminish conditionality, as well as make the conditionality more supportive of growth and poverty reduction. This could be done, for example, by allowing—where feasible, that is to say, in post-stabilization countries with low levels of inflation—higher levels of government spending and particularly that implying positive impacts on growth (see Oxfam, 2003).

Access under the PRGF arrangements should be increased

Given that about half the eligible low-income members have PRGF arrangements, this would be an important channel, which would provide such liquidity support at subsidized rates. Augmentation of the PRGF has in fact been the main vehicle the Fund has used to provide financing for low-income countries hit by shocks. However, as IMF (2003a) itself recognizes clearly, the “small size and infrequency of PRGF arrangements suggests that there may be room for a more systematic response”. Indeed, in PRGF programmes where the Fund staff has estimated the direct impact of the shock (on average, 70 per cent of quota), PRGF augmentation has been very small in relation to the impact (only

12 per cent of quota, that is to say, less than a fifth of the IMF impact of the quota). These augmentations have also been very infrequent. It is therefore desirable that there be a genuine liberalization of the PRGF. An important source of concern would then be whether the resources available for the PRGF are sufficient to meet the liquidity needs of low-income countries facing external shocks.

For low-income countries that do not have PRGF arrangements, but are eligible for assistance from this Facility (about half), there are a number of options available for financing shocks outside their control (“silent crises”). One option, which seems very appropriate, would be to liberalize access to the CFF, liberalize its conditionality and introduce a subsidy element into it for low-income countries. Another option would be for PRGF-eligible countries that do not have such a programme to be granted subsidized loans from the Fund via a standby-like window, within the PRGF Trust.

Low-income countries are also vulnerable to natural disasters. In early 2005, IMF agreed to subsidize emergency assistance for natural disasters to PRGF-eligible members. However, the total amount allocated has been very limited, and was to an important extent, used up in the first few months.

Conditionality of IMF lending

As important as the lending facilities of IMF is the conditionality attached to them. Conditionality in IMF-supported programmes had been introduced in the 1950s and incorporated as a requirement into the Articles of Agreement in 1969. Until the 1980s, conditionality mainly focused on monetary, fiscal and exchange-rate policies. However, in the late 1980s, and especially in the 1990s, in addition to traditional quantitative targets for macroeconomic variables, IMF financing was increasingly made conditional on structural changes, involving changes in policy processes, legislation and institutional reforms. This resulted in a significant increase in the average number of structural conditions in Fund-supported programmes. These climbed from 2-3 per year per programme in the mid-1980s to 12 or more per year per programme by the second half of the 1990s, and to as high as 117 in the case of Indonesia after its financial crisis in 1997 (International Monetary Fund, 2003b). This change was also reflected in increasing numbers of performance criteria, structural benchmarks and prior actions.

The increase in the number of structural conditions raised concerns that IMF was exceeding its mandate and expertise. It has also been argued that the number and detail of structural policy conditions attached to IMF loans were too extensive to be fully effective (United Nations, 2001b). In this regard, it has been observed that the rate of member countries’ compliance with Fund-supported programmes fell from over 50 per cent in the late 1970s and early 1980s to about 16 per cent in the 1990s, if compliance is defined as that which permitted the full disbursement of the loan (Buire, 2003).

There were also concerns that excessive conditionality might have undermined the national ownership of programmes thereby impeding their implementation. Indeed, following closely the arguments related to external assistance in general (see chap. IV), it has become clear that lack of real domestic ownership is the most important obstacle to effective programme implementation, and that conditionality is not a substitute for government commitment. In this regard, it has also been argued that “ownership” can be promoted only by an effective plural discussion of the virtues of alternative types of “structural reforms” (Griffith-Jones and Ocampo, 2003).

For low-income countries without PRGF arrangements, other options should be available, such as a subsidized CFF

The increase in the number of structural conditions in IMF programmes ...

... has raised concerns about programme effectiveness ...

... and about their national ownership, credibility and catalytic role

In response to these concerns, in September 2002, the IMF Executive Board approved new conditionality guidelines, the first revision since 1979. A review of the new guidelines is scheduled for early 2005. The basic objective of the 2002 guidelines is to streamline conditionality and enhance programme ownership. Accordingly, conditionality is to be focused on policies essential to restoring and maintaining macroeconomic stability and growth, and better tailored to the country's circumstances. Structural issues are to be covered only if critical for these objectives. In this regard, the new guidelines stress a test of "criticality" for any variable selected for conditionality. The guidelines also stress the need to seek national ownership of programmes but they do not provide any formal guidance on how to identify and foster domestic ownership of sound policies.

The progress in implementing new guidelines is rather difficult to assess. There may still be a temptation to use IMF financial leverage when the country is in a difficult situation, and this temptation needs to be resisted (Allen, 2004). Also, it has been noted that since 2000-2001, the first phase of the "streamlining" initiative, the number of conditions in programmes has not declined but stayed fairly constant, with about 15 conditions per year per programme (IMF, 2004b; Allen, 2004), which is similar to the average of the 1990s.

A key challenge is to determine which actions are critical to the success of programmes. There appears to be no consensus among IMF Executive Directors regarding the extent to which structural conditionality should be streamlined (IMF, Independent Evaluation Office, 2005). IMF staff may have different views on the new policy (Killick, 2004). This can explain, at least partly, why conditionality streamlining has been so slow.

Another concern is that the reduction of the number of structural conditions in Fund-supported programmes may lead to an expansion of conditionality by the World Bank with the aggregate conditionality burden remaining unchanged or even increasing. There are differences between the two organizations in terms of mandates, cultures and structures (Commonwealth Secretariat, 2004). Finding the appropriate collaborative framework is an issue of great priority.

The role of SDRs in the international financial system

The creation of SDRs in 1969, as a result of international financial debates in the 1960s, was a major advance in the design of the international financial system. It gave birth to a true world money, with the potential to generate a more balanced distribution of powers of seigniorage. In a world characterized by the use of the national currencies of major industrialized countries as international monies, the accumulation of reserves and their cost generate, in fact, a redistribution of income from developing economies to the major industrialized countries, a large flow of so-called reverse aid (see Zedillo report (United Nations, 2001a)).

Unfortunately, no allocations of SDRs to IMF member countries have been made since 1981. The IMF Board of Governors did approve in 1997 a special one-time allocation of SDRs that would have doubled cumulative SDR allocations to SDR 42.9 billion and would have corrected the fact that new IMF members (since 1981) had never received an SDR allocation. However, this decision has not become yet effective.

New conditionality guidelines stress the test of "criticality" and the need to seek national ownership

Thus far, conditionality streamlining has been slow and indecisive

The creation of the SDR was a major advance in the design of the international financial system ...

... but no allocations of SDRs have been made since 1981 ...

... with negative effects
for developing
countries

The cessation of SDR allocations had negative effects for developing countries, as it coincided with a growing demand for international reserves. In recent years, in particular, many developing countries (especially, but not only, in Asia) accumulated substantial foreign-exchange reserves, partly to protect themselves against the risk of future financial crises due to reversible capital flows. However, holding such high levels of reserves with the aim of “self-insurance” implies high costs which are particularly onerous for low-income countries. Polak and Clark (2005) estimate the significant cost of the holding by low-income countries of about SDR 90 billion of reserves at about US\$ 10 billion per year; this is about one sixth of total annual net official development assistance (ODA).

Such high demand for reserves also reduces aggregate world demand and therefore has a deflationary effect at the global level. There are therefore clear benefits to be derived from internationally issued reserves which, together with emergency financing during crises, would provide developing countries with a “collective insurance” that was cheaper and therefore more efficient than “self-insurance” via foreign-exchange reserve accumulation.

Proposals to renew
SDR allocations have
increased in recent
years, with one model
suggesting temporary,
counter-cyclical
issuances of SDRs that
would not increase
total liquidity

Proposals to renew SDR allocations have been increasing in recent years. They follow two different models. The first calls for SDRs to be issued in a temporary way during episodes of financial stress and destroyed once financial conditions normalize (United Nations, 1999; Camdessus, 2000; Cooper, 2002; Ocampo, 2002a). This would develop a counter-cyclical element in world liquidity management, as sudden drops in private lending would be partly compensated by increased official liquidity; furthermore, total long-term liquidity would not increase, since normalization of private lending would imply a cancellation of those SDRs issued during the preceding crisis. Output in developing countries currently lowered by temporary shocks would be higher than otherwise, and the risk of additional world inflation would be minimal.

This proposal would solve the problems of adequately financing needs for extraordinary and temporary official liquidity but not the distributive issues associated with uneven distribution of seigniorage powers. The solution to this problem requires permanent allocations. Such allocations could go (directly or indirectly) to developing countries only or to the entire Fund membership. The advantage of the former is that it would focus SDR issues on the countries that need them the most. Furthermore, it would avoid the risk of creating more SDRs than the membership would collectively want to have. Alternatively, allocations of SDRs to industrialized countries could be used to finance important international objectives, particularly increased international development cooperation (see chap. IV).

For developing countries, holding additional SDR reserves would have a zero net cost or even a net benefit, as payment by the country for its reserves would be equal to or lower than the interest earned if they did hold them (Polak and Clark, 2005). There would also be no fiscal cost to industrialized countries if IMF issued SDRs, and they held them. Indeed, if an industrialized country is allocated SDRs, it will also have either zero net costs, or even a small positive net benefit (see UK Treasury, 2003).

Currently, greater SDR liquidity could allow other countries, including developing countries, to relax their efforts directed at increasing current-account surpluses (Williamson, 2004). Furthermore, it would help somewhat to reduce the massive dependence of the United States on the foreign central banks financing its deficit, a dependence that may be or could become problematic for the United States authorities.

One of the main reasons for traditional opposition of some industrialized countries to SDR issues is that those issues could increase inflation globally. This concern seems exaggerated, as the amount of SDRs that were issued would constitute an extremely small proportion of the world's total money supply. For example, in the most recent allocation of SDRs approved in 1997, but not yet ratified, an issue was proposed of SDR 21 billion, or approximately US\$ 30 billion. If we compare this with the total money supply (M2) of the United States, of over US\$ 6,000 billion, the amount of possible SDR issue is less than 0.5 per cent, and therefore represents an even smaller proportion of the world's total money supply (Griffith-Jones and Gottshalk, 2004). Furthermore, if SDRs were issued in a counter-cyclical way, the risk of inflationary impact would be even smaller, as they would be compensating for a decline in private liquidity.

The risk of an increase in inflation would be minimal

The role of regional financial arrangements

A strong case can also be made for the creation and development of regional reserve funds, which can provide a valuable complement to multilateral and national mechanisms in the case of capital-account crises. The large currency crises of the last decade have been regional in nature. Therefore, neighbouring countries have a strong incentive to extend financial assistance to each other in the face of potentially contagious threats to stability “to help put out a fire (a financial crisis) before it spreads to them” (Ito, Ogawa and Sasaki, 1999). Also, despite contagion, critical demands for funds do not coincide exactly in time, a fact that generates the possibility of a useful role for regional reserve funds as a first line of defence during crises. Besides, regional institutions can and should play a stronger role in relation to small and medium-sized countries, which will usually receive less attention and have a weaker bargaining position than larger countries with multilateral institutions. Indeed, a case could even be made that they could provide full support to the small and medium-sized countries within some regions, as well as part of the financing for larger countries. Furthermore, greater attention—especially in East Asia—to the formation of regional financial arrangements reflects frustration with the slow reform of the international financial system, and particularly the limitations of multilateral official emergency lending (Ocampo, 2002a).

There are several important reasons for creating regional reserve funds

Looking into the future, an organizational structure for crisis prevention and regulation could be conceived entailing the establishment of a dense network of multilateral, regional and subregional financial institutions to provide official financing, basically on a complementary basis. This model could be extended to macroeconomic surveillance, again with regional institutions complementing multilateral ones, whereas regional arrangements might be especially suitable for macroeconomic policy coordination. Such a network of institutions would in the future be similar in some ways to federal arrangements, like those of the United States Federal Reserve Board, or to a form of slightly looser integration, like that provided by the European Central Bank. Indeed, the post-war European experience of building financial cooperation, combined with growing macroeconomic surveillance, may offer some interesting lessons at the global level.

In the future, multilateral, regional and subregional institutions could provide complementary financing

Despite these potentialities, existing regional financial arrangements among developing countries are only in an embryonic stage. The valuable role that regional reserve funds can play is illustrated by the Andean Reserve Fund, which became the Latin American

Existing regional arrangements are embryonic ...

Reserve Fund (FLAR). Its main function is the provision of short-term liquidity support to countries in crises. Though the total of its loans has been relatively small (between 1979 and 2004, it disbursed loans of US\$ 4.9 billion), it provided 60 per cent of the exceptional financing lent by IMF to the Andean countries in that period. In some cases, this institution was the only one to disburse loans, as was the case for Peru in 1988. Furthermore, disbursements of loans have always been rapid (Titelman and Uthoff, 2004).

... but some, like FLAR in Latin America, have been successful

The Latin American Reserve Fund is financed by the capital of member countries. These countries have always paid back their loans promptly, even when some of them had moratoriums with other creditors. This zero default and preferential creditor status contributes to the very high credit ratings of the Reserve Fund, well above the rating of the countries that constitute it.

The Chiang Mai Initiative was created after the Asian crisis and its bilateral swap arrangements have recently been increased

After the East Asian crisis, Japan had proposed the creation of an Asian monetary fund. Though the proposal was well received throughout the region, the idea was shelved owing to objections from outside the region (Park, 2004). However, a more modest version was created in 2000, when the Association of Southeast Asian Nations (ASEAN), China, Japan and the Republic of Korea created a system of bilateral currency swap arrangements known as the Chiang Mai Initiative (CMI). They also institutionalized meetings of finance ministers for policy dialogue and coordination, and are working on a plan to establish a surveillance system. In May 2005, the Initiative was increased significantly from its \$39 billion level. It is based on 16 bilateral swap arrangements, and thus any country in need of short-term liquidity must discuss activation with all swap-providing countries individually.

Disbursement of 20 per cent of the maximum drawing would be automatic; a country drawing more than 20 per cent is placed under an IMF programme. In this sense, the Initiative is of somewhat limited size and clearly complementary to IMF lending facilities. Its efficacy in firefighting crises has not yet been tested. In the meantime, efforts are being undertaken to overcome potential problems, such as the bilateral nature of swap arrangements, which could reduce the speed of response of the mechanism, so essential in times of speculative attacks. There is an understanding that the multilateralization of the bilateral swap arrangements would require a more formalized and rigorous surveillance system. However, there are some doubts concerning the ability of the member countries to develop appropriate surveillance mechanism acceptable to all (Park, 2004).

Enhancing the voice and participation of developing countries in international financial decision-making

The Monterrey Consensus stressed the need to enhance participation of developing countries in the Bretton Woods institutions and in other policymaking bodies

The Monterrey Consensus of the International Conference on Financing for Development stressed the need to broaden and strengthen the participation of developing countries and countries with economies in transition in international economic decision-making and norm-setting. It encouraged the Bretton Woods institutions to continue to enhance the participation of all developing and transition economies in their decision-making. However, the Monterrey Consensus goes beyond the Bretton Woods institutions and highlights the need to extend the discussion of voice and participation to other policymaking bodies, including informal and ad hoc groups. Although the discussion below will focus on two of those institutions, the Basel Committee on Banking Supervision and the Financial Stability Forum, the principle is applicable to similar organizations.⁵

There were two main reasons behind the position adopted at Monterrey. It seemed necessary to review the governance of these institutions in the light of the vast changes that had taken place since their creation, in particular the increasing importance of emerging economies. Also, these institutions would be more effective and efficient if their agenda and decisions better reflected the needs and issues of the majority of the countries affected by them.

The Bretton Woods institutions have taken some limited action to make more effective the participation of developing countries, leading, inter alia, to strengthening the offices of African Directors in IMF and establishing an Analytical Trust Fund to support the African Chairs at the World Bank. Modalities for consultations in the Basel Committee and the International Stability Forum have also widened; yet, in respect of the crucial issue of participation of developing countries in decision-making, there has been no progress.

In the Basel Committee and the Financial Stability Forum, developing countries are not represented at all. The Basel Committee defines regulations—including the capital adequacy regulations discussed in chapter III and the Core Principles for Effective Banking Supervision—that strongly influence, in turn, the cost and distribution of bank lending, as well as banking stability, in developed and developing countries. Lack of any representation by developing countries makes their analysis incomplete in crucial aspects, as shown by the new Capital Accord (Basel II) (see chap. III).

All members of the Basel Committee are developed countries: 10 Western European countries, Canada, Japan and the United States. There is no representation of developing countries in this Committee. Notwithstanding, the Basel Committee does liaise with developing and transition economies. However, consultations are no substitute for having a seat at the decision-making table. A Basel Committee with a more appropriate representation from the world economy could result not only in a fairer system, but also in better regulation leading to a more stable financial system with welfare-enhancing effects for all.

The question of strengthening representation of developing countries is now clearly in the agenda of the Bretton Woods institutions. The voting structure and composition of the Executive Board of IMF determine to a large extent the policies of the Fund, in particular those that affect the use of IMF resources. Yet, policy discussions and policy formulation in the Board and the International Monetary and Financial Committee often involve areas in which IMF resources are not directly involved. Such discussions and the policy orientations that they provide deal mostly with international economic and financial cooperation, but they also touch upon policy orientations of individual countries or groups of countries. In fact, such policy orientations exert a significant influence on the scope for autonomous policy formulation. This illustration relates to IMF, but the same arguments are applicable to the World Bank.

The report of the IMF Executive Board to the International Monetary and Financial Committee on quotas, voice and representation of 24 September 2004 (IMF, 2004c) lays out the elements that would need to be considered to make additional progress on these questions: a general quota increase with a relatively large selective element allocated by means of a new quota formula; ad hoc quota increases with the objective of addressing the clearest cases where the relation between quota and economic size is significantly out of line; and an increase in basic votes to correct the erosion of voting power of countries with small-sized economies, such as many in Africa.

The way in which quotas are calculated is central to the relative voting power of individual countries and country groupings. Also, the individual country quota determines the amount of financing the country can obtain from the Fund. A central consideration in

The limited actions to date have not included any progress on participation in decision-making

In bodies like the Basel Banking Committee, developing countries are not represented ...

... although the Committee does liaise with developing economies

The question of strengthening the representation of developing countries is receiving more attention

determining the quota is the capacity to contribute. Thus, the economic size of a country largely determines its quota level. From the perspective of a potential user of IMF resources, the eventual need to finance its balance of payments is a key factor to be considered. Currently, the formula to calculate the quota includes GDP or gross national income (GNI), current-account transactions, official reserves and a measure of variability of receipts in foreign currency (for example, exports of goods and services plus income revenues).

Even without a change in the IMF Articles of Agreement,⁶ there are several changes in the method of calculating the quota that would lead to a comparatively larger quota for developing countries as a whole. Those widely mentioned in current discussions include: using the GNI measured in purchasing power parity (PPP) instead of GNI at average exchange rates as a measure of economic size in the quota formula; excluding the amount of trade among EU members that adopted the euro, as it does not generate potential balance-of-payments difficulties; and increasing the coefficient assigned in the quota formula to the indicator of variability of receipts.

The first of the aforementioned factors could be the most critical in redefining quotas. Purchasing power parities (PPPs) represent an effort to apply a common set of prices to the same activities in all countries so that measures of aggregate output and similar variables are comparable. For a variety of reasons, market exchange rates do not necessarily achieve this comparability. Particularly for developing countries, they do not necessarily reflect market conditions, as they sometimes experience long periods of misalignment and are often volatile. PPP exchange rates provide a more accurate reflection of the relevant weight of individual countries in the world economy and, correspondingly, are more stable (since economic weight does not itself change much in the short term). For these reasons, several international organizations prefer to use GNI/PPP directly when making cross-country comparisons or to use them indirectly as weights when aggregating certain country data. For example, the Organization for Economic Cooperation and Development (OECD) incorporates GNI/PPP in much of its statistical and analytical work. GNI/PPP is also used to determine budget allocations for the structural funds used to reduce economic disparities among the members of EU (McLenaghan, 2005). Of particular relevance to the matter of voice in the Bank and the Fund is the fact that IMF utilizes the GNI/PPP to estimate rates of growth at regional and world levels in its *World Economic Outlook*. Even more pertinently, because of the shortcomings of official exchange rates for these purposes, a PPP conversion factor was adopted by IMF in the 1980s and 1990s when the economies in transition joined IMF and their quota levels had to be decided. This suggests that there is a strong case for using PPPs for quota calculations in IMF. If they were used, developing countries' share of IMF quotas would be 40 per cent, compared with 31 per cent at present (see table VI.2).

As table VI.2 indicates, the use of purchasing power measures of GNI would increase substantially the quota of developing countries. Most of the increases in the quota share would go to developing Asian countries, particularly China, India and the Republic of Korea. Indeed, the quota share of developing Asia is barely 17 per cent while its share of GNI/PPP is 28 per cent. This would require, as the table also suggests, a significant adjustment of the share of the European countries whose quota share as a whole is 1½ times its GNI/PPP share.⁷

On the other hand, enhanced representation of countries with small size economies can be increased only by restoring basic votes to close to their original weight. There are also strong arguments to do so. Basic votes initially constituted about 11 per cent of total voting power in the Fund; with the increases in quota since the creation of the Fund and no adjustment in basic votes, the latter represent only 2 per cent of total voting

Using GNI measured in terms of purchasing power parity could offer the most potential for redefining IMF quotas ...

... and would substantially increase the quota of developing countries, especially those in Asia

Enhanced representation of small countries could be achieved by restoring basic votes to their original weight

Table VI.2.
Shares in world total of IMF quotas and GNI/PPP, 2002

Country or region	IMF quota share (percentage of total IMF quotas)	GNI/PPP share (percentage of world GNI/PPP)
United States	17.4	21.5
Japan	6.2	7.1
EU-25	32.2	22.5
Other European	8.5	5.9
Australia, Canada, New Zealand	4.9	3.3
Subtotal	69.2	60.3
Developing countries	30.8	39.8
<i>Memorandum items:</i>		
Brazil	1.4	2.8
China	3.0	12.2
India	2.0	5.8
Republic of Korea	0.8	1.7

Sources:

IMF, International Financial Statistics; World Bank, World Development Indicators, 2004; and DESA estimates.

power. This figure of 2 per cent becomes even more insignificant when the size of the IMF membership—which grew—is taken into account.

In any event, a sizeable quota increase with a large selective component would be necessary to move in the desired direction. The adjustment in relative positions can be implemented only by measurable increases in countries whose calculated quota is higher than actual quota, unless those countries with calculated quota lower than actual quota accept a lower absolute quota.

In the end, the way the variables are defined and the magnitude of the coefficients used for each variable in the quota formula will depend on their acceptability to the members of the IMF Executive Board—and, by extension, the Executive Board of the World Bank. This would require an essentially political decision. Representation in other international financial institutions, particularly those setting international norms, requires additional political determination. Because democracy has become such an important aim of nations and of the international community, it is to be hoped that such political agreement can be reached.

Notes

- 1 According to some analysts, the Plaza Accord might have exacerbated the downturn of the dollar, contrary to its initial objective of achieving an orderly devaluation of the United States currency. The purpose of the Louvre Accord was to stabilize the dollar. For a detailed account of policy coordination during the late 1980s, see Frankel (1994).
- 2 This view, that maintaining weak exchange rates to fuel export growth should be the goal of exchange-rate interventions in Asia, ignores certain facts behind recent foreign-exchange pressures in Asia, particularly the fact that the largest accumulation has taken place in Japan, a country that has already experienced a sizeable appreciation of its currency, that some countries have also allowed their exchange rates to strengthen and, particularly, that the pressure on others (including China) come more from the capital account than from current-account surpluses. See, in this regard, Genberg and others (2005).
- 3 Japan's holdings of foreign exchange reserves, approaching \$1 trillion, are much larger than foreign holdings of Japanese yen as foreign-exchange reserves, suggesting that the "net" role of Japanese yen as an international reserve money is limited.
- 4 In the United States, the Securities and Exchange Commission (17 CFR Parts 275 and 279 [Release No. IA-2333; File No. S7-30-04] RIN 3235-AJ25), "Registration Under the Advisers Act of Certain Hedge Fund Advisers", now requires certain advisers to hedge funds to register with the Commission under the Investment Advisers Act of 1940. While registration and compliance with the Advisers Act require maintenance of business records for perusal by the Commission, provision of disclosure statements to clients and a legal fiduciary obligation to clients, they do not entail the imposition of a detailed regulatory regime.
- 5 Examples include the Bank for International Settlements, the International Association of Insurance Supervisors, the International Accounting Standards Board, the International Organization for Standardization and the International Federation of Stock Exchanges.
- 6 A decision to increase the number of basic votes would also lead to an increase in the share of the voting power of developing countries, in particular the countries of small economic size (see below). However, such a decision would require an amendment to the Articles of Agreement.
- 7 Several observers have suggested this should be seen in the context of EU policies and the possibility of one chair representing the Union.