

Reforming the International Financial System

Crisis Prevention and Response

Edited by
Jan Joost Teunissen

FONDAD
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Forum on Debt and Development (FONDAD)

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Director: Jan Joost Teunissen

Reforming the International Financial System: Crisis Prevention and Response

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The views expressed in this book do not necessarily represent those of the Forum on Debt and Development or any of the co-sponsors. The summaries of the floor discussions, following the papers, attempt to convey the sense and substance of what was discussed. They have not been reviewed by all of the participants.

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Abbreviations

ADB	Asian Development Bank
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BCBS	Basel Committee on Banking Supervision
BCCI	Bank of Credit and Commerce International
BIS	Bank for International Settlements
CCFF	Compensatory and Contingency Financing Facility (of the IMF)
CCL	Contingent Credit Line (of the IMF)
CFF	Compensatory Financing Facility (of the IMF)
CGFS	Committee on the Global Financial System (of the BIS)
CMR	Capital Market Report (of the IMF)
DCs	developing countries
EAC	East African Cooperation
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN)
EFC	Economic and Financial Committee (of the EU)
EFF	Extended Fund Facility (of the IMF)
EMEs	emerging market economies
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism (of the EMS)
ESAF	Enhanced Structural Adjustment Facility (of the IMF)
EU	European Union
FDI	foreign direct investment
FSA	Financial Sector Assessment
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
FSSA	Financial Sector Stability Assessment
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
HIPC	Highly Indebted Poor Countries
HKMA	Hong Kong Monetary Authority
HLIs	highly leveraged institutions
IASC	International Accounting Standards Committee
IAIS	International Association of Insurance Supervisors
IDRC	International Development Research Centre
IFIs	international financial institutions
ILO	International Labour Organization

IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee (of the IMF)
IOSCO	International Organization of Securities Commissions
LOLR	Lender of Last Resort
LTCM	Long-Term Capital Management
MAC	Monetary Affairs Committee of the East African Cooperation
NAB	New Arrangements to Borrow (of the IMF)
NAFTA	North American Free Trade Agreement
NGO	non-governmental organisation
NPLs	non-performing loans
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
PRGF	Poverty Reduction and Growth Facility (of the IMF)
PRSP	Participatory Poverty Reduction Strategy Papers
ROSCs	Reports on the Observance of Standards and Codes (of the IMF)
S&P	Standard and Poor's
SBA	Stand-By Arrangement (of the IMF)
SDDS	Special Data Dissemination Standard (of the IMF)
SDR	special drawing right
SRF	Supplemental Reserve Facility (of the IMF)
UDROP	universal debt roll-over option with a penalty
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNU	United Nations University
URR	Unregulated Reserve Requirement
US	United States
WIDER	World Institute for Development Economics Research
WTO	World Trade Organization

Preface

In the current debate on international financial reform, efforts at bringing together Northern and Southern perspectives are rare. In general, the way the international system works seems to give predominance to the views from advanced rather than developing countries. Therefore, I most heartily accepted the invitation of FONDAD and IDRC to be involved in an initiative to bring together Northern and Southern perspectives on international financial reform – the so-called Global Financial Governance Initiative (GFGI) – and act, together with Jan Joost Teunissen, as a co-chair of GFGI’s working group on “Crisis Prevention and Response”.

In recent years, there have been a lot of interesting new initiatives and a growing literature on the subject. However, the agenda continues to be restricted and most of the fora lack vigorous representation from developing countries. This is not only true for fora that do not include developing countries or just include them by invitation – which is a very partial way of being included – but there is also an unbalanced representation from developing countries among those that do include them, such as the IMF International Monetary and Financial Committee.

As a consequence, in these fora a number of issues have not yet received adequate attention. Let me mention a few of them. First, there is the issue of the coherence of macroeconomic policies of leading industrialised countries and the distortions that a system based on purely national institutions can generate in this regard. Second, there is the issue of the role of regional institutions in the developing countries – both in development finance and the field of crisis prevention and management. Third, there is the issue of maintaining national autonomy in certain areas, given the incomplete nature of the existing or proposed international arrangements. In developing countries, for instance, it is strongly believed that capital account regulations and the choice of an exchange rate regime are areas where national autonomy should be maintained.

It is useful to make a distinction between the real systemic and global macroeconomic issues versus what I would call “centre-periphery issues” (I use this term for historical reasons but also for the lack of an adequate alternative). Most of the literature takes the perspective of the classical discussion of the “lender of last resort” versus the “moral hazard” debate in banking regulations, which is basically a discussion about market versus policy failures in the financial sector. Although this discussion is certainly

important, I would like to emphasise that the essence of centre-periphery issues is that there are basic asymmetries at the international level which are not captured in the ongoing debate.

First, shocks generally come from the centre in a context in which there is no such a thing as macroeconomic regulation and coordination at the world level. Moreover, when a crisis emerges, developing countries are supposed to respond in a pro-cyclical way, because “restoring confidence” generally implies the pursuance of pro-cyclical monetary and fiscal policies. Unfortunately, during boom periods the response is also likely to be pro-cyclical, because if authorities had to adjust during the crisis, they are unlikely to have any political support for applying anti-cyclical policies in order to save for the bad times that may come again.

Second, there is a large asymmetry in the development of domestic financial markets. Developing countries have to choose between currency and maturity mismatches. If they choose to not have foreign exchange risk and borrow nationally, they will have maturity mismatches because the domestic financial market normally lends on short-term maturities. If they choose instead to use international financial intermediation on a large scale, they will have foreign exchange mismatches. You may also prefer to eliminate those mismatches by adopting an international currency, but then you eliminate your macroeconomic flexibility as well. So you are trapped into having inefficient financial management of some sort. Solutions are always partial: you can solve one part of the problem, but you always keep another.

Third, there is an asymmetry in adjustment costs. Aside from the fact that developing countries usually have larger economic shocks as a proportion of GDP than industrial countries, their social safety nets are also less developed. As a result, economic and social shocks are larger in the periphery than in the centre.

An essential problem that we face in the developing world is the increase of risks that are incurred during periods of financial euphoria. These boom periods generally lead to risks that only later on, during a crisis, become apparent as a mix of debt crises, maturity mismatches and currency mismatches. The only way to address this problem is to go to the source of the distortion, which is international financial capital fluctuations.

Although a crucial part of the effort to reduce these fluctuations and prevent the outbreak of financial crisis lies in strengthening the global institutional framework – one of the important issues discussed in this book – developing countries also need to develop an adequate domestic policy response. The policy options available to them include: choosing an exchange rate regime that, together with capital account regulation, provides room for anti-cyclical monetary and financial policies; strengthening

anti-cyclical prudential regulation and supervision; improving the debt profiles of both the private and the public sector; and applying adequate anti-cyclical fiscal policies.

The current “calm” phase in which emerging markets find themselves provides an excellent moment to examine ways to improve financial crisis prevention and management. It also offers the opportunity to broaden the reform agenda. In my view, the agenda should be broadened in at least three ways. First, it should go beyond the issues of financial crisis prevention and resolution to include those associated with development finance and the “ownership” of economic and, particularly, development policies. Second, it should consider not only the role of world institutions, but also of regional arrangements. Finally, developing countries, as major actors in the world economy and as frequent victims of crises, should play a larger role in the discussions about reforming the global financial system as well as in its governance.

José Antonio Ocampo

