Reforming the International Financial System

Crisis Prevention and Response

Edited by
Jan Joost Teunissen
Forum on Debt and Development (FONDAD)

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Reforming the International Financial System: Crisis Prevention and Response

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Editor: Jan Joost Teunissen

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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
<table>
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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>IMFC</td>
<td>International Monetary and Financial Committee (of the IMF)</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
</tr>
<tr>
<td>LOLR</td>
<td>Lender of Last Resort</td>
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<tr>
<td>LTCM</td>
<td>Long-Term Capital Management</td>
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| MAC          | Monetary Affairs Committee of the East African Coopera-
|              | tion |
| 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