
Is there Progress Towards a Development-orientated International Financial System?

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1 Introduction

The wave of currency and banking crises that began in 1997 in East Asia generated a broad consensus that fundamental reforms were required in the international financial system. Particularly during 1997 and 1998, the view became dominant that existing institutions and mechanisms were inadequate for preventing and managing crises in the dramatically changed world of the twenty-first century. It has become increasingly evident that achieving stability requires changes to the international financial architecture itself, though as discussed below, change at the international level has been insufficient.

Besides the objective of achieving international financial stability, an equally important objective, to which insufficient attention has been given, is the provision of adequate capital flows, both private and public, to different categories of developing economies. The two major goals for a new international financial architecture from a developmental perspective are thus: (a) to prevent currency and banking crises and better manage them when they occur, and (b) to support the adequate provision of net private and public flows to developing countries, including, in particular, low-income ones.

In this article, we attempt to assess progress on international financial reform, in relation to these two goals. In this sense, our article is broader than most of the literature on the subject, which has focused on achieving international financial stability and avoiding contagion. To the extent that private capital flows do not recover sufficiently (either spontaneously or encouraged by government

policies), a greater role would need to be played by official liquidity and development finance. A particular source of concern is that an important part of this decline may be the result of structural factors such as the fact that banks have increasingly “crossed the border” by buying or establishing local banks and subsidiaries in developing countries, from which they lend in local currency (Griffith-Jones 2001; IMF 2003). This would imply that net private flows to developing countries could remain very low for a fairly long time period.

Progress on international reform so far has suffered five serious problems.

First, there has been no agreed international reform agenda. In this regard, the ‘Monterrey Consensus’ of the International Conference on Financing for Development of the United Nations, held in March 2002 (see United Nations 2002), provided, for the first time, an agreed comprehensive and balanced international agenda that should be used to guide and evaluate reform efforts.

Second, the progress made has been uneven and asymmetrical in several key aspects. The focus of reforms has been largely on strengthening macroeconomic policies and financial regulation in developing countries – in other words, on the *national* component of the architecture – while far less progress has been made on the international and, particularly, the regional components. These are major weaknesses, as crises have not just been caused by country problems (even though these have been obviously important), but also by imperfections in international capital markets, such as herding, that lead to rapid surges and reversals of massive private flows, and multiple equilibria,

that may lead countries into self-fulfilling or deeper crises.¹

Third, the reform effort has been focused excessively on crisis prevention and management, mainly for middle-income countries. This may have led to a neglect of the equally, if not more, important issues of appropriate liquidity and development finance for low-income countries. Moreover, the problem of availability of development finance has clearly moved to centre stage for all developing economies. Thus, although some of the reforms adopted will be crucial in the future to help prevent a new wave of crises, the problem at present is the opposite one, of insufficient private flows. This situation is likely to continue for several years. Therefore, an important task is to design measures, which will both encourage higher levels of private flows (especially long-term flows) and will provide counter-cyclical official flows (both for liquidity and for development finance purposes) during the periods when private flows are insufficient. Without this combination of private and official flows, the financial system will not be able to contribute effectively to economic growth and the achievement of the millennium development goals.

Progress has also been uneven in the realm of crisis prevention and management. In the area of crisis prevention, much work has been done in relation to strengthening domestic financial systems in developing countries and in drafting international codes and standards for macroeconomic and financial regulation, but few steps have been taken to guarantee a more coherent macroeconomic policy approach at the global level. Also, the drafting of new International Monetary Fund (IMF) financing facilities has received much more attention than international debt standstills and workout procedures. Some advance has been made in redefining IMF conditionality. The IMF quota increase and the extension of the arrangements to borrow, which became effective in 1999, has also been an advance, but several proposals made on the more active use of Special Drawing Rights (SDRs) as a mechanism of IMF financing have not led to action. Furthermore, frustration has been the characteristic of the design of the new IMF facility to manage contagion, the Contingency Credit Line (CCL).

Fourth, even some of these advances in the international financial architecture run the risk of reversal. There has been growing reluctance by

developed countries to support large IMF lending (or to contribute bilateral short-term lending) to manage crises better. The main arguments given have been that these large packages lead to excessive moral hazard, which implies that both borrowers and lenders behave more irresponsibly, knowing that they will be “bailed out” and that taxpayer money from industrialised countries should not, in any case, be risked in these operations. These arguments have been vastly overstated. If progress was made on international debt workouts, this would reduce moral hazard. However, mechanisms such as international workouts, should be a complement, and not a substitute, for IMF lending in times of capital account crises.

Fifth, the slow progress in reforming the international financial architecture and the inherent asymmetry in the measures taken results in part from limited participation of developing countries in the fora where reform has been discussed, and more generally in the institutions of global financial governance. Enhancing the participation of developing countries in these institutions would imply significantly greater impulse for necessary changes in the global financial architecture. These changes, and the resulting positive impact on global financial stability and growth, would not just benefit developing countries; it would also have significant direct and indirect benefits for the developed world. A more balanced representation of developing countries in key institutions and fora, such as the IMF, the World Bank and the Bank for International Settlements (BIS) needs to be discussed in parallel with a redefinition of their functions. It is also urgent that developing countries be fully represented in the Financial Stability Forum, and in standard-setting bodies, like the Basel Banking Committee, as they will be asked to implement the standards there defined.

In what follows, we examine issues relating to IMF financing facilities; world regulatory standards, highlighting problems with Basle II; international debt workouts; development finance; and regional schemes. The article concludes with thoughts on the political economy of international financial reform.

2 IMF financing facilities

During the 1990s, capital account liberalisation and the large scale of private capital flows greatly increased the need for official liquidity to deal with

sudden and large reversals of flows. As a result of the 1997–98 Asian and Russian crises, IMF resources were significantly enhanced. This facilitated the provision of fairly large financial packages that helped in the management and containment of crises, though the conditionality applied was often problematic.

Particularly, two new facilities were designed as a result of these crises. The first was the Supplementary Reserve Facility (SRF), which facilitated the provision of fairly large, more expensive, relatively short-term loans to countries hit by crises, resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the member's reserves. The SRF was useful in providing large loans to countries like South Korea and Brazil, once they were hit by major crises.

Contrary to the relative success with this new facility, several of the developed countries recently expressed their wish to establish limits on the scale of lending through the SRF. Potential borrowers rightly do not wish such limits to be set up, as in a multiple equilibrium situation, more limited IMF loans could imply that the undesirable bad equilibrium could take place implying deeper crises in individual countries, as well as more risk of contagion to other countries. Clearly in that case the SRF would be less effective. Delays in granting IMF support or loans of an insufficient size may well lead to a worse outcome than more rapid IMF lending in adequate quantities. Delays in IMF negotiations with Argentina were one of the factors that led to a hypersensitivity of financial markets to developments in South America and, therefore, to a stronger regional contagion during 2002 than was originally expected (ECLAC 2002b). This seems to have led to a renewal of large-scale IMF lending, as seen in the case of Brazil in mid-2002. Furthermore, the September 2003 IMF deal with Argentina showed some welcome flexibility.

The second facility created after the Asian and Russian crises was a preventive one, the Contingent Credit Line (CCL). As the IMF defined it, the CCL was created as 'a precautionary line of defence readily available against future balance of payments problems that might arise from international financial contagion'. The creation of the CCL was a potentially very important and positive step because it could significantly reduce the chances of a country entering into a crisis, by providing

contingency lending agreed in advance. However, the problem is that in the four years following its creation no country applied to use it, even though the terms and conditions were modified to make the CCL more attractive to borrowers. The key problem is that countries with "good" policies, and who are perceived as such, fear that there could be a stigma attached by the markets if they applied for a CCL. In particular, countries fear to be the first to apply on their own for a CCL. The fact that the CCL has not been used implies that it may be suspended. This would seem very unfortunate and a far better option is to make it more attractive.

To make this facility more attractive, and diminish or eliminate any potential stigma attached to it, some modification could be introduced. Particularly, it could be agreed that all countries that have been very favourably evaluated by the IMF in their annual Article IV consultations would automatically qualify for the CCL. Therefore, a country would have a right to draw on the CCL should the need arise. This would imply that quite a large number of countries, including the developed ones, would qualify for the CCL (even though few would use it), thus eliminating the current stigma on its use. The fact that countries would be named as eligible for the CCL by the IMF, would make it a sign of strength (indicator of good policies), rather than – as currently feared – a request for a CCL being seen as a sign of possible future weakness.

3 Strengthening world regulatory standards

Capital and credit markets have become increasingly integrated between countries, in what is becoming an increasingly internationalised market. These markets have also become more integrated with each other, as big financial conglomerates combine activities in banking, securities, insurance and other financial fields. In order for the globalised financial system to work effectively to sustain both stability and growth, appropriate transparency and regulation of international financial loan and capital markets is essential.

For regulation to be efficient, it is essential that the domain of the regulator is the same as the domain of the market that is regulated. Ideally, this would imply the need to create a world regulatory authority, as Kaufman (1998), and Eatwell and Taylor (2000) have suggested. However, this seems at present unlikely, both because of the complexity

of the task, and because of the unwillingness of national governments and regulators to give up sovereignty on this issue.

A second best alternative to creating a global regulatory authority is to significantly improve exchange of information and coordination amongst regulators, both across countries and across financial sectors. In the last two decades, there had been initial steps in this field, mainly via the three Basel Committees, of which the main one is the Banking Committee. This started to generate, via soft law, (that is via informal *ad hoc* arrangements that are binding), common regulatory standards that are initially applied by the regulatory authorities of the countries participating in the Committees, and then – either by peer encouragement, by pressure from the IMF and the World Bank and/or from the markets – implemented by developing and transition regulatory authorities.

A further step towards identifying vulnerabilities and sources of systemic risk was the creation of the Financial Stability Forum (FSF) following the 1997–98 crises in emerging markets. This is intended to fill gaps in regulations and develop consistent financial regulations across all types of financial institutions. The work of the FSF and its Working Parties has been valuable, but has been insufficiently implemented, especially in developed countries. The FSF Working Party recommended important improvements on far greater transparency of hedge funds and other highly leveraged institutions (HLIs), but even these rather modest, but important, steps have not been implemented because in the US, the major country where HLIs operate, Congress rejected two bills for improved transparency (White 2000).

There are two significant weaknesses in the operation of the FSF. One is its limited ability to influence decisions to be taken by national regulators, especially in source countries. The second is the total lack of participation of developing and transition economies in the main body of the FSF. This poses not just problems of legitimacy, but also of efficiency, as it accentuates the types of asymmetries in the international financial system.

The potentially most important regulatory development since the 1997–98 crises in emerging markets is the proposed modification of the 1988 Basel Capital Accord which could have a profound impact both on international bank lending (its level, cost and cyclicity) to developing countries and

on bank lending (its cyclicity and distribution), within developing countries.

While the effects on developing countries are not central to the new Basel Capital Accord (both because its aim is to try to align banks' regulatory capital requirements with actual risk, and because developing countries have no representation in the Basel Banking Committee) very significant effects of the new accord would be felt on developing countries. This is particularly problematic given the fact that bank lending to developing countries has become negative since the Asian crisis (BIS 2001). Serious concerns existed that the January 2001 proposal could have large net negative effects on developing countries. Later modifications, especially those introduced in November 2001, have dealt with some of the problems, and somewhat diminished others. This is encouraging. Nonetheless, the possibility that the proposed new Basel Capital Accord could further discourage lending to developing countries is still a matter of great concern.

The key proposed changes relate to the measurement of credit risk. In the proposed Accord, there would be two basic approaches, the standardised and the internal rating based (IRB) ones.² The new standardised approach addresses several previous concerns raised by developing countries, for example by reducing the incentive towards short-term lending. However, the IRB approach, if implemented in its current form, could have important negative implications.

The first problematic aspect is that the proposed IRB approach could further reduce international bank lending and increase costs of such lending to developing countries, particularly those (the large majority) that do not have investment grades. Both effects would institutionalise increased perceived risk.

Second, and equally serious, the proposed IRB approach would exacerbate pro-cyclical tendencies within the banking systems. The drive for risk-weights that more accurately reflect the probability of default (PD) is inherently pro-cyclical; during an upturn, average PD falls, and the IRB approach, based on banks' internal risk model, would reflect lower capital requirements; during a downturn or recession, average PD will increase, as deteriorating economic conditions cause existing loans to "migrate" to higher risk categories. This raises overall capital requirements, and as it is difficult to raise

capital in a recession, it may lead to a credit crunch, which would further deepen the downturn. Concerns with increased pro-cyclicality of the proposed new Capital Accord are widespread (see, for example, Goodhart 2002).

Increasing pro-cyclicality would go against what is increasingly accepted as best practice, which is to introduce a neutral or counter-cyclical elements into regulation, so as to counteract the natural pro-cyclicality of banking and capital markets (BIS 2001; Ocampo and Chiappe 2002). For developing countries, increased pro-cyclicality of bank lending is particularly damaging, given that this increases the likelihood of crises, as well as their development and financial cost.

A new Basel Capital Accord proposal, that would overcome some of the problems listed above should include some of the following elements: (a) in the IRB approach, capital requirements should be lowered for low-rated borrowers which include most developing countries; this would imply a significant flattening of the IRB curve (that is, the capital required for lending to borrowers perceived as more risky, would not increase so sharply); (b) a special curve for small- and medium-sized enterprises was introduced by the Basel Committee; if that is implemented, the possibility of a separate curve for developing countries should be seriously studied, to avoid excess discouragement of bank lending and to more accurately reflect risk of lending to them, particularly the benefits of diversification; and (c) serious attention given to counter-cyclical elements, such as creating forward-looking provisions, to mitigate inherent pro-cyclicality of the IRB approach.

4 International debt standstills and workout procedures

Although no actions have been adopted, there have been extensive discussions on the need for international rules on debt standstills and orderly workout procedures. As it is well known, such mechanisms are required to avoid the coordination problems implicit in chaotic capital flight, to guarantee an appropriate sharing of adjustments between lenders and borrowers, and to avoid “moral hazard” issues associated with emergency financing.

Though a great deal of work and discussions have been carried out in this field, progress for any radical change was frozen when the IMF Board rejected (mainly due to US opposition) proposals

for orderly debt workout procedures, the Sovereign Debt Restructuring Mechanism (SDRM).

Nevertheless, quite significant progress has been made on more voluntary initiatives, with several major developing countries introducing collective action clauses into their new bond issues. This would facilitate future debt restructuring. It is very positive that up to now, bonds which include collective action clauses do not have higher spreads (that is, do not imply higher costs) than those without.

It must be stressed that multilateral credit support mechanisms, particularly by multilateral development banks (MDBs), would be required during the period following a debt restructuring. As an essential role of such support should be to catalyse the reinsertion of countries into private capital markets, a possible mechanism could be a guarantee fund managed by MDBs. This mechanism would guarantee private sector lending to private or public sector borrowers in the affected countries with adequate provisions (partial guarantees, higher in the initial years, at an appropriate cost). This issue has not been included in recent debates and should thus be added as an integral element of any international debt workout scheme.

5 Development finance

The issues of volatility of private capital flows and contagion have been at the centre of discussion on the international financial architecture in recent years. However, they only capture some of the most problematic features of international finance. Another worrisome issue, the marginalisation of the poorest countries from private capital flows, is equally important. These countries depend on official development assistance, whose largest component, bilateral aid, has lagged behind.

Bilateral aid has fallen in real terms, leading to a reduction in official development assistance (ODA) in relation to GDP: from 0.35 per cent of the GDP of industrialised countries in the mid-1980s to 0.22 per cent in 1998–2000, i.e. one-third of the internationally agreed target of 0.7 per cent of GDP. Trends are not uniform, however. Some countries – Denmark, Netherlands, Norway and Sweden – meet that target, and a few increased ODA in the 1990s, particularly the UK in the late 1990s. The overall trend and the low current level of ODA are largely determined by the evolution of aid flows from a few large countries, particularly the USA.

There is also strong volatility of private capital flows, in particular short-term debt, but also long-term debt and equity flows. These private flows experienced a strong decline during the Asian crisis and never recovered. Thus, although the initial reduction was viewed as a sign of volatility, it led to more permanent regime change in terms of the availability of private financing. Therefore, the evolution of private financial flows may be viewed as characterised by two different cycles: a short-term one, associated to volatility in the strict sense of the term, and a medium-term cycle, in which phases of “risk appetite” are followed after some years by periods of strong risk aversion. The only steady source of private external financing has been foreign direct investment. Even in this case, however, the strong upward trend characteristic of the 1990s was interrupted at the end of the decade and has been followed by a decline, particularly during the recent world recession.

From the point of view of development policy and the Millennium Development Goals, one of the most important aspects of private capital flows is their strong concentration in middle-income countries. The share of low-income nations in private financing has been not only lower than their share of the total population of developing countries, but also lower than their share of developing countries’ GDP. This fact is particularly striking in bond financing, commercial bank lending and portfolio flows (for more details, see Griffith-Jones and Ocampo 2003).

Low-income countries have thus been marginalised from private flows and have depended on declining official development assistance, particularly grants coming mostly in the form of bilateral aid. If we again exclude India, this is the only component of the net resource flows to developing countries that is highly progressive, in the sense that the share of low-income countries in net flows exceeds not only their share in developing countries’ GDP but also in population. This is also marginally true of multilateral financing, excluding the IMF.

Due to the importance of ODA in the financing of low-income countries, this issue has received a significant attention in recent debates. Commitments made at the United Nations Conference on Financing for Development in March 2002 will lead to a reversal of the adverse trend experienced by bilateral aid in recent decades.

Nonetheless, those commitments represent only a quarter of the US\$50 billion aid requirements estimated by the Secretary General of the United Nations (and similar estimations by the World Bank) to halve extreme poverty by 2015 and would remain equally below the target of 0.7 per cent of GDP, which was reiterated at the Conference.

Recent proposals, such as the UK suggestion for an International Financing Facility, that would front load aid flows, by obtaining private finance, are very valuable, though a more permanent increase in aid would be even more desirable.

6 Regional schemes

The role of regional institutions in the international financial system is one of the most prominent items missing from the mainstream discussion and agenda on international financial reform. It is absent from the main Northern reports and from the views on financial reform which come from the Bretton Woods institutions.

This is an important deficiency. There are, indeed, several arguments for a strong role for regional institutions in international finance.³ The first relate to the growth of macroeconomic linkages at the regional level, as a result of the growth of intra-regional trade and capital flows. This creates a demand for regional surveillance and consultation of macroeconomic policies, as well as for peer review of national prudential regulation and supervision of domestic financial systems. One advantage of regional surveillance is that asymmetries of information are smaller at this level.

The second are the classical risk-pooling arguments. Regional and sub-regional development banks, even those made up entirely of developing countries, are likely to face lower risks than individual members. This creates the potential for profitable financial intermediation. Also, contagion of crises often starts within regions; therefore, regional mechanisms for liquidity provision can provide a first line of defence in deterring contagion. This preventive line of defence is facilitated by the fact that, despite contagion, critical demands for funds do not coincide exactly in time, a fact that generates a useful role for regional reserve funds and swap arrangements. Moreover, the sense of “ownership” of regional and sub-regional development banks and reserve funds by developing countries creates a special relationship between them and member countries that helps to reduce

the risks that these institutions face, further encouraging the virtues of risk pooling.

The third set of arguments relates to the virtues of an international order that combines world and regional institutions. Given the heterogeneity of the international community, world and regional institutions can play useful complementary roles, particularly in macroeconomic policy coordination, in the adaptation of international norms to the specific regulatory traditions and in reducing learning costs and sharing experiences in institutional development. At the same time, for smaller countries, the access to a broader alternative set of institutions for crisis management and development finance, including regional ones, may be particularly valuable, as they have relatively less influence and bargaining power *vis-à-vis* global institutions. More generally, the creation and strengthening of regional developing institutions will help increase developing countries' ability to participate and influence the global financial architecture negotiations.

The history of regional financial cooperation has been particularly rich in postwar Western Europe, from the development of European Payments Union and the European Investment Bank, to a series of arrangements for macroeconomic coordination and cooperation, that eventually led to the current monetary union of most members of the European Union. To a lesser extent, financial cooperation has been present in the developing world over several decades. One remarkable example are the institutions designed in the context of Andean cooperation. This includes the Andean Development Corporation, which provides development finance to both public and private sectors in several Latin American countries, and the Latin American Reserve Fund, which includes Andean countries and Costa Rica, and has provided emergency liquidity financing to all Andean countries over the past decades.

The major advances in this area in recent years have taken place in Asia. They include, first, the May 2000 Chiang Mai Agreement between ASEAN countries, China, the Republic of Korea and Japan, to create a swap arrangement among central banks (Park and Wang 2000). This initiative followed the Japanese suggestion to create an Asian Monetary Fund, which generated major opposition by the IMF during its 1997 Hong Kong annual meetings. The second was the creation of the ASEAN

Surveillance Process, for exchanging macroeconomic and financial information, and providing early warning signals and peer review among ASEAN countries. In Latin America and the Caribbean, there have been some steps towards developing mechanisms for macroeconomic coordination in the context of the four sub-regional integration schemes and initiatives to strengthen the Latin American Reserve Fund.

These experiences indicate that regional bodies can be very effective in providing liquidity, facilitating development finance and sustaining trade links. They can also contribute to macroeconomic policy peer review and coordination. Nonetheless, these institutions remain limited in their scope so far, and are not recognised as central to the international financial architecture. This would require formal links between the IMF and regional reserve funds and swap arrangements. It also requires an explicit policy by the World Bank to support regional development banks, including new institutions exclusively owned by developing countries.

An institutional framework such as that suggested would have two positive features. First of all, it may bring more stability to the world economy by supplying essential services that can hardly be provided by a few global institutions, particularly in the face of a dynamic process of open regionalism. Second, from the point of view of the equilibrium of world relations, it would be more balanced than a system based on a few world organisations. This would increase the commitment of less powerful players to abide by rules that contribute to world and regional stability.

7 The political economy of international financial reform

Progress on international financial reform has been uneven and asymmetrical; more progress has been achieved in areas implemented nationally by developing countries (e.g. Codes and Standards) than in the equally important and complementary international measures (e.g. provision of sufficient official liquidity and development finance, and design of international debt workout procedures). What are the main reasons for this uneven progress? More importantly, what strategy and bargaining tactics could be most productive for achieving a more symmetrical process?

Clearly, the asymmetries in the international

Table 1: Objectives of key actors

	Dominant objectives	Other objectives
Developed country governments	<ul style="list-style-type: none"> ● Growth in their own economies ● Profits for their financial sectors ● Global financial stability ● No large bail-outs 	<ul style="list-style-type: none"> ● Growth in developing countries ● No crises
Developing country governments	<ul style="list-style-type: none"> ● Growth in their own economies ● Global financial stability ● Stable and adequate flows 	<ul style="list-style-type: none"> ● Growth in developed countries
Banking and financial markets	<ul style="list-style-type: none"> ● Maximise profits 	<ul style="list-style-type: none"> ● Global financial stability ● Growth in developed and developing economies

financial reform process reflect certain political realities. The most powerful governments, and especially their financial authorities, have not thrown their weight consistently behind a deep international financial reform, in spite of their temporary enthusiasm for it after the 1997–98 Asian and Russian crises. In large part, this enthusiasm derived from the brief credit crunch in the industrialised world generated by these crises.

An important reason for lack of consistent developed country support for the reform process may be that some powerful actors in those countries (e.g. major banks and other financial actors) do not see it in their interest to support or promote major changes in the international financial architecture. This seems quite clear in the discussions on an internationally agreed orderly debt workout mechanism. Another problem is that those who would benefit most from such changes in developed countries (e.g. shareholders and workers of companies trading and investing long-term in developing economies, or who support development in poor countries) are not represented properly in financial decision-making processes, such as development ministries and NGOs.

For these reasons, the main impulse for international financial reform might have to come from developing countries. However, developing countries have their own restrictions. First and most important, they have relatively limited power, as reflected in their exclusion or limited participation in key bodies. Second, developing countries have seen their ability to generate strong coalitions

weakened; this may be linked to the “policy competition” to attract foreign capital, and thus the resulting unwillingness to make or support proposals that could modify their image as friendly to foreign investors. Finally, developing countries – especially but not only the poorest ones – may have insufficient technical capacity and resources to generate complex blueprints for international financial reform, and participate effectively in complex negotiation processes.

If conscious and deliberate efforts are not made to overcome the basic asymmetries in global power relations, and obstacles (technical and non-technical) that prevent the development of international coalitions to compensate for these power imbalances, the international financial agenda would continue to be biased towards the views of a limited set of financial and governmental actors in the industrialised countries and the negative impact of this agenda and policies on the rest of the world – and in particular developing countries – will not be fully taken account of.

A second reason restricting progress in international financial reform is the reluctance of most countries to give up economic sovereignty to international organisations. This is particularly marked in industrialised countries, but also evident in developing countries. In this sense, regional organisations and mechanisms may be very valuable, both in themselves and as stepping stones towards global organisations and mechanisms, and for improving the bargaining position of developing countries for a better financial architecture. A

problem here is that most countries (with the exception of the European Union), have been reluctant to give up sovereignty even to regional organisations.

Nevertheless, there are two very positive elements that may be helpful in the process of genuine international financial reform. One is that all key actors involved share a common objective, which is that they are in favour of – and benefit from – sustained growth in developing countries. As seen in Table 1, for some actors this is more important than others, but all share this objective.

A second potentially very positive element is the existence of a set of actors in developed countries, who are, and could become even more, important allies of developing countries in building a better international financial system. These include government departments not concerned directly with finance (e.g. Development Cooperation Ministries), NGOs, political parties and parliamentarians, as well as non-financial corporations. In different ways, and for different reasons, these actors are supportive of more rapid growth in developing countries, and therefore are or could become very supportive of an international financial reform that helps make growth possible. For this purpose, developing countries' governments need to have an active dialogue on international financial reform, not just with financial authorities in developed countries, with market actors and International Financial Institutions (who clearly are the main actors in the reform process) but also with other actors in the developed world.

Developing countries could attempt to design and offer a “grand bargain” on international and national financial reform that would be attractive to a whole range of actors in developed countries, both in the public and the private sector, as well as supportive of their own growth and development.

Such a bargain would have two sets of elements. Developing countries could say they would be keen to implement initiatives that are of particular interest to developed economies, such as Codes and Standards on financial regulation and a fuller liberalisation of their capital accounts, if, *and only if*, developed countries start reforming the global financial system in ways that would facilitate larger and more stable capital flows to developing countries and that would make costly crises in these countries less likely. Whilst such a reformed international financial system would not exist, they

would clearly be less able and less willing to open their capital accounts fully, as the potential risks of doing so could outweigh the benefits. Particularly, developing countries could argue that implementing Codes and Standards and a commitment to adopt proper domestic macroeconomic policies should be explicitly linked to some regulation of developed countries' financial markets to help avoid excessive surges of potentially reversible capital flows to developing countries; to mechanisms that encourage long-term flows; to the design of (low-conditionality) international liquidity mechanisms that would significantly protect individual developing countries from crises and stop them from spreading to other countries; and to fair multilateral debt workout mechanisms that would be used to manage solvency crises (debt overhangs).

Thus, developing countries that followed good macroeconomic policies and significantly improved their financial regulation (as certified, for example, in their annual Article IV IMF consultations) could have virtually automatic access to sufficient IMF lending if hit by a crisis whose origin was not of its own making, but was due to unexpected changes in perceptions of international lenders or investors or due to large terms of trade shocks. Low-income countries that followed good macroeconomic policies and improved financial regulation would have sufficient access not just to international liquidity, but also to development finance. Debt workout mechanisms would only be used when crises faced by developing countries were due to unsustainable debt burdens (and would not be used when they are associated to insufficient international liquidity), and appropriate mechanisms would be designed to guarantee financing in the post-debt restructuring environment to facilitate reinsertion into private capital markets.

Such a bargain would provide incentives for developed countries to make necessary international changes, as they would know that they would ensure the desired changes in developing countries and vice versa. Collective action problems could thus be overcome if genuine progress was made simultaneously by developed and developing countries. Most importantly, the result would be of great value, not just to developing countries, but also to developed ones.

Developing countries could draw here interesting lessons from both the bargaining tactics used and the vision presented by Keynes in negotiations that

led, at Bretton Woods, to the creation of the postwar international financial order (Skidelsky 2001). As regards bargaining tactics, Keynes presented two clear alternatives: an “ideal” scheme, with key international elements – such as a large IMF – and a “second best” case, wherein the UK would reluctantly follow a far more closed approach in trade and the capital account if the international financial system was not properly developed; there was, he argued, no middle way (though in practice he made some important concessions later).

Suitably adapted to the features of the early twenty-first century world economy, developing countries can argue that the same two clear options remain:

1. An appropriate international financial system, that would support development and make crises far less likely and less costly, not just for them but particularly for the global economy. Developing countries could contribute to this new IFA by implementing regulatory standards, adopting good macro-policies and by gradually liberalising their capital accord.
2. An incomplete and lopsided international financial system that could not guarantee

supporting developing country aims, and where they would not be able to open fully their capital accounts, as they would regretfully have to protect their interests by having, as a “second best solution”, more rather than less national policy autonomy. Similarly, they may be forced to rely on regional institutions and mechanisms even to perform functions that could be best performed globally, given vacuums in the existing global financial architecture.

8 Conclusion

To conclude, significant international financial reform is crucial to create a system that supports, and does not undermine, development and poverty reduction. The current system, with often insufficiently badly distributed, and very volatile private flows – and excessively limited international public institutions to deal with these problems – is highly problematic and implies that the financial dimension of globalisation is in many ways its Achilles heel. It is therefore crucial to design an international financial system that facilitates sufficient and sufficiently stable private flows to different developing countries, as well as preventing and managing better financial and currency crises.

Notes

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1. See the article by Valpy Fitzgerald, in this *Bulletin*.

2. For a more detailed discussion of these issues, see Griffith-Jones *et al.* (2002). See also the Proceedings of Commonwealth Secretariat/World Bank Conference on *Enhancing Private Capital Flows to Developing Countries*, July 2002, for views of the Basel Committee (www.bis.org) and the Bank of England (www.bankofengland.co.uk).
3. For a broader discussion of these issues, see ECLAC (2002a, Ch. 2), Agosin (2001), Ocampo (1999, 2002) and Park and Wang (2000).

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