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Role of Regional Development Banks in Rebuilding the International Financial Architecture

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This chapter proposes a role for the regional development banks (RDBs) in the implementation of a modern worldwide financial architecture. The discussion of the need for this new architecture has been prompted by two problems that have become evident in the last two decades: the protracted economic instability of developing countries, which results in defaults and crises with increasing frequency, and the fact that access to international private financial markets is volatile for some developing countries and totally absent for many others. Although the more urgent of these two problems is that of instability and the resulting crises, the more fundamental one is that of inadequate access to private markets, given that the multilateral development banks are too small to supply all the financial needs of developing countries. These two problems, however, are intimately linked, because the main reason why most developing countries have no access to the private markets, and why those that have it suffer from volatility in such access, is precisely their protracted instability. Thus, the main long-term objective should be the integration of the developing countries into private financial markets. Resolving the instability problem, although it would bring about abundant benefits on its own, is a prerequisite to meeting that objective.

The need for a new financial architecture has become pressing because the official international financial institutions—the International Monetary Fund (IMF), the World Bank, and the RDBs—have worked on these problems for over two decades without finding a solution. Thus,

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the discussion largely centers on how to increase the effectiveness of the official financial institutions in solving these problems.

This chapter does not discuss the shape of the new architecture. However, it makes four assumptions regarding its workings: first, because to date there has been no credible proposal for changing the current institutional setting, this chapter assumes that it will remain in place under the new scheme. Second, given that the official international financial institutions by themselves are too small to meet the financial needs of developing countries, this chapter focuses on creating a set of economic incentives that would encourage and facilitate access of developing countries to the private international markets—the only source of funding large enough to meet these countries' needs. Third, because the future of developing countries' financing should be increasingly tied to private markets, this chapter assumes that a similarly increasing measure of market discipline should be introduced into the lending operations of the official institutions, so that the transition to the market will be carried out in a more harmonious fashion. This would also help in increasing their efficacy in resolving the problem of instability and, through this, the problem of lack of stable access. Fourth, because not all developing countries are the same, this chapter assumes that the new architecture should rely on mechanisms that allow countries to be differentiated according to their performance. The market approach implicit in the previous two assumptions should provide the mechanisms for making this differentiation in a manner consistent with the ultimate objective of integrating the developing countries into private international financial markets.

Do the RDBs Have a Role in the New International Financial Architecture?

An assessment of the problems that have inspired proposals for a redesign of the worldwide financial architecture is presented here. It argues that the RDBs have an important role to play in solving those problems, and it focuses on the two problems posed in the introduction: the protracted instability of developing countries, and their consequent lack of adequate access to private financial markets.

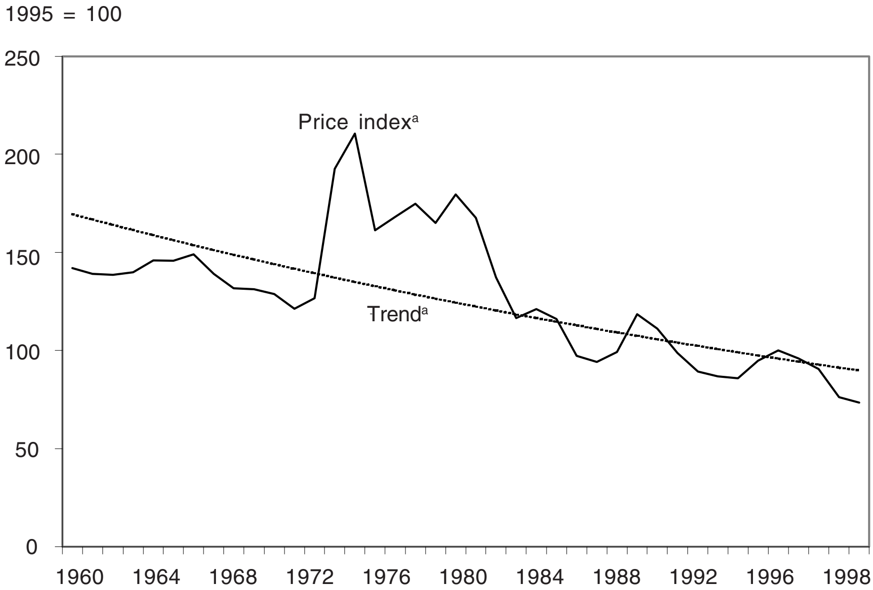
Instability in Developing Countries and Its Causes

The commonly held view is that problems of instability are the exclusive purview of the IMF. This is certainly true when a crisis has already exploded. However, the processes that lead to crises exceed the limitations that its own nature imposes on the IMF, which, like a central bank, operates mostly in the short-term, liquid end of the financial market. Building a resilient domestic financial system is a long-term process, well within the purview of the development banks. In addition, although short-term fiscal issues are within the province of the IMF, the longer-term issues of fiscal management—especially those concerning the allocation of fiscal resources for the country's development—are more in keeping with the role of the development banks. The two dimensions of the problem obviously interact. There is no way to say what portion of the debt of an overindebted country is the cause of its overindebtedness, and thus the development banks, like any other lender to a country, have a direct stake in preventing crises—and in solving them when they occur—beyond that dictated by their own developmental objectives.

Moreover, although financial crises by definition arise in the financial sphere, many have their roots in the real side of the economy, which is in the province of the development banks. In fact, issues associated with technological development, protection, and trade liberalization are intimately linked to the wave of instability that developing countries have suffered over the last two or three decades. Traditionally, a combination of three factors has made developing countries prone to financial instability: extreme dependence for foreign exchange earnings on commodities with volatile prices, lack of monetary and fiscal discipline, and weak financial institutional settings. This tendency toward instability has become more marked in the last two decades as a result of several developments in the world economy.

First, throughout the world economy, value added is increasingly a function of the amount of knowledge imbedded in production. As a result, real prices of nonoil commodities—goods that embody low levels of knowledge in their production—have been declining for the last 30 years, straining developing countries' ability to finance their imports (figure 5.1). Because, with some exceptions, the industrial sectors of developing countries operate behind high rates of protection, they are not competitive enough to sell their manufactured goods in international markets, and therefore these countries cannot compensate for the fall in foreign exchange revenue by increasing their manufactured exports. On the contrary, the industrial sectors of these economies typically need foreign raw materials and intermediate inputs to produce their goods, which tends to make these industries net importers. Thus, declining commodity export revenue introduces recessive tendencies in these countries' industrial sectors and in their economies in general. To counterbalance this trend, many developing countries have resorted to monetary creation, overvaluation of their domestic currencies, and foreign borrowing to keep the economy growing. Without an expansion of their export base, this has resulted in the classic cycle of overborrowing, financial crisis, and default. Through these mechanisms, the lack of competitiveness becomes manifest in the capital account of the balance of payments in both the borrowing and the defaulting phases of the cycle, even if the root of the problem is the lack of a diversified exporting base that could support

Figure 5.1 Real nonoil commodity prices, 1960–99



a. Nominal prices deflated by the US consumer price index.
b. Five-year moving average.

Source: International Monetary Fund, *International Financial Statistics*, various issues.

the servicing of foreign debts. For this reason, depressions in commodity markets have usually led to financial crises in developing countries.

Second, the long-term solution to these problems, namely, opening these economies to increase their competitiveness and diversification, creates transitional instability. In the 1990s, most developing countries, while remaining heavily protectionist, made some progress in liberalizing their trade regimes. Increasing competition from abroad initiated a structural transformation that necessarily implied the disappearance of inefficient activities, to be replaced by more efficient ones. This process, although necessary for solving the problem in the long run, worsened the instability in the short run, as banks experienced losses when foreign competition made the assets they had financed obsolete. Other liberalizing measures, such as the opening of the capital account and the liberalization of the financial system (including the removal of interest rate controls as well as greater ease of entry for new competitors), have also resulted in increased instability in the short term—particularly when these measures have been taken precipitously, without other measures that should accompany them, without proper analysis of sequencing issues, or without the necessary institutional support. For example, liberalizing the capital account while keeping imprudent monetary, fiscal, and foreign exchange policies in place has been a recipe for disaster. Equally disastrous has been liberalization of the financial system without adequate regulation and supervision of financial institutions.

Third, protection in the industrial countries has become a substantial obstacle to the diversification of the developing economies, even those that have made great progress in liberalizing their domestic markets. Although the trade policies of the industrial countries are relatively liberal in the complex goods and services that they trade among themselves, they are highly restrictive in those areas in which value added per worker at international prices is low, such as textiles and other goods and services in which developing countries might compete. In addition to undermining the credibility of reformers in the developing countries, the presence of high protection in the industrial countries blocks the major markets that diversified developing economies could otherwise access, trapping them in their dependence on commodities.

In combination, these problems have worsened the instability of many developing countries to the point where this volatility has become their most urgent problem. With distressing frequency, governments in these countries engage in imprudent fiscal and monetary policies to spur the growth that their dwindling foreign exchange is depressing. They then borrow abroad to finance their excessive expenditures, and eventually they default on these loans and a financial crisis begins. Such crises sweep away the gains accrued over many years in terms of increased economic activity and reduction of poverty.

The solution is not to close these economies once again—that would lead to even more instability and rapid impoverishment—but to stick to prudent fiscal and monetary policies, complete the reforms, and deal with the temporary instability to which those reforms give rise. Completing the modernization of developing economies requires heavy investment in more efficient activities. That, in turn, requires not only eliminating the distortions in relative prices that protection creates in these economies but also obtaining access to fresh financial resources, so that resources can flow to the new, more efficient activities that undistorted price systems would encourage. The main source of these resources should be the domestic market. However, the same monetary and financial policies that lead to instability also repress the growth of the domestic financial system. Fiscal and monetary prudence would open this source of financing and make it possible to solve the other fundamental problem of developing countries: their lack of access to international financial markets.

Lack of Access to Financial Markets

Sustained access of developing countries to private markets is essential, because the magnitude of the investment they need far exceeds both their current saving potential and the lending capacity of the multilateral institutions. In many of these countries, these institutions and friendly industrial-country governments are the only sources of long-term funds. This dependency must be overcome to unlock the opportunities for growth for those countries. This does not mean that multilateral institutions should disappear or be converted into grant-dispensing mechanisms. They are the equivalent of international credit unions, where countries can borrow on more favorable terms than if they borrowed individually in the markets. By enabling their members to access the market directly, the multilateral institutions would be able to concentrate on the needs of long-term financing for social purposes, which cannot be funded in the markets.

The problem of access is closely related to that of instability. The moral hazard caused by insufficient fiscal and monetary discipline, together with the volatility and long-term decline of foreign exchange revenue produced by dependence on commodities for export, poses major obstacles to the development of financial markets in the developing countries and to their integration into world markets. In combination, these trends have resulted in a strong reluctance of international markets to finance the developing countries' transition into an integrated world. As the previous section pointed out, these problems not only block developing countries' access to global financial markets but also deter the development of domestic financial systems, which remain small in most developing countries, and retard the development of regional financial markets, which are practically nonexistent in those countries.

Instability is not the only problem leading to volatile access to international markets. Although all developing countries share these problems, there are substantial differences among them. Some countries have been able to stabilize their economies fiscally and monetarily and have aligned their domestic prices with those prevailing in the international markets by reducing protection and dismantling suffocating regulations. Yet the international markets tend to see the developing countries as a whole when analyzing risks. Even if the markets have recently learned to be somewhat more discriminating, a crisis in one developing country tends to lead to a withdrawal of financing to all of them. Thus, where it exists, access to international markets has been fragile even for the most disciplined of developing countries. If this problem is not resolved, the result might be a vicious circle, in which the long-term transformation of the economy that is needed to eliminate volatility is prevented by lack of access to international markets. In this scenario, instability tends to increase, exerting unmanageable pressures on the global financial system and making it increasingly difficult for the IMF to maintain global financial stability.

Thus, resolving the long-term problems that lead to financial crises and hinder developing countries' access to financial markets is essential if the world is to have a stable and efficient financial architecture. The multilateral financial institutions, including the World Bank and the RDBs, have a comparative advantage in resolving these problems.

Competitive Advantage of Development Banks

Integrating developing countries into the global financial architecture requires dealing with four problems:

- The developing countries must carry out several tasks to stabilize their economies. These include imposing discipline on their fiscal and monetary policies, strengthening their financial systems, and diversifying their exports through trade liberalization.
- They must carry out what are often called second-generation reforms, to create an institutional setting adequate for a modern economy. These include ensuring the rule of law, facilitating the creation of and properly enforcing property rights, giving transparency to economic and political activities, improving financial regulation and supervision, strengthening banks, and undertaking other structural reforms.
- Those countries that have already accomplished these tasks, or made substantial advances toward doing so, need to overcome the resistance of international markets to financing developing countries on a sustainable basis.
- Although completing these tasks would significantly reduce the risk of financial crises, such crises are not likely to disappear. Therefore mechanisms to deal with them should be established, aimed at reducing their effect on the countries suffering them and on the rest of the developing community.

A sustainable solution to these problems goes well beyond the mandate of the IMF, which deals primarily with short-term liquidity issues and, therefore, is more naturally prepared for the third task—that of dealing with financial crises. The multilateral development banks would complement the IMF in the global financial architecture because they differ from that institution in several important ways:

- They deal with the entire range of factors influencing financial markets—including not just activities in the financial sector itself but also those in the real economy and the social sectors. Because many financial events are rooted in the nonfinancial parts of the economy, this is a clear advantage.
- They operate at the long-term end of the financing spectrum, which is essential for the long-term solution of the problems now affecting the global financial architecture.

- They work on the structural and institutional aspects of development that need to be resolved to reduce the instability of developing countries and to increase their access to private financial markets.

Competitive Advantage of the RDBs

Either the World Bank or the RDBs could play this complementary role to that of the IMF. How, then, to allocate the task between them? Answering this question requires addressing three other questions. First, can the RDBs add value to the new financial architecture beyond that which the World Bank could provide? Second, should the tasks associated with building and maintaining the global financial architecture be formally split between the World Bank and the relevant RDB in each of the regions of the world? Third, how should these institutions coordinate their activities?

Regarding the first question, this chapter argues that the RDBs are in a position to provide a distinct value added to the new financial architecture. The comparative advantage of the World Bank is that it can shift knowledge and experience across regions. However, the RDBs are best placed to help in the solution of problems that demand close regional focus and coordination.

The financial problems discussed previously tend to have strong regional differences. Although the fundamental problems are common to all developing countries, they tend to take different shapes in the different regions. For example, countries in Latin America tend to be more unstable and prone to crises than countries in Africa, whereas the problems resulting from lack of access to international markets tend to be graver in the latter. Levels of income also tend to diverge across regions, and therefore the problems that must be resolved to integrate countries in the global financial architecture also differ. Furthermore, this integration means not only bringing the developing countries to the developed international markets but also integrating the financial systems of the developing countries with each other. That task will be easier to carry out regionally, because trade among developing countries tends to develop first among neighbors. For these reasons, RDBs are ideally positioned to help in the solution of these problems.

Regarding the second question, it would not be in the interest of the developing countries to allocate tasks in a rigid manner to each of these institutions. Some overlapping of tasks between the World Bank and the RDBs is unavoidable. Regional and global issues are inextricably linked, and so the comparative advantages of both the World Bank and the RDBs are needed. Moreover, overlapping is actually desirable for three main reasons: it spurs creativity by mixing the global and the regional approaches, it introduces a healthy competition of points of view, and it allows for the strengths of some institutions to compensate for the shortcomings of others. Competition need not lead to duplication if there is close coordination between institutions.

This leads to the third question. The gains of competition can be reaped only if there is close coordination not only between the World Bank and the RDBs but also between these institutions and the IMF. Such coordination may require splitting responsibilities in individual cases. The circumstances vary so much from case to case that these responsibilities should be split in a pragmatic fashion, depending on the advantages that each institution may have in dealing with specific problems in specific countries. However, all the multilateral institutions should share responsibility in building a more coherent global financial architecture—working with instruments and policies aimed at resolving the problems that this chapter has identified.

The case for giving the RDBs an important role in the new architecture can also made indirectly by asking whether there is any way they could be excluded from that architecture. It is clear that their omission would be inconceivable, because of the externalities of financial markets already mentioned. Large operators like the RDBs could easily and involuntarily disrupt any efforts of the IMF and the World Bank toward resolving the problems discussed in this chapter. In contrast, they can be of great help in solving these problems because of their competitive advantage in regional issues, their focus on the main problems of the region, and their easier adaptation to the mores of their customers. Any unnecessary duplication should be avoided through close coordination.

If these arguments are valid, the RDBs should prepare formally to help in building a more efficient and secure global financial architecture. In fact, because the problems addressed here have been around for a considerable time, all the multilateral institutions have experimented with many ideas for resolving them, most of which have proved useful, or could be useful with some modifications. These instruments, however, have been created in ad hoc ways to deal with specific crises; they have not yet coalesced into institutionally defined instruments and policies. The aim of this chapter is to put these well-tried ideas into a consistent framework that would result in a more coherent financial architecture.

Toward an Improved International Financial Architecture: Proposals for the RDBs

Objectives

The main objectives of the RDBs with respect to improving the stability of their member countries' economies and their access to financial markets would be the following:

- to help their member countries develop their domestic financial markets, so that they can mobilize their own savings for development purposes;
- to bring their member countries to the international financial markets in a sustainable fashion; and
- to mitigate, as much as they can with their scarce resources, the procyclical behavior of private sources of financing.

Meeting these objectives would have implications in several dimensions for the RDBs. They would have to

- develop new instruments,
- design special lending policies, and
- improve their capacity to generate and disseminate knowledge and best practices.

This section develops each of these aspects of the proposal and discusses the policies and instruments that RDBs could use to integrate their member countries into international markets and manage financial crises. It proposes policies and instruments that RDBs could use to integrate their private sectors into global financial markets as well as to mitigate the procyclical behavior of private financing and discusses the role that RDBs can play in generating and disseminating knowledge and experience.

Instruments and Policies to Integrate the Public Sector into International Markets

Two issues arise under this heading: improving access to financial markets and dealing with financial crises.

Improving Access to Financial Markets

To help countries acquire financial resources adequate for their needs, the RDBs' lending policies should be geared to two main objectives: developing the domestic financial markets of their member countries and bringing them to global markets, thus reducing their dependence on the development financial institutions. The design of the operations and their conditionality should be framed within this principle. As emphasized before, this would entail working to resolve the structural issues that give raise to instability, as well as assisting countries in achieving access to financial markets until they are able to do so on their own. Thus, the multilateral institutions as a whole, and the RDBs in particular, should work to reduce their own participation in the financing of developing countries (but not necessarily to reduce their lending in absolute terms), bringing their members to a more plentiful and more sustainable source of financing for their development needs. This would allow the RDBs to concentrate their operations on social projects whose benefits accrue in the long term. As already mentioned, the justification for this recommendation is simple and pragmatic: the lending power of all the multilateral institutions combined represents only a small fraction of the financial needs of developing countries. If countries fail to develop their own domestic markets and are not brought to the international markets, they will be condemned to underfinancing in perpetuity.

To accomplish this objective, the RDBs have to deal with three problems. First, they have to work closely with governments and with the World Trade Organization to liberalize trade in both industrial and developing countries, in order to reduce the dependence of the latter on a few commodities for foreign exchange earnings. Second, they have to work to improve the quality of their customers' macroeconomic management and institutions (including through the second-generation reforms mentioned before), to make the debt instruments of developing countries attractive in international financial markets and to allow for the development of a sound domestic financial system. Third, they have to help their member countries carve a niche for themselves in the global financial markets.

Regarding the first problem, the RDBs and the World Bank have already achieved substantial progress in helping developing countries liberalize their trade regimes. Exports as a percentage of GDP have increased in the last decade, particularly in Latin America, and they have tended to become more diversified. This is a long-term effort that should be continued. As discussed earlier, however, its success largely depends on the availability of domestic and international financing for the new activities that a more liberal trade regime would elicit.

Regarding the second problem, the development banks have lent substantial amounts to help countries attain stability and have introduced conditionalities in these loans to attaining the stability goals since the early 1980s. Nevertheless, after uncountable operations, true policy reform to ensure stability has not been achieved. Periodic calls to resolve this problem, by having the IMF and the development banks condition their loans on the attainment of macroeconomic stability, have proved ineffective. The reason is not that the staffs of these institutions did not know that they could use conditionality for these purposes—in fact, the IMF has used conditionality in this way since the Fund's inception, and the development banks have been doing so for more than 20 years—but because these institutions have been unable to enforce these conditions. In part, this outcome is the result of political pressure on the development institutions to lend as much as possible to all countries. This puts pressure on the staff to be overoptimistic in evaluating both the effectiveness of the measures proposed in the operations undertaken to overcome the instability problems and the willingness of the governments to put those measures in practice.

The fact that the institutions' operational staff are in charge of both assessing the likelihood of success of a given stabilization program and designing the program itself makes success very difficult to achieve, given the political pressure to lend. However, having independent agents evaluate the performance of the financial institutions would not resolve this problem, because such evaluations would be carried out years after the operations are completed. In fact, at least one of the development banks, the World Bank, carries out evaluations in this way, with the evaluating staff separated from the operational staff by a firewall. Although extremely useful, these evaluations have an effect only in the long run and are easily bypassed by arguing that conditions in whatever country one wishes to finance have changed since the evaluated operations were conducted. What is needed is a test of the real prospects of success at the time of the operation, and that is something that only the market can provide.

The solution proposed in this chapter is to give more weight in the development banks' lending decisions to the credit ratings of the professional rating companies, which, in any case, are essential if developing countries are to access private markets. Such ratings provide a quantitative assessment of the well-informed perceptions of the market. Private ratings could be used in the following ways.

- A grading from a recognized credit rating agency could be required as a precondition for any lending operation to any country.
- Such ratings, which would have to be updated from time to time, could serve as a benchmark of the success of the RDBs in enabling their member countries to access private markets. This would eliminate the conflict of interest embedded in having the same staff design the stabilization program and assess its chances of success.
- Failure to obtain progress toward good ratings should be a major obstacle in getting further financing.

One can anticipate four arguments being raised against giving such a prominent role to private credit ratings. One is the naïve argument that good ratings are the privilege of large and rich countries. This is simply not true. Ratings do not measure the wealth or size of a country but, rather, the prudence of its policies and its resulting ability to pay. Any country, whatever its size or level of income, can pursue prudent policies, and the ratings reflect this. For example, in Latin America the debts of only three countries enjoy investment-grade ratings: Mexico, Chile, and El Salvador. One of these is a large country, another is a medium-size one, and the third is a small country (or, seen from another perspective, they are two relatively rich countries and one poor one). Their favorable credit ratings translate into greater access to and lower costs of financing. For instance, whereas China, despite its gigantic size, is able to float debt of at most 10 years' maturity, tiny El Salvador can float 30-year debt at spreads over US Treasury bonds below those that China can command (in fact, on its 15-year loans El Salvador gets rates very close to those charged by the development banks).[1]

A second argument against ratings is that the accuracy of private ratings in the past has been less than flawless. This argument can be granted although there is no proof that the record of these ratings has been worse than that implicit in the repeated operations of the development banks in countries that have failed to stabilize for decades. The recommendation that private ratings be used, however, is a purely pragmatic one. Those ratings are the main piece of information that investors use in the markets. If one wants to go to the market, one has to be rated, and that rating largely determines the interest rate one pays. This is a fact of life. Thus, tracking the credit ratings of developing countries gives a good, objective measure of progress in bringing the countries to the markets, because if they do not get good ratings, they will not be able to go to the markets. The fact that they can go to the development banks without ratings weakens the effect of those ratings—the main instrument that keeps financial discipline in the industrial countries' sovereign and corporate financial markets—on developing countries' behavior.

The third argument against the use of private ratings is that the sheer number of developing countries seeking ratings would pose so great a burden on the rating agencies that they would be forced to reduce the quality of their services. This argument, however, ignores the fact that the number of developing countries is dwarfed by the number of companies that already operate in the financial markets of the industrial countries on the basis of private ratings. These companies run into the thousands, and many of them have financial operations larger than those of various developing countries. Adding the developing countries to the rating agencies' workload would represent a minor increase in the demand for their services.

The fourth argument is that the RDBs—and the World Bank—should focus their operations precisely on those countries that do not have access to the markets. Accepting this argument, however, would lead to perverse incentives: It would force RDBs to lend only to those borrowing countries with bad track records, and it would ensure financing for

1. In July 2002 El Salvador issued 10-year bonds at 7.2 percent interest, which is within the range charged by the development banks. A few months before, it issued 30-year bonds at 8.75 percent.

those countries, even if they do not mend their ways. Thus, it would perpetuate rather than resolve the basic problem. Furthermore, as already noted, having a good rating is a sign not of wealth but of fiscal prudence. Poor countries with a good macroeconomic track record would be denied the benefits of borrowing from the international credit unions, which they still need for long-term social projects, precisely because they have been prudent.[2]

Thus, although credit ratings are conditioned by the moods of the market, which sometimes may overreact, these ratings not only would free the operation of the development banks from political influences but also would allow for an objective assessment of the differences between developing countries (to the extent the markets' point of view is indeed objective).

Ratings are, in any case, essential for the solution of the third problem that RDBs should resolve: that of actually helping countries to float debt instruments in the markets. The RDBs should reach an agreement with each of their member countries on a long-term strategic program aimed at bringing them to the global markets, and it should evaluate the performance of their operations using their progress at completing this program as a benchmark. Domestic financial markets would be taken as part of the global system, and the proposed programs could start with issues of debt in the domestic market and then in both the domestic and the international markets.

To induce countries to access the markets, the program should also include a downward-sliding schedule of the proportion of loans that the RDB would finance in full. This is necessary because, in the short run, governments find it more comfortable to borrow from a single multilateral. The loans that the RDBs would finance in full would include all loans for social projects and a diminishing portion of all other financial needs of the state. The remainder would be cofinanced in the market with the RDB's assistance. These programs should be flexible within certain

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2. The argument that solvent countries should be left out of the development banks' lending is based on the highly debatable assertion that the credits from these institutions are subsidized and that prudent countries should not receive subsidies. The assertion about subsidies, in turn, is based on the observation that development banks lend to countries that nobody else wants to finance and at interest rates below what even the best developing countries could get in the markets. However, the fact that a group of borrowers can lower their costs by pooling their risks is not evidence of subsidization. Those who argue that there is an implicit subsidy refer to the fact that the low cost of capital comes from the participation of developed countries in the capital of these institutions, which, through its callable portion, increases the rating that they could get. Yet, as the success of the Andean Development Corporation clearly shows, a pool of borrowers can get a rating much higher than its members can get individually—the corporation enjoys an investment-grade rating even though none of its members does. In fact, if there is subsidization, it is from the higher-rated to the lower-rated countries within the pool.

reasonable limits but should be seriously enforced. Countries approaching graduation would include their social projects in the sliding program.

Complementing this policy, the RDBs could provide enhancements for the instruments issued by the countries in the international markets, so that their exposure in these operations would exceed the amount in which they participate in the cofinancing. For example, an RDB could finance 50 percent of an operation and guarantee an additional 25 percent. The guarantees could take any form; for example, that of the familiar rolling guarantees covering the next two years, or those that guarantee the out years, or variations on these models. Cofinancing can also take several forms, including financing the out years of long-term loans and many other variations.

The RDBs can also open a new dimension of cooperation toward the integration of regional and subregional financial markets. As mentioned before, financial integration is needed not just between developing countries and the international financial markets but also between developing countries themselves. Financial flows between neighboring countries are increasing rapidly in many regions as a result of growing trade and incipient cross-border investments. This positive development is hindered, however, by a lack of coordinated financial regulation and supervision, which increases the risks of these financial flows. The RDBs are in an ideal position to help in removing those obstacles by promoting the coordination of financial regulation and supervision as well as by helping to create financial vehicles that would facilitate cross-border investments. In addition, the RDBs could help in developing regional financial institutions, such as stock exchanges.

Helping in the Prevention and Management of Financial Crises

There are four aspects to solving the problem of financial crises: preventing crises, dealing with crises when they occur, dealing with contagion, and managing the increased risks that action on the first three aspects presents for the portfolios of the RDBs. This section discusses all of these aspects, beginning with the fundamental problems caused by financial crises. The discussion of the needs posed by crises illuminates the discussion of the ways to prevent them and deal with their consequences.

Dealing with financial crises. Multilateral institutions have participated in the resolution of most recent crises, with varying degrees of success. In general, the development banks' performance has been timely and effective. However, two issues should be resolved to prevent future problems. The first is the definition of the roles of the banks—both the World Bank and the RDBs—and of the IMF in providing liquidity. The second is the potential conflict embedded in the twin objectives of providing both short-term liquidity and funds for the long-term restructuring of the banking system.

One point should be clarified before discussing these issues. In some cases the best strategy for dealing with a crisis, from the point of view of the international community, may be not to intervene but, rather, to allow the country to default and the country's financial system to fail. This discussion refers only to those cases in which the international community decides to intervene. Given that decision, the logic of events leads to the necessity of refloating the country's financial system and of creating and supporting a strategy aimed at making the country financially viable. Many critics of the official international financial institutions' handling of the recent crises see these actions as unwarranted, uneconomic, and even immoral. These arguments, however, pertain to the first issue: whether the international community should intervene. Once the decision has been made to intervene, the logic of the solution mandates that these actions should be taken. What some see as the bailout of financial institutions, others see as the enforcement of financial contracts—which, in any case, is done with resources that the country in crisis will eventually repay.[3]

Regarding the first point, it has long been recognized that the provision of emergency liquidity is an IMF responsibility, whereas the provision of financing for the restructuring of the system—plus all the required technical assistance—is within the purview of the multilateral development banks. Recent crises, however, have exceeded the IMF's financial capacity, and other institutions—the World Bank, the Inter-American Development Bank (IDB), the Asian Development Bank (ADB), and the US government, among others—have been called on to complement the IMF in the provision of emergency liquidity. This was the case in Mexico's crisis of 1994–95 and in the Asian crises of the late 1990s. As members of the international community, the development banks had no other option than to answer such calls for assistance.

Many critics of the current financial architecture point out that the provision of liquidity should be the exclusive function of the IMF. This may be a solution to the problem. However, if the development institutions are to stay away from this kind of operation, the resources of the IMF will have to be increased substantially in preparation for such contingencies. If the international community does not increase the IMF's liquidity, the development banks—including the RDBs—will have to help with their much larger liquidity in cases of emergency. Because it is difficult to anticipate the magnitude of crises, it is important that the RDBs

3. The impression that by saving a country's banks one necessarily bails out their shareholders is wrong. Saving one does not mean saving the other. In most, if not all, the restructuring processes supported by the development banks in the past, the shareholders of financial institutions have lost their capital—the bailout was directed to the depositors. The loans provided for the bailouts have been repaid with domestic taxes, not with the resources of the development banks' shareholders.

be prepared with appropriate policies and instruments for an emergency. If the RDBs are to continue helping to resolve liquidity problems in financial crises, they should design instruments specifically for this purpose.

To do this, they must first analyze the needs that crises present. Governments of countries experiencing financial crises need financing for two purposes: emergency liquidity, to restore the confidence of depositors and lenders in the domestic financial system and the government's ability to repay its obligations; and funds to carry out structural reforms aimed at preventing a repetition of the crisis. The latter is accomplished mainly by recapitalizing or liquidating failed financial institutions without imposing losses on depositors and by improving supervision and regulation. Each of these two problems poses different financial needs. Loans for the first purpose should be provided with short maturities, under the assumption that, as soon as confidence is restored, the country's government and financial system will recover the necessary liquidity and will repay the loans. The maturity of loans provided for the second purpose must be long, to allow the government to spread over time the losses it incurs in absorbing the losses to the financial system.[4] Also, the recapitalization of banks is a difficult task that requires substantial technical work of the highest quality.

Up to now, for lack of an instrument to convey liquidity, the multilateral development banks have used loans aimed at the subsequent recapitalization of the local institutions, so that these institutions can be used as conveyors of liquidity assistance. This has created severe tensions in the resulting operations, because the purpose of providing liquidity to restore confidence and the purpose of providing resources for the recapitalization of the banking system can easily become contradictory. By their nature, loans to recapitalize banks have to include conditions that should be met before disbursements are made: Basically, these conditions are that the banks have been recapitalized and that sufficient steps have been taken to prevent the repetition of the crisis. In contrast, the only condition for the disbursement of an emergency loan should be the

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4. These funds, however, are not needed in all cases of restructuring: The government can cover the losses with long-term, interest-bearing bonds issued to the failed banks, using these to replace the nonperforming assets on the institutions' books. Liquid funds are needed only to liquidate institutions and, in some cases, to facilitate the sale of failed banks, because the problem facing failed banks is that their assets do not generate enough income to pay for their liabilities. Substituting interest-bearing bonds for the bad loans in the portfolio solves this problem—provided, of course, that the interest payments are calculated so as to cover the expenditures of the liabilities. Buying the bad portfolio with cash may be counterproductive, because it would give too much liquidity to the banks, which they would then have to lend quickly to generate income-earning assets. This hasty lending could lead to more bad loans as well as to inconvenient expansions of the money supply. The problem is different when the problem is a run on the banks: Stopping a run requires rapid injections of liquidity to restore confidence.

existence of a program guaranteeing its repayment. By mixing these two objectives in a single instrument, the development banks place themselves in a potentially difficult position. If a country has not complied with the conditions for disbursement but is in need of the emergency funds, any decision is bad. If the banks refuse the disbursements, they are reneging on their commitment to help in an emergency. If they do disburse, they are undermining their developmental commitment to help in the recapitalization of the domestic financial system and to improve the resilience of the system.

Thus, the following points are needed to deal with financial crises.

- RDBs need an instrument to convey liquidity help in cases of financial crisis. This instrument would have features similar to those used by the IMF in terms of maturity and conditions of disbursement.
- To complement this instrument, the RDBs should redesign the instruments used for the recapitalization of the financial system, making disbursements contingent on the occurrence of actual expenditure by the government for this purpose. Structuring these operations as classic adjustment loans, disbursed against general imports on the fulfillment of certain conditions, weakens the connection that should exist between disbursements and actual project costs, and may result in cases in which the loan is disbursed even though the banking system has not been yet recapitalized.

Preventing crises. The tasks outlined above in connection with the integration of the developing countries into international financial markets would go a long way toward preventing crises. RDBs can further this objective by supplementing an instrument already created by the IMF. This instrument, the contingent credit line (CCL) facility, aims at providing lines of credit to be disbursed in the event of a crisis that develops in a country as a result of causes other than fiscal or monetary indiscipline: The IMF interprets such a crisis as caused exclusively by contagion (IMF 2001). RDBs could enter the field of contingent operations for any of three main reasons.

- As in the case of emergency loans, RDBs might enter if the IMF facilities are too small to provide comfort to the markets. The CCLs are limited to three to five times the country's quota.
- Emergencies not rooted in fiscal or monetary indiscipline might arise for reasons other than contagion. Natural disasters and terrorist attacks are just two examples of the many events that could unravel into a liquidity crisis even in a prudently managed country. RDBs

and the World Bank have facilities for this kind of need; however, such loans are not preapproved and therefore cannot provide the confidence that automatically disbursable contingent loans would provide.

- A related point is that only a third of the amounts approved for CCLs may be disbursed automatically. The rest are subject to a review of the situation at the moment of disbursal. This effectively reduces the size of the contingent loan to a third of its nominal value, or about 11.6 times the country's quota with the IMF. Here, again, RDBs could enter to fill in the gap in financing.

Thus, RDBs could make a substantial contribution by increasing the funds available for contingencies and by including emergencies other than contagion as justifications for disbursements. In these operations the RDBs should closely coordinate their actions with the IMF, although their instruments would not be exactly like the CCLs. The promise to disburse would be provided based on a program approved by the IMF and would be binding only if the government's actions coincide with what it promised when it contracted for the contingent facility. Thus, the conditionality of these operations would refer to policies and not to outcomes. A country would be able to withdraw from these facilities regardless of the depth of a crisis only if it has followed the prudent policies agreed to with the RDB when contracting the loan. Symmetrically, if the conditions established in the contract—which would be designed specifically for each country, to take into account its particular features—are met, the country would have the right to have the loan disbursed in its entirety. Given the complexity of the issues involved, the conditions would be different for each country.[5]

Dealing with contagion. Ripple effects tend to happen as a result of the sudden panic that overtakes international markets when one developing country falls into a financial crisis and defaults. As a result, even well-managed and secure developing countries find that they cannot access their private sector sources of financing. This problem is one of insufficient information, which the CCL is aimed at ameliorating. A quick-disbursing facility also should be opened for countries not contracting for CCLs. As discussed before, the IMF may lack the resources and staff to provide these facilities for countries in danger of contagion. If this is the case, the RDBs can play a decisive role by providing rapid credit to countries in this situation and, through this and other measures, by encouraging the private sector to keep on providing credit to them. As argued earlier, if the size of the IMF's resources is not increased, reality

5. For the need to have different indicators in the contracts with each country, see Fischer (2001).

will force these operations on the RDBs, which lack an instrument with which to carry out these operations.

Managing the risks of liquidity operations. In summary, if the IMF is not enlarged substantially, RDBs should create three liquidity facilities to deal with financial crises:

- an emergency loan to be provided in coordination with the IMF when a crisis has already erupted,
- a contingent line of credit to protect solvent countries against sudden and unforeseeable events that could destabilize them, and
- a credit facility for solvent countries that fall victim to contagion as a result of a crisis in another country.

Although creation of these instruments may prove inevitable, their operation poses two serious problems for the RDBs. The first is the effect of the risks of these operations on the overall risk of the RDBs and, therefore, on the cost of their normal developmental operations. Even if carried out prudently, these operations would be much riskier than the RDBs' traditional loans. For this reason, they should be priced at interest rates higher than those applied in normal operations. The RDBs, the World Bank, and the IMF have applied this solution in the small number of operations they have carried out with instruments similar to these. Once one RDB has lent to a country that has fallen into a crisis, there is no way that institution can avoid an increase in the level of risk of its lending portfolio. In fact, liquidity loans that are well designed under a strategy coordinated by the IMF would reduce the overall risk in an RDB's portfolio at the margin, because they would eliminate the risk of default, which, in the absence of the loans, would be a certainty.

The second problem is that of the size of these operations. RDBs should avoid a situation in which liquidity loans crowd out their traditional development operations. A quantitative limit should be imposed on the former, and the costs of the staff working on them should be covered by the operations themselves, so that there is no crowding out of the staff working in traditional operations. However, this does not resolve the problem entirely, because a major crisis may explode at a time when the relevant RDB may have already exhausted its quota for these operations. This problem could be solved by allowing RDBs to invest in detached subsidiaries dedicated to these risky operations. These subsidiaries would rely on their own capital to mobilize resources and manage their risks. Of course, these subsidiaries would have a much higher cost of capital than their parent RDBs. Yet, because their operations would not be consolidated with the RDB's, the increased risk would not affect the RDBs' own credit ratings. Also, the subsidiaries would resolve the problem of crowding out, because their sources of funds would be different from those of the RDBs. This idea is worth considering.

Bringing the Private Sector to the International Markets

The main reasons for the lack of financing for the private sector in developing countries are to be found in the unstable fiscal and monetary policies prevailing in many of these countries, as well as in the inadequate regulation and supervision of the local financial system. The main efforts of both governments and the RDBs should be directed toward solving these problems. In the meantime, RDBs could help in the financing of the private sector. The objective of these operations, however, should not be to substitute for private financing (which, to the contrary, is what should be elicited) but, rather, to catalyze its development. Meeting this objective might be difficult because the presence of officially backed financing may stifle the development of domestic sources, defeating the ultimate purpose of the exercise. As in the case of the public sector, the needs of the private sector exceed by several orders of magnitude the capacity of the multilateral institutions to finance them, and creating a dependency on these institutions for the financing of the private sector would be damaging for developing countries.

There are three main issues to be resolved to ensure that financing the private sector will not damage the development of local financial systems. First is the issue of lending to the private sector with sovereign guarantees. Such lending introduces a distortion in both the local and the international markets, because other potential lenders do not enjoy such an advantage. Because governments do not have the capacity to guarantee all potential lending to the private sector, the only solution to this problem is to deny such guarantees to all of them. There is, however, another possibility; namely, lending to the private sector without a sovereign guarantee. The World Bank cannot lend without such a guarantee, but its subsidiary the International Finance Corporation not only can do so but can also invest in equity holdings. Some RDBs, such as the IDB, and some subregional institutions, such as the Central American Bank for Economic Integration and the Andean Corporation of Finance, lend directly to the private sector and can even invest in equity holdings. In addition, the IDB has a special subsidiary aimed at lending without sovereign guarantees, and this subsidiary may also invest in equity holdings.

Operations carried out without government guarantees have, in general, been financially successful, but to date the volume of resources intermediated in this manner remains small. The growth of these institutions is constrained by the very same factors that prevent developing countries from accessing private international markets. Naturally, these institutions can lend only in dollars, which poses almost intractable foreign exchange risks for most, the main exception being the relatively few companies that generate dollars in their normal operations, which tend to be large companies with good credit. In these cases, they face the competition of private international banks. The RDBs are at a disadvantage in such competition. Their credit analysis tends to be lengthy and cumbersome because, lending from afar, their knowledge of potential borrowers is scant and because their procedures tend to reflect their ultimately public sector nature. Besides, the additionality of the participation of the RDBs is questionable. In many cases, the role of these institutions is to provide comfort to large international private investors, who have access to other sources of funds but view having an RDB as a partner as reducing the risk of their investment. It can be argued that, to the extent that these investments would not take place without their participation, the RDBs' private sector subsidiaries play a useful role. However, it is clear that the market for them is very limited. Most of the domestic private sector in the customer countries is left out.

RDBs and their private sector subsidiaries have also lent to private commercial banks, which then on-lend the proceeds to private companies. These operations resolve the problem of lack of local knowledge that plagues direct lending from abroad. However, other problems conspire against these operations, particularly the already mentioned problem of foreign exchange risk, which reduces their market considerably. Overall, experience has shown that RDBs cannot become large providers of funds to the private sectors of developing countries.

Even so, the private sector subsidiaries of RDBs can continue to play a useful role, mainly through demonstration effects in innovative projects. Regional initiatives provide new opportunities for this kind of operation, particularly in cases of private international infrastructure projects, such as international electric power transmission lines, water pipelines, toll roads, and other transportation works. The presence of subsidiaries of the RDBs in these investments would provide a comfort where it is more sorely needed, rather than in cases of purely national undertakings.

One area in which these operations are badly needed is the development of credit to small enterprises and microenterprises, an area that corporate financial institutions are reluctant to enter because of the high costs and risks. As with the other operations involving the private sector, the RDBs should focus on transferring best practice while helping countries develop their own sources of financing.

Developing countries may also pool financial operations in certain sectors and gain by reducing their overall risk. One example of this is mortgage financing. Private or public financial institutions in countries with sensible monetary and financial policies can pool their mortgages and sell them in the United States or in international markets. RDBs can help in creating vehicles to carry out these operations. Their private sector subsidiaries could enhance these instruments with properly priced guarantees. Of course, these operations are more viable in countries with stable monetary and fiscal policies that make catastrophic devaluations unlikely. Otherwise, the costs of covering the foreign exchange risks would be prohibitive.

Countering the Procyclical Behavior of Private Financing

The volatility of international financing to developing countries has already been discussed in relation to the declines in lending that tend to take place after a serious crisis affects one of them. Declines may also result from global cyclical movements. The role that RDBs can play in this respect is quite modest. However, engaging in countercyclical lending activities would mean that RDBs would necessarily have to maintain excessive capital during the expansionary parts of the cycles to accumulate the financial resources needed to inject liquidity during the downturns. In fact, RDBs keep high levels of liquidity at all times, and there is no evidence that they have been unable to increase their lending during downturns for lack of financial resources. Rather, the availability of staff seems to be the binding constraint. To resolve this problem, RDBs would need to have idle personnel ready to take on the additional work when such situations arise, which would increase the overall cost of their lending. All of these problems should be studied in detail to determine whether RDBs could have lent more during contractions and, if so, to devise policies to deal with this problem. The approach to lending recommended in this chapter would provide an easy solution, as RDBs would be able to increase their share of cofinancing during times of global deceleration and also to reduce their share during times of global expansion.

Knowledge Exchange

The exchange of knowledge is one of the most important functions of development institutions, and it is one with long-lasting effects. This function has two dimensions: acquisition of knowledge and dissemination of knowledge. The staff of these institutions naturally acquires knowledge through their normal operations. However, such knowledge does not necessarily remain with, nor is it necessarily systematized by, the institution. For this to happen, institutions need two mechanisms (a small research unit and, very important, an independent system for evaluating operations) to identify both best practices and those practices that should not be repeated.

The need for research units at the RDBs may be questioned on the grounds that the World Bank already has a very good one. Other institutions could benefit from its output, which is publicized for free over the Internet. In fact, RDBs do benefit from such output. However, the research interests of the World Bank do not completely coincide with those of the RDBs: There are many subjects with which, although interesting to the RDBs, the World Bank (with its limited resources) does not deal. The World Bank provides large amounts of knowledge on issues of global importance, but not on issues that are important only, or primarily, to regions. In Latin America, for example, the IDB has been able to fill the gaps in the World Bank's research with high-quality research relevant to the region's problems.

Similar to the IDB, some of the other RDBs already have research units, but they need to develop systems to evaluate their operations. These are essential not just to control quality but also to learn what works and what does not. As mentioned before, some RDBs have proposed subcontracting these evaluations to third parties to ensure objectivity. Although this idea should be considered, an alternative might be to create, as at the World Bank, units within the RDBs to carry out these evaluations and ensure that a firewall exists between these units and the operational units. One way or the other, independent evaluation of operations is badly needed.

Conclusion

This chapter recommends that the RDBs create five new instruments or series of instruments in their core institutions:

- A series of instruments aimed at enhancing debt issued by their member countries should be created. The purpose of these instruments would be to ease the access of solvent governments of developing countries to private markets by eliminating the asymmetry of information that frequently prevents such access.
- Contingent lines of credit, to be contracted with countries in fully stable conditions and to be disbursed when those conditions deteriorate for reasons other than lack of fiscal or monetary discipline, should be formed. Countries contracting for such a line of credit would pay a commitment fee, calculated like an insurance premium. If funds are disbursed, the rate of interest would be substantially (by an amount that fully compensates for the increased risk to the institution but that is below the rates charged for emergency lending) higher than the normal rates charged by the institution.
- Emergency loans should be contracted in the midst of financial crises if and only if the country in question is putting in place a program,

approved by the IMF, to resolve its problems. The approval and disbursement of each of these loans would require the approval of the IMF. Loans would have short maturities and high interest rates.

- Liquidity loans should be aimed at ameliorating the effects of contagion on financially healthy countries. These loans would have short maturities and interest rates that are below those of emergency loans but that are higher than those contracted under contingent arrangements.
- Loans specifically designed to finance the cash costs of revitalizing banks after a financial crisis should be produced. These loans would be different from those currently granted for this purpose in that they would be disbursed not against policy reforms but against actual transactions carried out to revamp the financial system. The loan amounts would be based on estimates of those costs.

Regarding lending policies, I recommend the following steps.

- A rating from a recognized credit rating agency should be required as a precondition for any lending operation to any country. Such ratings, which would have to be updated from time to time, would serve as a benchmark of the success of the RDBs in enabling their member countries to access private markets. Failure to obtain progress toward good ratings should be a major obstacle in getting further financing.
- Strict limits on the maximum exposure that any RDB can take with individual countries should be established and enforced, with an extra margin left for increasing the limit in case a major financial crisis should develop. A maximum period within which lending must return to precrisis levels should also be established.
- The RDB staff needed to manage the contingent and emergency loans should be funded with the proceeds of these operations exclusively, so that their appointment does not crowd out staff working on traditional projects.
- A schedule for graduation should be established for countries with an income level that should ensure their access to markets on their own. Graduation, however, should not be a one-step process. To entice countries to go to the market, RDBs should have a sliding schedule for the portion of financing that they would provide on projects not associated with social development, and should offer countries help in accessing the private markets for the difference. Without such a schedule, there would be no short-run incentive for countries to make the extra effort needed to integrate into the world's financial markets.

RDBs should also expand nonsovereign lending to the private sector, preferably through the subsidiaries dedicated to these operations, aiming at enhancing the access of private firms to private markets, and giving emphasis to the development of regional financial markets, the participation in the development of private infrastructure projects with a regional dimension, and the creation of markets for the financing of small enterprises and microenterprises.

RDBs should step up the evaluation of their operations and publish the results, except in those cases where sensitive information is involved. This, in addition to being an indispensable management tool, would help them to become knowledge centers.

These recommendations would help in solving the problems posed at the beginning of this chapter. Through the use of private rating agencies to evaluate countries' macroeconomic status and the mandatory cofinancing of their needs, these recommendations would help generate a harmonious integration of the developing countries into the international financial markets—which should be the long-term objective of the new global financial architecture. The use of private ratings would also allow for an objective differentiation between countries, taking into account their dissimilarities.

These recommendations would also require relatively minor changes in the way RDBs operate. The idea that RDBs should cooperate with the IMF in the solution of financial crises may elicit strong opposition. Yet there is no way in which they can be separated from the reality of their customer countries, and there are many aspects of financial crises that only the development banks can address. It is also better to address these aspects through coordination between the World Bank with the RDBs than by the World Bank in isolation, because of the externalities of financial operations. Coordination between these parties is not just desirable but also indispensable, because both the World Bank and the RDBs are large-scale lenders to developing countries.

Some of the recommendations, however, refer to the provision of liquidity loans, which RDBs have provided in the past, even though they are different from their long-term, project-oriented operations. My recommendations in this respect are contingent on what the international community decides to do with the IMF. If the community decides to fund the IMF with resources sufficient to face several financial crises simultaneously, the participation of the RDBs is not needed. Otherwise, however, the RDBs will end up participating anyway, even if doing so is inconsistent with their purpose. When the neighborhood is in flames, the firefighters must get water anywhere they can. Thus, it would be better to prepare the RDBs to play this role in a more efficient way than to pretend that they would be able to resist the pressure of the international community to help resolve an urgent crisis.

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Comment

ROBERTO ZAHLER

The chapter by Manuel Hinds is an important contribution to a very relevant topic in the current discussion of the new international financial architecture. The chapter is well and clearly organized in three sections. The first section assesses the problems that the new architecture is intended to solve and proposes a role for the regional development banks (RDBs) in that solution. The second proposes instruments and policies that the RDBs can use to play this role. The third summarizes the proposal and raises some issues for discussion. My comments relate to those issues about which I believe Hinds's analysis and proposals could be improved. Where I have no comments, it is because I agree with the bulk of the author's analysis and recommendations.

Hinds mentions two main problems with the functioning of world financial markets in relation to developing countries. One is the instability of developing countries, and the other is their lack, or volatility, of their access to international financial markets. He also attempts to identify the roles that RDBs can play in solving these two problems. This section, however, fails to mention some crucial problems related to the working of the international financial economy that have a direct effect on the stability of emerging market economies or on their access to international financial markets, and where RDBs could, and probably should, play an important role.

First, there is no mention of the supervision and regulation of financial markets at the international level, which is far from perfect. In particular,

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the more favorable treatment of capital requirements for short-term interbank lending, as provided in the current Basel Capital Accord,[1] adversely affects the stability of banking flows to developing countries by hampering their governments' efforts to extend the maturity structure of their foreign liabilities. Although it can be argued that the preferential treatment given to short-term interbank lending aims to strengthen banks in industrial countries, nonetheless, it has clear adverse systemic consequences, as it exacerbates the fragility of emerging markets by encouraging them to increase their short-term indebtedness.[2]

Second, although booms and busts are endemic to all financial markets, recent experience indicates that short-term financial international swings need to be brought under some kind of control. This is especially important if the main participants in the new financial architecture, which include the RDBs, are to concentrate their efforts more on crisis prevention than on crisis management. An important common feature of many of the crises we have witnessed in emerging market economies, in particular the Mexican, East Asian, Turkish, and to a certain extent, current Argentinean crises, is that the crisis originated from excessive short-term capital inflows to and from the private sector. Experience shows that, if the capital inflow booms that precede these crises can be moderated, the subsequent busts can to a certain extent be prevented. Here RDBs could play an important role by helping to place an appropriate value on the social costs and risks of short-term international lending to emerging market economies.

Hinds also fails to mention that, in many cases, instability in emerging market economies is related not to inappropriate trade policy but to inappropriate (either too sudden or wrongly sequenced) opening of the capital account of the balance of payments. In other words, in many of the recent crises the problems originated in the capital account rather than the current account (through excessive protectionism). The chapter concentrates only on the latter, as if it were the unique source of instability. In other cases, ill-conceived domestic financial reform (e.g., interest rate liberalization without proper regulation or supervision) has been the main cause of instability, rather than issues related to trade liberalization.

In addition to these general comments on the first section of Hinds's article, I have a couple of specific complaints. Hinds says that, "the in-

1. This favorable treatment would be augmented if the proposed revisions to the Basel accord are implemented as proposed. Furthermore, in the proposed accord, internationally active banks and large banks can choose either to use ratings provided by external agencies or their own internal rating systems as a basis for classifying the credit risk of a particular loan and for calculating the regulatory capital requirement. Adoption of either approach in industrial countries could exacerbate the already high volatility of capital flows to emerging markets (see Latin American Shadow Financial Regulatory Committee 2001).

2. The editors note that this issue is discussed in the accompanying essay of Rojas-Suarez.

dustrial sectors of developing countries operate behind high rates of protection." In many developing countries, however, this is no longer true. Nor does Hinds mention the fact that, even as many developing countries have opened their economies, liberalized, and privatized, protectionism remains quite prevalent in some industrial countries. Indeed, this is what lies behind the "declining commodity export revenue" that Hinds notes, even more than the deterioration of terms of trade.

Turning to the discussion of developing countries' lack of access to financial markets, I agree with Hinds's logic in saying that, if countries have insufficient or fragile access to foreign saving, investment opportunities cannot be realized. However, I would also mention the need for these countries to implement policies oriented toward increasing domestic saving, and especially long-term domestic saving. Here Latin America has some interesting lessons to convey from its recent experience. On the one hand, Latin America's experience shows the catalytic role that fiscal surpluses can play with regard to private saving; on the other hand, it also shows the potential contribution of social security reform to the development of bond and equity markets, which constitute the domestic basis for long-term sources of investment financing. RDBs are especially well equipped to transfer knowledge and experience in these two areas to countries in their regions.

Again I have a few comments on specific points made in this section. Hinds says that lack of access to the international markets is "the other fundamental problem of developing countries." This is a very strong statement and, as I have mentioned elsewhere, under certain and not so uncommon circumstances, it is precisely excessive access to international financial flows that has created or at least facilitated crises, even in emerging market economies that have sound macroeconomic policies.

Hinds goes on to say that "these problems not only block . . . access to global financial markets but also . . . retard the development of regional financial markets, which are practically nonexistent in those countries." This is an area in which it would be difficult to find institutions better suited than the RDBs to devoting resources and efforts to promote financial regional integration (more on this topic follows). In fact, there have been a number of interesting experiences involving regional and subregional institutions in the developing world. Examples include the agreement reached by the Association of South East Nations (ASEAN) countries, China, the Republic of Korea, and Japan to establish swap arrangements among their central banks; the ASEAN's pilot macroeconomic surveillance and monitoring schemes; the Arab Monetary Fund's provision of liquidity for intraregional trade; the Latin American Reserve Fund, which complements the International Monetary Fund (IMF) in providing liquidity financing during crises; the operations of subregional development banks such as the Andean Development Corporation; and the Arab Investment Guarantee Fund.

These experiences indicate that regional bodies can be effective in providing liquidity, sustaining trade links, and facilitating access to international financial resources through risk pooling. They can also contribute to macroeconomic policy coordination and to the adaptation of regulatory systems to regional conditions. The sense of ownership that they inspire contributes to efforts aimed at adapting stringent rules, promoting full disclosure, and undertaking joint monitoring and surveillance of regional financial markets, as well as encouraging regional arrangements for monetary, financial, and fiscal coordination to support sound macroeconomic policies. Regional and subregional institutions should actively be promoted and recognized as central players in the international financial architecture.

In particular, regional reserve funds and swap arrangements can contribute to crisis prevention and resolution, thanks to their ability to provide international liquidity. In addition, as Hinds mentions, RDBs as well as subregional development banks can complement multilateral financing by providing and facilitating access to financial resources that support activities that yield high social returns but that the private sector is not prepared to finance. They can also play a countercyclical role in providing access to financial resources at times when international private capital becomes scarce. Experiences in this area are highly specific to each region but may serve as a basis for productive interregional exchange of best practices.

In Hinds's discussion of the competitive advantage of RDBs, I suggest mentioning explicitly a very crucial event "rooted in the nonfinancial parts of the economy." This is the need for so-called second-generation reforms to improve the judiciary system, establish well-defined property rights, introduce sound bankruptcy laws, promote transparency, avoid conflicts of interest, provide appropriate corporate governance, protect minority shareholders' rights, and so on. These issues are becoming a major source of concern not only to domestic savers but also to potential suppliers of foreign savings. Again, this is an area in which RDBs could play a very significant role.

In the same discussion, Hinds mentions that "all the multilateral institutions have experimented with many ideas for resolving [these problems], . . . most of which have proved useful," but no example is given. In fact, the contingent credit lines established by the IMF for coping with liquidity problems have not yielded the expected results, probably because it takes a considerable amount of time for countries to qualify for this facility, and partly because of the possible loss of confidence or stigmatization that may be associated with its use.[3] Furthermore, only recently has the IMF declared an interest in private sector participation in

3. The editors note that this facility was, in fact, abandoned in late 2003.

crisis management by suggesting the implementation of an international equivalent to US Chapter 11 bankruptcy proceedings. Such an arrangement could help toward an orderly workout of debt crises in emerging market economies by mandating creditor coordination and a payments standstill.

In the section that outlines Hinds's proposals for an enhanced role for the RDBs in improving the international architecture, although he states that one of the main objectives of the RDBs would be to "bring their member countries to the international financial markets in a sustainable fashion," no suggestion is made regarding the potential role of the RDBs in improving the working of the international financial markets in this regard.[4] Hinds also states that "the RDBs . . . should work to reduce their own participation in the financing of developing countries . . . bringing their members to a more plentiful and more sustainable source of financing for their development needs." No mention is made here of the very well known procyclicality of private sources of finance, however, or of the need for the multilateral banks to play a countercyclical role when private financing is scarce. It is not clear, in my opinion, that overall financing by the RDBs should be reduced as a way to ensure that developing countries integrate more aggressively and in a stable fashion with international financial markets.

Later in the same section, Hinds says, "RDB's lending policies should be geared to two main objectives: developing the domestic financial markets of their member countries, and bringing them to global markets, thus reducing their dependence on the development financial institutions. The design of the operations and their conditionality should be framed within this principle." For reasons I gave in the previous paragraph, I consider that such a conclusion requires more grounding.

Hinds comments that the RDBs should work closely with the World Trade Organization (WTO) as part of their effort to bring developing countries to international financial markets. However, the need for such cooperation relates mainly to trade liberalization and, in my view, only in a very roundabout way to access to international financial markets. I would emphasize that, on this topic, RDBs should also work with the WTO on improving the openness of industrial-country markets to developing-country exports.

In the same paragraph, Hinds calls on the RDBs to "work to improve the quality of their customers' macroeconomic management . . . to make the debt instruments of developing countries attractive in international financial markets and to allow for the development of a sound domestic

4. For a recent view regarding international action required to ensure stable and sustainable access for emerging market economies to world financial markets, see *Rebuilding the International Financial Architecture*, Emerging Market Economies Eminent Persons Group, Seoul Report, October 2001.

financial system." Regarding the reasons why "true policy reform to ensure stability has not been achieved," there is no mention of mistakes made by the international financial institutions themselves in their approach to proper macroeconomic management in many countries, such as Mexico in 1994, Thailand in 1997, Turkey in 1999 and 2000, and most recently in Argentina. Some mention could be made of the need for a less narrowly ideological perspective on the part of these institutions; for example, acknowledging that corner solution exchange rate policies are not necessarily the best solution; that the current account matters, even when the fiscal sector is in equilibrium or in surplus; that capital account liberalization does not need to be implemented in an abrupt way; and so on. Often the international financial institutions have not appropriately assessed these crucial components when designing stabilization and adjustment programs, and this has been an important cause of major macroeconomic and banking crises in developing countries.

Furthermore, I have serious doubts regarding Hinds's proposed solution "to give more weight in the development banks' lending decisions to the credit ratings of the professional rating companies . . . [which] provide a quantitative assessment of the well-informed perceptions of the market." For one thing, the track record of most rating agencies has been quite mediocre. In addition, adopting such a process of qualifying countries' sovereign risk is likely to create significant demand for new and frequent ratings by governments, because they will have a strong incentive to obtain a favorable rating to lower the interest rates they pay and extend the maturity of their international loans. The existing rating agencies will probably be unable to satisfy this new demand for ratings, and although good new agencies will enter the market intending to provide fair assessments and build up countries' reputations, bad ones will enter as well, with the purpose of maximizing short-term profits through the provision of relatively favorable ratings. In these circumstances, the rating agencies, which best serve their purpose when ratings are investor-driven, not when their services are demanded by borrowers (including governments) seeking finance, will probably not contribute to market discipline in the forceful way that the chapter indicates they will.

Hinds's point regarding the need to improve coordination among supervisors of financial institutions is worth developing further because this is an area in which very little has been done. Increasing regional and subregional cooperation among supervisors and regulators would be very useful not only in relation to the stock exchange but also in relation to banks and pension funds. Improved cooperation among supervisors and regulators should become increasingly important as a way of promoting labor mobility within regions and subregions.

Turning to Hinds's discussion of the prevention and management of financial crises, it is not clear to me why it is better for RDBs to use their resources to complement the IMF in dealing with liquidity issues rather than to work more closely with the IMF in designing more effective crisis prevention instruments. RDBs could play a more active role in monitoring developments in international financial markets; for example, by designing vulnerability indicators or early warning systems, monitoring domestic macroeconomic policies, and as the chapter mentions, developing programs aimed at strengthening domestic financial sectors. RDBs could also help the IMF in designing debt workouts. These should be seen not as a substitute for emergency financing but, rather, as a complement to it, and one that would play an essential role in managing liquidity issues. Although such workouts do not eliminate the need for adequate provision of liquidity during crises, which has tended to increase given the increased severity of global financial instability, they could help substantially with this concern. Furthermore, before using the RDBs' resources, consideration could be given to the temporary issue of special drawing rights, which could become the major source of funds for IMF emergency financing.

A final, specific comment on this section is that I do not think it is convenient to say that funds being provided to recapitalize or liquidate financial institutions require that this be done without imposing losses on depositors.

Hinds offers some suggestions for complementing and improving the IMF's recently established contingent credit lines. However, this would require (for reasons I noted in my discussion of these credit lines above) using the RDBs' resources for purposes not directly related to their specific task. As already mentioned, in my opinion it would be preferable if the RDBs could devote their efforts and research primarily to helping improve the working of the international financial system. Finally, it is my impression that what Hinds proposes would require a high and difficult degree of coordination between the RDBs and the IMF. This coordination would become even more burdensome if, as seems highly probable, the World Bank would also need to become involved in these operations.

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Comment

GUILLERMO CALVO

This is certainly a very challenging topic. There are so many things that we want to do—the question is how to accomplish them as a bank. Thus, I will follow the economic tradition of being very narrow in my scope, leaving out many important issues, and concentrating on regional development banks (RDBs) as banks.

Why do we need RDBs? First, the big challenge, of which everyone is aware, is the enormous gap between developing and industrial countries that we have been trying to close for many years. We are concerned about the security implications of this gap, not to mention the miserable human conditions that it implies. I think there is a general feeling that we have not been successful, because the gap remains very large and hard to explain. If you go to the heart of those differences and approach them as an economist, however, you will certainly start to think about public goods, including regulatory reform and basic education.

Why does anyone need a bank? That is easy—because loans are needed. Why do you need a public bank? That is a harder question to answer. Before I address it, let me refer to the problem of instability of capital flows. At the Inter-American Development Bank (IDB), we believe that aside from institutional reform, developing countries need finance—they need capital. Once the conditions have been established to ensure that this capital is used in an efficient way, it will flow to those countries.

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Unfortunately, the 1990s, which started out as a very promising decade, did not turn out as we expected. As of the beginning of the 21st century we see problems ahead. Argentina is one of the latest problems, and it is a very difficult one, but I do not think it will be the last one. So we have to ask ourselves: If we want to be effective, what is missing? Why have things not worked out as we expected? What happened has to do more with moral hazard than with moral failure. What we have is a market failure problem. Economists know how to address market failure, but there are issues having to do with sounder macroeconomic policy, more adequate banking systems for developing countries, regional agreements, and so on, which are issues that may require finance—or they may not—but they certainly require knowledge.

These are other aspects closely interlinked in these banks: finance and knowledge. You can make a bigger difference with knowledge—you can identify and disseminate best practices or do policy-oriented research—than with money. However, the size of the multilateral development banks is very small, and therefore money cannot be the essential ingredient of these systems.

From the narrow perspective of an economist, one justification for international financial institutions is that they help overcome what one might call the sovereignty problem. Lending to sovereigns is not the same as lending to individuals: One country is not subject to another's legislation, a sovereign's goods cannot easily be attached, and so on. Lending to sovereigns requires an international community that will put enough pressure on sovereign borrowers to induce them to repay their loans. Otherwise, however honest a country's policymakers may be, they represent other people: They are accountable to those people, and they have to deliver.

These issues are brought up in policy discussions in every borrowing country every day, and the opposition always questions the wisdom of repaying loans. Obviously, Argentina has been forced into default, but when you look around Latin America, you see some very important politicians also questioning whether their countries' debt should be paid in full. That debate is always going to be there—the only way to deal with it, in the absence of international courts, is to exert peer pressure.

Because the international financial institutions are very small relative to the need and the markets, these institutions have to be very selective in what they do. The question thus becomes, as mentioned before, money versus knowledge. I doubt that we intended, when we created these institutions, that they would come to be thought of not so much as money banks but as knowledge banks; but that is what they have become and that is how they operate day in and day out. The academic community does not provide policy-oriented knowledge because the motivations in academia are very different. Policy-oriented research is not done in a systematic and serious way in most academic institutions. Of course, there are institutions that contribute to providing that knowledge, but in the case of the international financial institutions, I think the fact that they lend as well as preach gives some greater credibility to their preaching.

If, then, there is a role for these institutions in general, the question becomes, what is the role of the RDBs specifically? Why have them at all? Why not just have the World Bank? That is not an easy question to answer, because if one thinks of these institutions as cooperatives, there is merit in having the cooperative be as large as possible to spread the risk. Why concentrate efforts in Latin America instead of spreading them around the world? From that perspective, admittedly, the World Bank would seem to dominate.

I think the comparative advantage of the RDBs has to do more with culture than with economics, taking into account the fact that they involve countries that are closely connected culturally and geographically. I am delighted that one of the issues that has been discussed here is the issue of regional trade integration. This is an area in which the RDBs have a definite advantage, because we are at the beginning of the integration process, which, especially in Latin America, has been tried before and failed. This time we want to do it the right way and that requires much more global thinking, but at the regional level. In that sense, I can see the banks, including the IDB, playing an important role.

Of course, money is needed. Money will have to be channeled to sovereigns. However, now you are dealing not only with one sovereign but with several sovereigns at the same time. Thus, having a fluid relationship with one's region helps a lot.

To summarize, from a purely economic point of view, the need for international financial institutions has not yet disappeared. It has changed in many ways, because the world has changed, but as long as the borrowers are sovereign countries, it will be difficult to have a free market, no matter how highly one values the free, unfettered, private sector markets. It is difficult to think of a situation in which such a market by itself will be able to provide all the financial services that are necessary, because of the sovereignty problem.

In that context, I see the RDBs as playing a key role, especially in connection with issues of regional trade integration. In whatever activity the bank operates, the dissemination of knowledge and the creation of basic, policy-oriented knowledge is something that these banks can provide —and can provide effectively.

Comment

ALLAN MELTZER

I have many points of agreement with Manuel Hinds's background chapter, and a few differences. I regret Hinds's tendency to use the phrase "developing countries" as if it were a collective term, implying that one size fits all. This usage becomes particularly difficult when opportunities to borrow are discussed. Implicitly, Hinds and many others treat China, which can borrow very large sums at interest rates not much above those charged by the development banks, as on par with Zimbabwe or Kenya. The problem with this approach is that it neglects the reasons why some countries can borrow and others cannot. Despite the growing problems in Argentina in recent months, we have seen Peru come to the capital market, for the first time in living memory, and borrow for 10 years at 9 percent annual interest. Of course, within Latin America alone there are countries as different as Brazil, Chile, and Mexico, all of which have access to the capital market on quite reasonable terms.

Indeed, I see in Argentina's case the recurrence under different circumstances of a problem that has emerged several times in the last 25 years. Some countries that were able to borrow a great deal borrowed more than they could service or repay. Argentina's debt in 2000 and 2001 was unsustainable. So was that of Mexico in 1982, and that of Russia in 1998. Many other developing countries have faced the same problem: too much spending and too much borrowing. I believe we can get some idea about future capital flows if we pause to consider why lenders have

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been willing to lend so much to countries that eventually had to default and restructure their loans. Nobody likes lost decades, and so it is crucial to be concerned about the excessive lending and borrowing that lead to lost decades.

Why do lenders overlend? My answer is that they do it because they believe they will be bailed out, when and if a crisis comes, by the international financial institutions—especially the International Monetary Fund (IMF). As Adam Lerrick says, when creditors are asked to restructure voluntarily, they end up with more, not less. No one voluntarily takes a loss that they can avoid. Until recently, most restructurings have been voluntary. The restructuring extends the maturity of the debt, and creditors receive better terms and fees.

In the last few years, however, something has changed. Starting with Ecuador, and most recently in Argentina, countries have defaulted on their sovereign debt. In Argentina, new issues offered in July 2001 for $85 sold in November for $25 or $30, inflicting almost Enron-size losses on creditors. A reasonable guess at the time of this writing is that if the IMF continues to insist that Argentina restructure its debt before it lends any additional money, creditors will receive no more than 25 to 30 percent of the face value of their bonds.

I do not believe we can ignore this default or the defaults that preceded it when thinking about the future of international lending to developing countries. Nor should we ignore the experience itself. One remarkable fact about Argentina is that responsible observers like Charles Calomiris and Adam Lerrick predicted publicly, months before the event, that Argentina would have to default. These predictions became public in the winter of 2000–01, but despite these very public warnings, Argentina was able to sell debt at $85 as late as June 2001.

Two significant changes occurred between June and September and October 2001 that will have implications for the future. One we need not pursue today: It became clear as the summer progressed that the de la Rua government and Finance Minister Domingo Cavallo had no plan or program for restoring growth or repaying the debt. The government made promises about the budget that soon were seen to be empty. The sight of increasingly desperate ministers thrashing around was not an attractive one to Argentina's creditors.

The second big change came in August and the following months. Instead of the $30 billion to $40 billion in new loans that some at the IMF wanted to make, Argentina got only $5 billion, with an additional $3 billion earmarked for debt restructuring. This amount was too small to be useful, unfortunately. Soon thereafter, the new officials at the IMF and the US Treasury made it clear that there would be no more money until Argentina met its past commitments. These included a promise to balance the budget month by month. Default now appeared not just likely but inevitable. The days of large bailouts were not over for countries like Turkey with important systemic risks, but they were over for many countries. Creditors who had benefited from moral hazard lending now had to be more careful. The risk premiums on some emerging market debt no longer offered a windfall.

One implication is that if the IMF keeps to its new policy, creditors will be more careful about the amounts they lend and the countries to which they lend. The entire history of postwar lending to emerging market countries, particularly the last 20 years, occurred under the old rules. The new rules, if they stay in place, call for greater prudence.

What can borrowers do? They can—indeed they must—become more prudent. The report of the International Financial Institutions Advisory Commission proposed four conditions for automatic lending by the IMF to countries in difficulty. Those four conditions, perhaps supplemented by one or two others, define a prudent macroeconomic policy with diversification of risk. In Brazil, and even in Argentina, we have seen that one of these conditions—the presence of competing foreign banks—greatly increases financial stability. The largest source of capital for developing countries is private lending. Such lending dwarfs any current or prospective lending from any international financial institution—or even all of them together. If the IMF persists in its new policy, borrowers will have to show evidence that their policies are and will remain prudent.

To be lasting and effective, the adoption of prudent policy must be voluntary. The minister must go to parliament with a message that says, in effect, "We must adopt these policies because it is in our interest. We will get more capital on better terms to build our country and raise our living standards. We are not making these changes because the IMF or the Inter-American Development Bank (IDB) or the World Bank insist on it. We make them because they are in our interest."

An important role for the multilateral development banks is that of helping countries that want to attract long-term capital in the form of foreign direct investment and to attract foreign banks and participants in this market. These multilateral development banks should lend in order to permit countries to make necessary structural reforms. This means instituting the rule of law, reforming the judiciary, and establishing transparent accounting and financial practices. It means adopting financial standards, opening the economy to trade, and securing property rights. The experience of Chile and Mexico is evidence that, when these reforms are in place, countries acquire more capital at lower cost.

What is the more general role of the IMF and the multilateral development banks, and what is the particular role of the regional banks? Our commission's report saw the core competence of the IMF as the prevention and mitigation of crises and the collection and dissemination of information on developing countries. If the IMF could free itself of the bureaucratic embellishments that it puts on its contingent lines of credit and condition its commitment only on keeping prudent policies in place, it would take a large step toward a more rational financial and institutional structure. Countries would have an incentive to make structural reforms that are for their own benefit.

As for the development banks, like Jurgen Stark, I believe in specialization. The development banks should not be involved in crisis lending. Our commission proposed three major roles for the development banks. The first is to improve the quality of life in very poor countries by making grants instead of loans, monitoring the outcomes, and paying for performance. To their great credit, Treasury Secretary Paul O'Neill and the Bush administration have proposed adopting this policy, and President Bush endorsed it directly in his speech to the World Bank. Second, the development banks should lend for structural reform by making long-term commitments to continue lending for many years, provided the borrowing country continues to strengthen and extend its reforms. This proposal recognizes that reforms take time, and unlike much current structural lending, it does not confuse promise with performance. Third, the development banks should lend to support the creation of regional and global public goods. There is considerable overlap among the World Bank, the regional development banks, and the IMF. I believe that if the development banks became more effective institutions and achieved greater success in their programs, the IMF would—and should—relinquish its role in structural reform and poverty alleviation.

How should we separate the tasks of the World Bank and the regional banks? Manuel Hinds takes the position that competition between them is useful. This might be true if they actually competed, and if there were some metric by which we could compare their performances. Where Hinds sees competition, however, I see overlap and duplication. To move forward, we need to learn about the comparative advantage of the different lenders. The World Bank is generally acknowledged to have greater technical expertise than the regional development banks, over a wide range of topics. This expertise should be available as a common pool for all development banks to draw on: There is no need to duplicate it.

To learn more about what the multilateral development banks do well, I have proposed independent performance audits of the major ones. Let us learn what they do well and what they do poorly, what they should continue to do and what they should stop doing. Most of the banks do not evaluate many of their projects five or ten years after their completion, and so we have a very poor record of their accomplishments and failures. An independent performance audit is overdue.

One of the striking features of lending by the multilateral development banks is that most of it goes to countries that can borrow in the capital markets. This is as true of the IDB as it is of the World Bank. In many of these countries, the banks provide little or nothing beyond the subsidy, and there is very little, if any, addi-tionality: This money should be redirected. Our commission proposed concentrating the World Bank's lending mainly in Africa and the Middle East. It might supply technical assistance in other regions, but responsibility for lending to those regions would remain with the Asian Development Bank and the IDB. I continue to believe that this move would reduce costly duplication.

In summary, I would emphasize the need to shift to more effective policies of grants and lending. The emphasis should not be on how much is lent, but on what is being accomplished. We can wave plastic cards with the numbers of people living on less than $1 a day until eternity. We will not reduce that number until we have more effective policies. We should start with performance audits and continue with policies that reward incentives. Loans do not raise living standards unless they raise productivity, and incentives at all levels are required to raise productivity.

I dislike the word architecture, as it suggests a structure that lasts a long time. Development, however, is a process that changes as countries evolve. The key word is not architecture, but incentives.

Comment

JURGEN STARK

Neither a rebuilt nor a totally new international financial architecture is needed. By no means are all of the parts of the global financial system broken, nor has the system become obsolete. What is needed, as other collaborators in this book have already said, is a stronger and better-functioning financial system at all levels: global, regional, and national.

What has been achieved thus far in strengthening the global financial system? There has been particular progress in crisis prevention: Financial systems have been made less vulnerable through enhanced International Monetary Fund (IMF) surveillance and through improved transparency and disclosure within the setting of internationally accepted standards and codes. There have also been attempts to streamline the IMF's conditionality.

Less progress has been made in the area of crisis resolution, and we must be aware that even if the international financial system has been made safer, crises will continue to happen. Within this broader topic, one major and crucial issue still remains unresolved; namely, how to involve the private sector. This issue should be addressed in the context of the access limits to IMF resources.

What should be the roles of the different international financial institutions, including the regional development banks? And what should be the principles for their design and operation? I will begin by noting that many of the tasks of these organizations can hardly be taken over by other organizations, whether private or national. If these tasks are to be completed, it is international institutions that will do so. However, to be effective and to realize the benefits of specialization and the division of labor, each international financial institution must have a clear mandate

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and clear-cut responsibilities. Overlapping mandates and activities tend to duplicate effort, waste resources, and blur responsibilities. It is obvious to me that, in the past, the IMF and the development banks either have sought on their own, or have been driven by their shareholders, to do too much. Some institutions went beyond their mandates and ended up competing with each other. Within these clear mandates, each organization should develop appropriate procedures for cooperation and make their work consistent and efficient. Finally, because official international organizations are public institutions, receiving and managing taxpayers' money (or central banks' money in the case of the IMF), their work must be transparent, accountable, and efficient if they are to be responsible to their official shareholders.

What is the role of the development banks? What should they do or not do? In my view, they should not be involved in crisis lending or crisis management, and they should refrain from publicly second-guessing the IMF's work in that area. In the crises of the 1990s, the IMF, the World Bank, and the regional development banks often pooled their funds in an attempt to resolve the crisis, but their decision to do this had little or nothing to do with the size of the crisis; it had only to do with the political approach on how to resolve the crisis.

It follows that I am not in favor of the new instruments for which Manuel Hinds called in his chapter, which would allow the regional development banks to convey financial support in time of financial crisis. These instruments would have features similar to the IMF's existing instruments. My plea is, rather, for establishing both clear-cut responsibilities for each of the international financial institutions and closer cooperation among them. Let the World Bank and the regional development banks focus on development and the IMF focus on macroeconomics and crisis management.

What should be the specific role of the regional development banks in providing development finance? Because each of the regional banks has specific knowledge about its region, in addition to financial and technical expertise, I believe they should play a more prominent role in providing technical assistance and advice in their regions; in particular, with respect to structural reform. They should work to develop regionally tailored solutions and intraregional coordination and cooperation; for instance, in the integration of regional financial markets. To reduce the vulnerabilities of their member countries, the regional banks should provide technical assistance in establishing sound financial systems and effective financial supervision. They should give advice on how to implement standards and codes in the financial sector, and on how to liberalize trade regimes and capital accounts.

Whatever the immediate source of development finance, public or private, ultimately it is funded out of the pool of world savings. On the public side of the World Bank and the regional development banks, such international or regional saving-investment channels are highly subsidized. Even here, the effectiveness and efficiency of these channels have reasonably been questioned because the real investment objectives of development lending have, in general, not been achieved—not despite their subsidization, but because of it. More often then not, the World Bank's client countries have found themselves with increased levels or subsidized external debt at an unchanged capacity of debt repayment. What we have all learned the hard way is that economic causality does not run from subsidized debt to increased economic capacity but, rather, the other way around: from increased economic capacity, including more effective, better mobilized domestic saving, to higher sustainable levels of external debt. Reasonable proposals to replace unrealistic World Bank loans with grants seek to acknowledge this experience.

The right kind of response to this experience is, therefore, to undertake a more determined and more ambitious effort to build domestic capital markets within the developing countries themselves. This is by no means an inward-looking or isolationist solution. To the contrary, broader opening of domestic capital markets would greatly improve developing countries' integration into truly global capital markets. They would also strongly stimulate intraregional capital flows, both within low-saving regions like Latin America and within high-saving regions like southeast Asia.

In my view, this approach has considerable potential for another reason; namely, that these countries' debt instruments share, broadly speaking, similar risks and rating properties. It is here is where I see the regional development banks playing an important strategic role. Each of them possesses, within its region, some natural competitive advantage over the World Bank, or at least over World Bank headquarters. Their credit officers are closer to the local investment projects being proposed. The regional banks are also constrained to deliver a solvent balance sheet at the regional level; they cannot cross-subsidize regions, as inevitably happens at the level of the World Bank. These features of regional development banks could greatly improve the overall efficiency of capital allocation.

Even more important, the regional banks could also play a catalytic role in the development of local and regional capital markets through a variety of funding instruments. They could issue instruments in local currency by assuming and pooling currency risks or by creating hedging instruments, thereby deepening markets in local currency-dominated instruments and providing necessary benchmarks. They could also help to extend the maturities of bonds denominated in local currency by assuming and pooling maturity risk. Finally, they could raise foreign exchange on global markets at market terms, which would likely be better than what individual borrowing countries could receive on their own. In all these ways, over the medium term to the long term, the regional development banks could more generally stimulate regional financial integration among emerging markets.