GLOBALISATION and poverty

Enhancing Private Capital Flows to Developing Countries in the New International Context[•]

Report on a Major Commonwealth Secretariat, World Bank and Commonwealth Business Council Conference

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Executive Summary

1) On the 3rd July 2002, a major Conference on Enhancing Private Capital Flows to Developing Countries in the New International Context was held in London (jointly organised by the Commonwealth Secretariat, the World Bank and the Commonwealth Business Council). It had two aims: first, to analyse recent trends in private flows and their determinants, with a view to encouraging more and more stable flows to developing countries; and second, to evaluate progress on international financial reform, especially from the perspective of developing countries. The following were the main issues discussed: Private Sector Involvement (PSI), Codes and Standards (C&S), Mobilising Private Capital Flows to Developing Countries, Basel II and Global Economic Governance and Developing Country Participation.

2) Two issues were initially identified: 1. How to create domestic and international conditions to increase the level of private capital flows to the developing world, particularly Africa and the poorest countries? 2. How to prevent – or, if they occur, manage better – financial crises?

3) It was noted that recent developments have negatively impacted upon investors' appetite for risk and their willingness to lend and invest in developing countries. Thus, despite developing countries' huge efforts to make painful reforms, private capital flows remain well below the levels of the mid-1990s. This makes governments unable to demonstrate to their peoples some of the fruits of this process. Equally worrying, the emerging market crises continue to happen at present, causing large GDP losses and huge social costs.

4) The discussion of the PSI in crisis resolution was placed against this backdrop. Although crises continue to happen, there is a vacuum in the international financial system today. There are no clearly established mechanisms for sovereign debt restructuring, nor are there sufficient official financial resources available to support countries to prevent crises or to manage them when they occur.

5) In this context, the two current proposals that involve the private sector in crisis resolution – the Krueger proposal and the voluntary approach – were discussed in some depth. The Krueger framework consists of the establishment of a sovereign debt restructuring mechanism (SDRM) that can be invoked by sovereign debtors. The majority of creditors would decide for restructuring and an independent judicial body would be established to supervise inter-creditor disputes and the organisation of votes. The Fund would be involved only as a provider of finance for economic and financial adjustment. The assumptions underlying the Krueger proposal are that a voluntary approach would not work due, first, to 'aggregation problems' (i.e. too many different creditors, with bonds issued under different jurisdictions); second, 'rogue creditors' could disrupt negotiations.

6) However, a strong case was made for a voluntary. The view expressed was that, under this approach, collective action clauses (CACs) could play a major role in crisis resolution, given today's narrowing in the differences within the private sector regarding the acceptance of such clauses. Major bond restructuring in Russia, Ecuador, Pakistan and Ukraine shows that a voluntary approach is possible.

7) The types of CACs that are likely to be accepted by the private sector include 1. Majority action clauses, which allow a qualified majority of creditors to agree to a change in the terms of a debt contract; 2. Non-acceleration clauses, which require a minimum threshold of bondholders before an immediate repayment of principal can be demanded, following default; 3. Collective representation or engagement clauses, which define mechanisms for co-ordinating discussion and possible action (ideally through a trustee).

8) However, it was noted that the reality is that IMF resources are scarce, and to date there are no effective mechanisms in place. Thus, a shared feeling among the participants in the conference was that whilst discussions on private sector involvement were important, still crises continue to happen due to lack of an effective framework for debt restructuring in place. Therefore, more official liquidity is needed to prevent new crises and stop the ongoing ones being further aggravated.

9) International codes and standards (C&S) were discussed next. There was general acceptance about their importance, and consensus that their aims were to provide transparency, prevent crises and help developing countries tap international capital markets; also, C&S can offer valuable benchmarks for developing and transition economies to improve their financial sectors. Thus, C&S were seen as potentially playing a very significant role.

10) However, strong doubts were expressed about whether C&S were effective in assessing vulnerability and preventing crises. It was even stressed that C&S had not diminished financial crises, nor had it improved developing countries' access to private flows. It was noted that a key vulnerability indicator was the government and the private sector balance sheets, thus requiring their explicit assessment; also, the need to evaluate debt sustainability, especially for middle-income countries, was stressed.

11) A number of problematic aspects concerning C&S were also noted. First, there was lack of adaptation of C&S to local conditions. Second, countries in the early stages of development were facing high costs. Third, shortage of technical skills was a major barrier for implementing them. Fourth, the number of C&S was seen as very large. A particular strong concern was that C&S do not necessarily contribute to growth and poverty reduction, and may even discourage them in some instances.

12) It was also suggested that C&S should not be based on single models, but should have some flexibility, to reflect local cultures and economic policy frameworks. Because implementing C&S should not reflect a single model and because implementing them implies a longer process, it was not deemed appropriate that they become part of conditionality. Finally, participants made the point that compliance assessment cannot be made mechanically, nor can C&S be evaluated on a numerical scale. An issue raised was the extent to which self-assessment by countries, with a peer review, was a better alternative to external assessment.

13) Moving the discussion to the issue of how to mobilise private capital flows to developing countries, it was observed that such flows rose significantly through the early 1990s, and have fallen sharply since 1997. The main reasons for this decline are the financial crises in emerging markets and an increase in investors' risk aversion. Concern was expressed that the problems of corporate governance and accounting standards in the developed world would impact most severely on developing countries.

14) In spite of economic reforms and implementation of C&S by developing countries, serious concern was expressed that "the emperor could have no clothes", as private capital flows have fallen sharply, could remain low for a long period, and are often very volatile. In this context, three challenges were highlighted.

15) First, what policies can be pursued to encourage capital flows to low-income countries? What additional roles could multilateral development banks and export credit agencies play? What additional policies, e.g. improving infrastructure, should developing countries adopt to encourage such flows? Second, the cost of borrowing for developing countries has deteriorated greatly in the last five years. Third, there has been an increase in volatility since the crises of the 1990s. Moreover, there has been an increase in risk premia, which sharply deteriorates countries' balance sheets, and makes crises far more likely. What can be done to make capital flows to middle-income countries and their cost more stable?

16) The discussion of Basle II Capital Accord that followed was placed in the context of declining private capital flows to developing countries. The decline has been particularly sharp in bank lending, which even became highly negative for most of the last four years. Although it would not be desirable to return to excessive bank lending to developing countries, the main danger is insufficient lending.

17) A central aim of the proposed new Capital Accord is to create a risk-sensitive capital accord that does not increase overall levels of capital. A key concern in the conference was that increased risk sensitivity may excessively increase pro-cyclicality. Banks are best at evaluating relative risk, at a particular point in time. However, banks and the models they currently use are not good at evaluating risk through time. That is, they have a tendency to behave pro-cyclically. There is growing recognition that this is the key market failure that should be addressed by regulators. The problem of pro-cyclicality of international bank lending (and of other capital flows) is particularly damaging for developing countries, as the impact and cost of crises is much higher than in developed markets.

18) Other problems that still remain in the second consultative paper (CP2) on Basle issued in January 2001 and that need to be urgently addressed include increased cost and smaller supply of bank lending to developing countries. It was agreed that the cost of bank lending implied in the current Basle proposal could be reduced by the flattening of the IRB risk weight curve. However, such costs could still increase fairly significantly, especially for borrowers rated below investment grade, which constitute the majority of developing countries, and access could be lost or diminished. Recent modifications to reduce capital requirements in response to the recognition of diversification benefits for lending to SMEs were welcomed. It was suggested that there could be a flattening of the IRB curve for developing countries as well, to take account of the lower correlation of their risk with developed countries.

19) Finally, it was stressed that the Basle Committee's membership should be broadened to reflect new realities, and to make sure developing countries' perspectives and problems are sufficiently addressed. Accordingly, it was essential that developing countries were invited to become full members of the Basle Committee.

20) Global economic governance and developing country participation was the last topic discussed in the conference. A first theme that emerged was that there are two different, yet interrelated, roles for global financial institutions. The first is systemic and associated with macroeconomic and financial stability as a global public good. The second role is developmental in nature, and comes from the recognition that the global economy is full of asymmetries that are basically North-South in character. One extreme manifestation of the asymmetries is the rationing of private finance to low-income, and on many occasions to middle-income, countries. These asymmetries imply two key roles for international financial institutions: a) to provide counter-cyclical finance to widen the room for counter-cyclical policies in developing countries and b) to support adequate provision of private and public flows to developing countries, particularly low-income countries.

21) The inadequate representation of developing countries in the governing bodies of the IFIs and their limited or complete lack of representation in crucial fora were emphasised. These aspects were seen as problematic on at least three grounds. First, they reduce the legitimacy of international financial arrangements. Second, developing country ownership of IFI country programmes and overall policies are limited. Finally, the stability and growth of developing countries have systemic effects, and their inadequate participation and ownership reduces efficiency and equity in the world economy.

22) Developing countries have almost no representation in the institutions that deal with systemic issues. One important reform aimed at strengthening developing country participation in global institutions that was outlined should be to increase their representation in key decision-making bodies of the IFIs, especially the IMF and the World Bank. Also, the membership of the Financial Stability Forum (FSF) should be extended to include some direct representation from developing countries, as these countries are very vulnerable to instability in global financial markets.

23) Regional co-operation among developing countries was seen as very important, including creating groups of developing countries sharing common interests, to pool their resources and agree to common representation in international organisations. It was also observed that regional organisations seem to give greater participation to developing countries than global ones. Their role in the international financial system should be strengthened for a number of reasons, including the growth of regional macroeconomic linkages due to the growth of intra-regional trade and capital flows, and risk-pooling, as regional and sub-regional development banks are likely to face lower risks than individual member countries.

24) Finally, it was emphasised that an important feature of governance of the international financial system is its incomplete character. For example, there is no international lender of the last resort. Under these conditions, second-best arguments may justify more national autonomy. In particular, capital account regulations, and the choice of exchange rate regime, should be maintained as an area of national policy autonomy.

25) The relationship between international rules and national autonomy will continue to be a major concern of global governance. A key issue is the relation between the conditions upon which international support is provided and domestic policy ‘ownership’. It was agreed that the defence of ownership is equal to the defence of democracy, and it does not make sense to promote democracy if national institutions do not have effective decision-making powers.

Introduction

On the 3rd July 2002, a major Conference on Enhancing Private Capital Flows to Developing Countries in the New International Context was held in London; it was jointly organised by the Commonwealth Secretariat, the World Bank and the Commonwealth Business Council. The Conference brought together senior policy-makers and regulators from developing and developed countries, and from the international financial institutions, as well as senior representatives from the private sector and academia.

The Conference had two main aims. The first was to analyse recent trends in private flows and their determinants, with a view to encouraging more and more stable flows, especially to low-income countries. The second was to evaluate progress on international financial reform, with a special emphasis on the perspective of developing countries.

This synthesis of proceedings is prepared as an input for the Commonwealth Finance Ministers' meeting in London in September 2002. It may also be of interest to the Annual Meetings of the IMF and the World Bank. The following were the main issues discussed:

- Private Sector Involvement
- Codes and Standards
- Mobilising Private Capital Flows to Developing Countries
- New Regulatory Developments: Basel II
- Global Economic Governance and Developing Country Participation

In opening the Conference, Dr Mohan Kaul, Director General, Commonwealth Business Council, set the symposium in the context of recent turbulence in financial markets. In this environment, the issues to address were seen as:

- Contributing to the debate on private sector involvement (PSI) in crisis resolution.
- The role of Codes and Standards (C&S).
- Possible routes to increasing private capital flows to a sustainable and developmentally suitable level.

Mr Winston Cox, Commonwealth Deputy Secretary General, emphasised that a main task to emerge after the Monterrey Consensus is to translate the shared view on the importance of private capital flows and financial stability to development efforts, into practical steps that can be taken by policymakers. Two key issues were identified:

1. How to create domestic and international conditions to increase the level of private capital flows to the developing world – particularly Africa and the poorest countries? It is accepted that private investment is good for sustained economic growth. FDI is seen as particularly important due to its potential for technological and knowledge transfers and, ultimately, the eradication of poverty through growth. Given this, it is important that efforts to create a stable economic environment are made, with established property rights, an open and transparent system, skilled labour force, and sound accounting standards.
2. How to prevent – or if they occur, manage better – financial crises? To further this aim, continuous improvement of the international financial architecture (IFA) and comprehensive implementation of Codes and Standards (C and S) is needed. These subjects have sometimes been portrayed as developed versus developing world issues. However, Mr Cox saw no such dichotomy. The rationale and principles behind the need for financial stability are the same for both developed and developing countries, and the former's longer experience of progress in these areas has not prevented recent scandals in the corporate world.

It should be accepted that some countries will not be able to rely on private capital flows, even if they get all the fundamentals right. The funds established by the Commonwealth Secretariat are important. These funds seek to mobilise investment through regional venture capital funds, acting in the process as catalysts in leveraging additional private capital flows while seeking a commercial rate of return.

The conference must address issues seeking to ensure that the developing world is not starved of the investment it needs to develop.

Opening Session: International Codes and Standards and Private Sector Involvement in Crisis Resolution.

The Chair, Earl Cairns, Chairman, CDC Group Plc and Chairman, Commonwealth Business Council, UK, highlighted the important role that this regular conference had come to play by providing a bridge between governments, regulators and private companies. He also stressed the particular importance placed on the subjects under discussion by the recent financial turbulence in the markets. In this context, Earl Cairn identified the following points as crucial:

1. The slowdown in global growth in the last twelve months has hit the developing world most strongly.
2. It is important, therefore, for regulators to ensure that their jurisdictions are attractive for both domestic and foreign investment.
3. The recent scandals involving Enron and WorldCom highlight the fact that the developed countries have no room for complacency on issues of corporate governance. Both developed and developing countries have a lot of work to do in this area.

Recent developments have negatively impacted upon investor's appetite for risk and their willingness to lend and invest in developing countries. This is particularly problematic for developing countries that have made large efforts to make painful reforms – designed to increase attractiveness to private capital flows. These countries now need to demonstrate to their peoples some of the fruits of this process. However, private capital flows remain well below the levels of the mid-1990s.

Keynote Address Paul Boateng, Chief Secretary to the UK Treasury

Mr Boateng stressed that the current challenge is to ensure that at a time of crisis we recognise that there are both problems and opportunities. We need to seize the latter to ensure that we come through this time stronger.

The current period is one of recovery. However, only co-operation will ensure that this recovery is sustained and succeeds. There is a need to ensure that this recovery is balanced and is robust enough to be able to withstand external shocks. Lessons must be learned and a shared commonality of interests built. There is no better context to achieve this than the Commonwealth, which is a unique institution.

Financial and economic stability is crucial for poverty reduction. The practical agenda of this conference provides a good way of contributing towards this goal. The outcome of the conference will inform the work of Commonwealth Finance ministers, and the forthcoming conference will be a milestone where the previous work at Monterrey and elsewhere will be built upon. The heart of the meeting will be to develop an action plan to deliver the Monterrey Consensus through the Commonwealth.

Huge challenges remain in the developing world: millions of children receiving no education; millions living on less than a dollar a day; children dying from preventable disease and billions in poverty. Globalisation is not benefiting the very poor in some Commonwealth countries. However, there are also opportunities in terms of growth, development, and poverty reduction. These benefits will only happen, however, if the correct structures to 'harness market dynamism' are in place.

Globalisation has long been with us. The challenge is not to retreat into isolationism – no country has reduced levels of poverty in isolation. However, the developed world needs to practice as well as preach; tariffs to developing country exports and subsidies for developed country producers must be reduced. Aid is necessary but not sufficient to reach the millennium goals of poverty reduction. It must be made more effective and used to leverage private capital flows. A new 'Marshall plan' is needed, with the transfer of resources going hand in hand with reform of the international financial architecture (IFA) and improvements in the terms of engagement for developing countries.

The Chief Secretary then outlined Gordon Brown's reform proposals:

- On crisis prevention, those countries that most need foreign capital are also those most subject to the whims of the market. Capital is more likely to stay in stable economies with good macroeconomic management: this is not an option, but essential.
- C&S are a crucial part of this process.
- The previous 'rush to liberalise' was a mistake; it is now recognised that a more measured approach is needed.
- The IMF should increase its surveillance role to monitor potentially unpayable debt, identify developing exchange rate problems and, where necessary, provide emergency funds in a crisis.
- A better framework of crisis resolution is also needed. Too often countries are faced with the choice between sticking with unsustainable policies or descending into turmoil and crisis.

Private Sector Involvement

The emerging market crises of the 1990s continue to happen at present, causing large GDP losses, important social costs, swings in the capital account and huge financial needs. The discussion of the private sector involvement in crisis resolution was placed against this backdrop.

Although the IMF has made available financial packages to counteract past and current crises, it was recognised that these resources have been largely insufficient to meet the countries' financing needs, given the resistance by developed countries to support and fund larger packages. In face of that, conference participants were in agreement that the private sector should contribute to debt resolution problems, mainly in cases it is clear the country is facing a solvency problem. However, unlike the 1980s, when involving the private sector in crisis resolution was possible with the existing mechanisms, today a different approach has to be sought.

In the 1980s, crisis resolution involved direct debt restructuring via Brady negotiations. This approach is not possible today for the following reasons. First, the scale of private capital flows has increased significantly. Second, the private actors involved are much more numerous and diverse. They hold sovereign bonds that have different legal characteristics, making the way to co-ordinated debt restructuring more difficult. Third, markets are much more integrated today, with domestic financial liberalisation being promoted alongside capital account liberalisation, thereby permitting direct transmission effects on the domestic markets. This implies that domestic actors (e.g. domestic banks and corporates) are directly involved in the crisis.

Thus, although crises continue to happen, there is a vacuum in the international financial system today. There are no clearly established mechanisms for sovereign debt restructuring, nor are there sufficient official financial resources available to support countries to prevent crises or to manage them efficiently when they occur.

In this context, the two current proposals that involve the private sector in crisis resolution – the Krueger proposal and the voluntary approach - were discussed in some depth during the conference.

The Krueger proposal consists of the establishment of a sovereign debt restructuring mechanism (SDRM) that can be invoked by sovereign debtors. In this framework the majority of creditors would decide for restructuring, and an independent judicial body would be established to supervise inter-creditor disputes and the organisation of votes. The degree to which the IMF would be involved in this framework has been a subject of debate by the international financial community. In this regard, an official sector representative reported that the Fund would be involved only as a provider of finance for economic and financial adjustment.

The assumptions underlying the Krueger proposal are that a market-based approach would not work due, first, to 'aggregation problems'. That is, there are at present too many different creditors, with bonds issued under different jurisdictions. Second, 'rogue creditors' could disrupt negotiations on debt restructuring.

However, a strong case was made for a voluntary approach, especially by private sector representatives. The view expressed was that, under the voluntary approach, collective action clauses (CACs) could play a major role in crisis resolution. This is seen as feasible, as today there is a narrowing in the differences within the private sector regarding the acceptance of CACs. The challenges this alternative approach faces are to make CACs work better in practice, and to convince investors that CACs are an opportunity and not a threat.

The assumptions underlying the sovereign debt restructuring mechanism were questioned. It was argued that, although it is always possible that 'rogue creditors' can disrupt negotiations, major bond restructuring in Russia, Ecuador, Pakistan and Ukraine shows that a voluntary approach is possible. As regards the 'aggregation problem', the point was made that bank lenders and bond holders would be more inclined to co-operate, if they perceived they were receiving fair treatment in relation to other creditors. Moreover, if the necessary majority needed for debt restructuring were not achieved, the exit consent strategy could constitute an alternative. Under this strategy, if the majority of bondholders agree to a bond exchange offer, they may in the process eliminate many of the clauses of the old bond contracts. This would encourage those remaining bondholders, and unwilling to restructure, to also agree to a bond swap in order to avoid being left with tainted bonds.

The types of CACs that are likely to be accepted by the private sector include:

- Majority action clauses, which allow a qualified majority of creditors to agree to a change in the terms of a debt contract that is binding on all bondholders.
- Non-acceleration clauses, which require a minimum threshold of bondholders before an immediate repayment of principal can be demanded, following default.
- Collective representation or engagement clauses, which define mechanisms for co-ordinating discussions and possible action between the issuer and bondholders (ideally through a trustee).

The view was expressed that the existence of non-accelerating clauses in combination with a strong provision for collective representation would do most to constrain the actions of the rogue creditor, and reduce the risk of litigation. Moreover, a strong provision for collective representation through a bondholder trustee would improve the communication between creditor and issuer.

It was observed that issuers do not pay a price for including CACs in bond contracts. It was noted that empirical evidence shows that there is no difference in spreads between English and New York law bonds, despite the fact that only the former includes CACs.

A developing country representative noted, however, that it is important to introduce some elements of realism in the private sector involvement debate. First, it was observed that whilst capital flows have been growing at 12.3% per annum, IMF resources have been growing at 1.3% since the 1970s. This implies scarcity of IMF resources. Second, to date there are no effective resolution mechanisms in place. The current ones have limitations and have failed to reduce systemic risk and coordination problems. Moreover, institutions have not been strengthened. As a consequence, GDP has fallen by 6% to 8% in debtor countries following failure, wages fell by 40% to 60% and the EMBI+ spread increased by 370 base points.

The current crisis in Argentina illustrates well what is happening, due to the absence of a framework in place for debt restructuring, and lack of official liquidity: the GDP has dropped dramatically, as has the country's currency, leading to an increase in the debt to 149% of the country's GDP, massive unemployment and high social costs.

Thus, a shared feeling among the participants in the conference was that whilst discussions on private sector involvement are important, still crises continue to happen due to a lack of an effective framework for debt restructuring in place. Therefore, more official liquidity is needed to prevent new crises and stop the ongoing ones being further aggravated.

Codes and Standards

There was general acceptance among participants about the importance of international codes and standards. There was consensus that their aims were to provide transparency, prevent crises and help developing countries tap international capital markets, thus assisting their development process. Codes and Standards can offer valuable benchmarks for developing and transition economies to improve their financial sectors. Thus, Codes and Standards were seen as potentially playing a very significant role.

However, a number of serious concerns were expressed about the inherent limitations of Codes and Standards (C and S), as well as a number of problems identified in relation to the ongoing process of implementing them, and several suggestions for improvements made.

There were very strong doubts expressed, including by the private sector, about whether C and S were effective in assessing vulnerability and preventing crises. The fact that Argentina had complied so well with C and S, and had been so positively evaluated on C and S by international organisations, was emphasised. However, C and S reports failed to capture what made Argentina vulnerable to crises (naturally Argentina was an extreme case). More critically, one participant stressed that implementing C and S had not diminished financial crises, nor had it improved developing countries access to private flows.

It was noted that a key vulnerability indicator was the government and the private sector balance sheets, thus requiring their explicit assessment; also, the need to evaluate debt sustainability, especially for middle-income countries, was stressed. A problematic aspect of this proposal was by whom and when would sustainable thresholds be defined?

Private sector participants also stressed the fact that the link between transparency and credit-worthiness is problematic, and there is a risk that rapid increase in transparency may actually cause crises. For example, very frequent disclosure of foreign exchange reserves may be misread by markets and increase volatility.

Thus improved information – though broadly good – may be very problematic at times. More generally, the private sector apparently was not very informed about C and S, and thus did not use them much.

Senior developing country policy-makers also stressed a number of problematic aspects, from their perspective. First, there was lack of adaptation of C and S to local conditions. This "one size fits all" approach should be adapted to provide more flexibility. Second, there was high cost to countries in an early stage of development. Thirdly, shortage of technical skills was a major barrier for implementing them. Fourth, the number of C and S was seen as very large.

There was a particular strong concern that C and S do not necessarily contribute to growth and poverty reduction, and may even discourage them in some instances. Given the priority that developing countries – and the international community – attach to growth and poverty reduction, an important challenge is to adapt C and S so that they contribute to create a financial sector supportive of economic development, as well as safeguarding financial stability.

The complexity of the process of designing and implementing C and S was highlighted. It was stressed that different codes were designed by different organisations (e.g. private sector, OECD, Basle Committees, IMF), with different bodies having different levels of global representativeness, with some being more legitimate than others. Furthermore, their different origin implies that compliance assessment cannot be made mechanically nor can C and S be evaluated on a numerical scale. Furthermore, the changes required need to be carried out at various levels (e.g. legislative, regulatory, etc) with the different levels inter-linked. Therefore, assessment through an integrated approach should be adopted.

It was suggested that C and S should not be based on single models, but should have some flexibility, to reflect local cultures and economic policy frameworks. This should be so, particularly in the initial transition period; in the long-term there may be a need for globalised C and S, but this is not feasible at present. Also, C and S need to be understood as a long-term process, carried out gradually and requiring institutional change. Furthermore, C and S themselves would need to evolve, as definition of best practice changes, even in developed countries.

Because implementing C and S should not reflect a single model and because implementing them through institutions implies a longer process, it was not deemed appropriate that they become part of conditionality. An issue raised was the extent to which self-assessment by countries, with a peer review, was a better alternative to external assessment.

A very important issue from the perspective of developing countries, is that C and S are defined, formulated and implemented, in fora with democratic representation, including from developing countries. This could even include mechanisms for conflict resolution on C and S, as this is part of good governance practice. These latter proposals would encourage a greater sense of ownership of C and S by developing countries, which tends to be seriously lacking at present.

It was also stressed that financial stability is a global problem, and it is equally important that developed countries also comply with C and S. Both very large developing countries (e.g. India) and smaller ones (e.g. Barbados), represented amongst the speakers have made significant progress in implementing C and S, as they recognise their importance.

Mobilising Private Capital Flows to Developing Countries

Private capital flows to developing countries rose significantly through the early 1990s, and have fallen sharply since 1997. The decline in private capital flows can be put down almost entirely to the fall in bank lending and portfolio flows. The main reasons are financial crises in emerging markets and especially the Russian default. This has been compounded by an increase in investors' risk aversion. Concern was expressed that the problems of corporate governance and accounting standards in the developed world would impact most severely on developing countries.

In terms of components, Foreign Direct Investment (FDI) flows increased steadily during the 1990s. It is often noted that private capital flows, including FDI, are highly concentrated. However, this is less obvious when they are weighted by GDP. Since the mid 1990s, FDI has played an important role in inflows to Latin America. In Eastern Europe FDI flows were steady, and in Sub Sahara Africa they were relatively higher than to South Asia and the Middle East. Since 2000, FDI to developing countries has started to decline somewhat due to slowdown in privatisations, weaker earning growth of multinationals and worse economic performance in the US.

In the 2001-2002 period, capital market flows have gone mainly to Asia and some to Eastern Europe – with nothing going to Latin America. Post Asian crisis, bank lending flows to developing countries turned negative – then began a recovery, but they have now turned negative again. Especially short-term lending became negative (which is a positive thing). Three key trends were seen in bank lending: the tightening of lending standards (which represented an over-reaction); sharp falls in bank lending from Japan; and European bank lending stayed in, now representing the main source of lending to Emerging Markets.

Developing country stock markets did not perform worse than other markets, but the risks were higher. Flows into developing country stock markets came mainly from the new 'cross-over' investors (global mutual funds and hedge funds dealing in high-yield securities); the investor base narrowed, as investment by more dedicated investors fell quite sharply.

Representatives from the private sector, however, highlighted that emerging markets as an asset class are attractive. In the long-term, emerging markets' assets are likely to outperform OECD assets, as their current valuation is lower, even though OECD assets are more liquid.

In terms of spreads, risk premia increased greatly in the mid 1990s and have stayed high. Spreads have moved more than ratings. Investors and lenders have become more sensitive to risk appetite.

In spite of economic reforms and implementation of codes and standards by developing countries, serious concern was expressed that "the emperor could have no clothes", as private capital flows have fallen sharply, could remain very low for a long period, and are often very volatile. In this context, three challenges were highlighted.

1. What policies can be pursued to encourage capital flows to low-income countries? What additional roles could multilateral development banks and export credit agencies play? What additional policies, e.g. improving infrastructure, should developing countries adopt to encourage such flows?

2. The cost of borrowing for developing countries has deteriorated greatly in the last five years – with costs rising and maturities shortening.
3. There has been an increase in volatility since the crises of the 1990s. For Latin America, volatility has been part of their history. For East Asia, capital flows have become much more volatile, with the 'sudden stops' having a far more negative impact than average volatility. The rapid increase in risk premia if problems are perceived by markets usually sharply deteriorates countries' balance sheets, and makes crises far more likely. What can be done to make capital flows to middle-income countries and their cost more stable?

Though many developing countries face a serious shortage of capital as a result of the financial crises of the 1990s and the global economic slowdown, some emerging countries e.g. transition ones in Central Europe, 'suffer' from an excess of capital.

The case of the Czech Republic was discussed to illustrate this point. In this country 20% yearly exchange rate appreciation has represented a major problem in recent years.

The Czech Republic was hit by the currency turmoil of 1997. It is interesting that the currency crisis gave rise to some positive changes, as it became a driving force for a number of necessary reforms. The bank privatisation programme was accelerated and institutional and supervisory issues came to the fore, all of which helped to restore the confidence of foreign investors.

The Czech Republic, together with other Central European countries, aims at early membership of the European Union and, later, the adoption of the Euro. This strategic orientation of the region, together with NATO membership, makes the region less vulnerable to uncertainties and yields substantial political stability. However, it also implies some costs. Central European countries will have to remove capital controls. Moreover, convergence may trigger exchange rate appreciation.

The role of investment incentives in Central and Eastern Europe was discussed. Such incentives were seen in practice as important. FDI is one of the key factors in restructuring and achieving convergence with the advanced economies. In the early stages of transition, the attitude of the Czech policy-makers was sceptical towards investment incentives. While the Czech Republic attracted some FDI, it received less than Poland or Hungary. Later, there was a large change with the Czech Republic creating a comprehensive package of incentives for foreign investors. This contributed to a major increase in FDI, even though such incentives may have other negative effects.

New Regulatory Developments: Basel II Capital Accord

The discussion of Basle II was placed in the broader context of increased relative importance of private – as opposed to public – capital flows to developing countries in the last fifteen years. However, it was stressed that since the Asian crisis there had been dramatic declines in net private capital flows to both emerging and low-income countries. The decline is particularly sharp in bank lending to developing countries, which even became highly negative for most of the last four years. A serious concern was expressed that there were important structural components in the sharp decline of international bank lending to developing countries, such as banks increasingly "crossing" the border, buying subsidiaries in developing countries and lending mainly in local currency; the memory of recent numerous crises also has naturally made bankers reluctant to lend.

Though it would not be desirable to return to excessive bank lending to developing countries, the main danger at present is insufficient bank lending. This is particularly worrying given that the G-7, and the UK government in particular, have rightly stressed the important role that private capital flows should play in development.

Current progress on the proposed new Basle Capital Accord was reviewed by the Secretary General of the Basel Committee on Banking Supervision. The proposed new Capital Accord would have three mutually reinforcing pillars: 1. Minimum capital requirements (where work is reportedly well advanced). 2. Supervisory review and 3. Market discipline.

The aim of the regulators is to create a risk-sensitive capital accord, that does not increase overall levels of capital. A key concern shared by all speakers is that increased risk sensitivity due to the new Basle Capital Accord may excessively increase pro-cyclicality. Banks are best at evaluating relative risk, at a particular point in time; increased use of their own models in the proposed Basle Capital Accord should enhance this positive aspect. However, banks and the models they currently use, are not good at evaluating risk through time. That is, they have a tendency to behave pro-cyclically. There is a growing recognition that this is the key market failure that should be addressed by regulators. The problem of pro-cyclicality of international bank lending (and of other capital flows), is particularly damaging for developing countries, as the impact and cost of crises is much higher than in developed markets.

For calculating capital requirements for credit risk, the proposed new Basle Capital Accord suggests three possible approaches: 1. Standardised approach, 2. Foundation Internal Ratings – based Approach (FIRB) and 3) Advanced Internal Ratings-based Approach (AIRB). In the future, the aim of the Basle Committee is to move to full Credit Risk Modelling.

The Secretary General of the Basel Committee on Banking Supervision outlined the next steps in the process:

The final quantitative impact study (QIS3) will commence on October 1st 2002. The outcome of QIS3 will be the final consultative paper (CP3), to be published by Spring 2003. This will be followed by a short consultation period of around three months.

It is planned at present that the final Accord would be published in the autumn of 2003, for implementation at the end of 2006.

As regards recent evolution, all the speakers agreed that there had been major problems with the second Consultative Paper (CP2) on Basle issued in January 2001; though several of these problems had been overcome to a fairly important extent by subsequent modifications. However, several important problems remain, particularly but not only, from the perspective of developing countries.

Among the concerns expressed by developing countries, which have been addressed in recent modifications is, for example, the need for a simplified standardised approach. The proposed solution includes the development of the simplest version of the standardised approach (only 12 pages long). Also, the Basle Committee has increased recognition of physical collateral under the FIRB approach as requested by developing countries. Similarly, in relation to the request for more room for partial use of IRB, the Basle Committee has committed itself to be very flexible, on the condition that this flexibility does not result in pure cherry picking. It was also welcomed that subsidiaries of international banks operating the IRB approach in developing countries will be able to stay on the standardised approach for a transitional period; concern was expressed, however, that this would be only temporary. As developing and transition economies have large parts of their banking system in foreign ownership, if these subsidiaries had to move to the IRB approach, they could face a large disincentive to lend domestically to lower rated borrowers who would lose access to bank finance. The Basle Secretariat, as well as other institutions, have also made a commitment to provide as much technical assistance as possible.

As mentioned, several important problems still remain, which need to be urgently addressed. They include the following:

1. Increased cost and smaller supply of bank lending to developing countries. All speakers agreed that some impact was likely. It was argued that the impact on cost and availability could be reduced by the fact that minimum capital requirements are not binding constraints for some banks. It was also argued that the recent (November 2001) flattening of the IRB risk weight curve would imply that the possible increase in the cost of international borrowing for developing countries – or loss of access to any borrowing – would be smaller than under the January 2001 proposal. However, especially for borrowers in developing countries rated below investment grade – that is, in the majority of developing countries – costs could still increase fairly significantly, and access could be lost or diminished, as a result of the introduction of the IRB approach by international banks.

2. There was agreement that increased procyclicality as a result of implementing the Capital Accord could be a serious problem. It could lead to very negative effects, by creating credit crunches in downturns, thereby exacerbating economic downturns. Some suggested that modifications to CP2 - especially the flattening of the IRB curve – coupled with possible further modifications, such as the inclusion of mandatory stress testing in the Accord, would moderate the problem. However, several speakers argued that the problem remained a serious one and it was essential that this concern be explicitly addressed by the simultaneous implementation of counter-cyclical mechanisms such as dynamic provisioning, at the time the Basle Capital Accord was implemented. If this was not done, there was the fear that the risk-sensitive nature of the proposals would exacerbate, rather than mitigate, the increasing tendency of banks – and other market actors – towards short-term, cyclical behaviour. Of particular importance in this regard was the approach banks took to loan assessment: it was

stressed that banks should be encouraged/ required to adopt neutral, rather than explicitly pro-cyclical, models.

3. Recent modifications to reduce capital requirements, via explicit recognition of diversification benefits for lending to SMEs, were welcomed. However, these modifications would mainly benefit SMEs in the developed world. It was suggested that similarly to the case of SMEs, there could be a flattening of the IRB curve for developing countries, to take account of the lower correlation of their risk with developed countries (as compared to the correlation between developed countries), which implies that diversification of bank lending to developing countries could imply lower risk, and therefore require a lower capital charge than would be calculated under the present proposal. All speakers expressed interest in this idea. The results of ongoing empirical research on risk correlation between developed and developing countries would be carefully examined by the Basle Committee.

4. There was consensus on the importance of involving developing countries more in the Basle Capital Accord definition process. All speakers stressed the desirability that as many developing countries as possible join in the final quantitative impact study (QIS3), that will start October 2002, as they are now being invited to do so by the Basle Committee. For this purpose, they should contact William Coen at the Basle Committee, in the BIS. This would hopefully enable the final consultative document to reflect as much as possible the issues and concerns specific to different types of developing countries. It will also provide developing country policy-makers more in-depth insights into the likely effects of Basle II, and an opportunity to comment in more detail on the last consultative document.

Several speakers and participants stressed that it was also essential that developing countries are invited as soon as possible, to become full members of the Basle Committee. For this purpose, a formula could be adopted, by the Basle Committee, that would be similar to those employed in the Executive Boards of the IMF and the World Bank. Alternatively, a minimum representation could be assured by having one (or two) representatives from each developing country region (Asia, Latin America and Africa) on the Basle Committee. Such formulas would ensure developing country participation without leading to a much larger membership, which could imply decision-making was too cumbersome. It was emphasised that the absence of developing country involvement was something of a historical anomaly. The original Accord had been devised only for the G-10 countries; since then, the Basle Accord has became an international standard, applicable to all countries and having effects on all countries. Therefore, the Basle Committee's membership needs to be broadened to reflect new realities, and to make sure that developing countries' perspectives and problems are sufficiently considered.

Global economic governance and developing country participation

A first theme that emerged was that there are two different, yet interrelated, roles for global financial institutions. The first is systemic in character and is associated with macroeconomic and financial stability as a global public good. This involves co-ordination in macro-economic policies of developed countries and setting regulatory standards.

The second role is developmental in nature. It comes from the recognition that the global economy is full of asymmetries that are basically North-South in character. Whilst industrialised countries have greater manoeuvring room to adopt counter-cyclical policies during shocks, developing economies have limited or no room to cope with such shocks. In fact, developing countries are rewarded when they adjust pro-cyclically. One extreme manifestation of the asymmetries is the rationing of private finance to low-income, and on many occasions to middle-income, countries. These asymmetries imply two key roles for international and financial institutions: a) to provide counter-cyclical finance to widen the room for counter-cyclical policies in developing countries and b) to support adequate provision of private and public flows to developing countries, particularly low-income countries.

The United Nations Conference on Financing for Development in Monterrey was the first time that these two agendas were truly integrated, and that should be a standard from now on, against which to measure progress.

Good governance at the global economic level matters for two reasons. Firstly, if markets fail, the poor will lose out more, as costs associated with market failure fall more on poorer countries and peoples. Secondly, when markets work well, they reward far more those who already have assets. Therefore, the global economy needs political arrangements to deal with market failures and asymmetries, as well as with market successes. It is crucial that this global governance is as representative as possible. Important parallels can be drawn with the national level, whereby domestic politics offsets economic power; similar mechanisms are required globally.

The inadequate representation of developing countries in the governing bodies of the IFIs and their limited or complete lack of representation in crucial fora is problematic on at least three grounds. First, it reduces the legitimacy of international financial arrangements. Second, developing country ownership of IFI country programmes and overall policies is limited. Finally, the stability and growth of developing countries have systemic effects, and their inadequate participation and ownership reduces efficiency and equity in the world economy.

It was therefore argued that the benefits of global integration can more than offset the costs for poor countries and the poorest in those countries only if there is better representation of developing countries in global economic governance. Such better and more legitimate global governance would enhance not just economic efficiency and financial stability, important as they are, but could also address large disparities in global wealth and income.

It was argued that developing countries feel they have received a raw deal in the international arena, and that this is partly due to existing decision structures. The reform efforts in the international architecture for finance, trade and development, provide an important opportunity to enhance developing country participation in global institutions.

Developing countries have much to gain from participating fully in global institutions, which can help improve their policies and strengthen their credibility so as to promote growth and investment. Full commitment by developing countries to these institutions and their conditionality can be harder to sell if these are perceived as simply the instruments of rich countries. It is therefore important that international financial institutions such as the IMF, World Bank, BIS and FSF, are – and are perceived to be – both by developing country governments and by NGO's, as more democratic. Following principles developed in relation to democratic governance, there is a need for explicit definition of the basic rights of developing countries, including smaller ones; following corporate governance principles, this requires the explicit definition of rights of minority shareholders.

Developing countries have almost no representation in the institutions that deal with systemic issues. Obviously, they have no representation in the G7 and the G10. They are invited to, but are not part of, the Financial Stability Forum and the Basle Committee on Banking Supervision. Of the institutions dealing with systemic issues, only in the IMF do developing countries enjoy membership, and the IMF is becoming restricted in its systemic role. Even in the IMF and the World Bank, developing countries have insufficient participation.

Some of the reforms necessary to strengthen the participation of developing countries in global institutions were outlined. One important reform should be to increase the representation of developing countries in the key decision-making bodies of the IFIs, especially the IMF and the World Bank. The current voting structure of these institutions reflects members' capital subscriptions – which naturally favours the rich countries. A system of weighting that takes account of other factors – such as the population size of a country, or purchasing power parity (PPP) GDP – would be more equitable and would give a greater voice to developing countries. Another proposal put forward is to strengthen the role of the IMFC (formerly the IMF's Interim Committee) in decision-making as it has a slightly more equitable voting composition than the Executive Board.

It was emphasised that the membership of the Financial Stability Forum (FSF) should be extended to include some direct representation from developing countries as these countries are very vulnerable to instability in global financial markets. The Basle Committee on Banking Supervision should also have some representation from developing countries.

Developing countries would also benefit from more technical assistance to help them participate more effectively in global institutions. Developing countries are often impeded by their acute shortage of specialist expertise (for example in WTO negotiations).

Regional co-operation among LDCs was seen as very important, including creating groups of developing countries sharing common interests, to pool their resources and agree to common representation in international organisations. If it is rational for the European Union to represent its members in international organisations such as the WTO, it is surely rational for developing countries' regional groupings to do the same. There are currently important initiatives in Africa to strengthen regional economic co-operation, and these should be extended to co-operation to pursue common interests in the international arena.

More generally, the role of regional institutions in the international financial system needs to come far more to the fore. This is the case for a number of reasons: a) the growth of regional macroeconomic linkages due to the growth of intra-regional trade and capital flows; b) risk-pooling, as regional and sub-regional development banks, even those entirely made up of developing countries, are likely to face lower risks than individual members; c) given the heterogeneity of the international community, world and regional institutions can play useful complementary roles. For example, regional institutions can play a useful role in setting and helping implement standards as they are more aware of the specific problems and conditions of the region; d) competition between global and regional organisations in the provision of development bank services, emergency financing and technical support can be very valuable, especially for smaller countries. The voice of small and medium-sized countries is unlikely to be strong in global institutions, and can be louder in regional ones. And finally, f) regional and sub-regional institutions bring a greater sense of ownership, which creates a special relationship between them and the member countries.

Regional organisations seem to give greater participation to developing countries than global ones. One example quoted is the Inter-American Development Bank, where borrower developing countries have 50% of the votes, 9 of the 14 chairs on the Executive Board, and elect the President. This governance structure affords a greater sense of ownership and a stronger focus on regional priorities.

One speaker argued that the international financial architecture should be seen as a network of institutions that provide services, rather than a few specialised world organisations. The International Monetary Fund of the future should be viewed as the apex of a network of regional and sub-regional reserve funds and swap arrangements (a structure more akin to the European Central Bank or the United States Federal Reserve Fund). In turn, competition in the provision of development finance between the World Bank, the regional development banks and a growing set of regional and sub-regional banks owned by developing countries could be the best arrangement in this area.

Finally, it was emphasised that an important feature of international governance is its incomplete character; for example, there is no international lender of the last resort. Under these conditions, second-best arguments may justify more national autonomy. In particular, capital account regulations should be maintained as an area of national policy autonomy. For the same reason, the choice of exchange rate regime should continue to be an area under national autonomy.

The relationship between international rules and national autonomy will continue to be a major concern of global governance. A key issue is the relation between the conditions upon which international support is provided and domestic policy ‘ownership’. It was agreed that the defence of ownership is equal to the defence of democracy, and it does not make sense to promote democracy if national institutions do not have effective decision-making powers.

The Conference ended with a keynote address by Trevor Manuel, Finance Minister of South Africa and Chairman of the Development Committee. Trevor Manuel spoke about the international financial architecture, international trade and development finance in the context of the Monterrey Consensus. The Monterrey Consensus highlighted the need to mobilise private capital flows.

A fundamental aspect of the new global order stressed was interdependence. The US economy faces twin deficits, a sharp fall in foreign inflows (including FDI) and in the stock markets. Sentiment has changed in response to corporate failure. These events show that volatility is becoming an issue for the US for the first time in many years, and that interdependence is extremely important. This means that institutions that manage interdependence are key.

In the last two decades the world witnessed a change in the size and structure of the international capital markets, with increasing flows between developed and developing countries in the first half of the 1990s, widely viewed as a positive contribution to development. However, in the second half of the 1990s, these flows became very reversible, resulting in a series of declines in output, investment, and employment as well as in dramatic increases in poverty. Clearly, financial liberalisation offers both opportunities and new risks. It affects macroeconomic stability by posing risks to financial stability. Risks also arise if liberalisation is not properly sequenced and co-ordinated with complementary policies, regulatory regimes and substantially improved supervisory capacity. Unfortunately, lack of prudent capital account liberalisation seems to have predominated. A recent study shows that of 35 countries that have promoted financial liberalisation, 24 countries experienced financial crises. In the context of fully liberalised capital accounts, the corner solutions that have been proposed for exchange rate regimes will not work. There has to be something in the middle, which would certainly involve issues such as a modicum of capital controls.

As regards international financial architecture, an important aspect is regulation. There are positive aspects in the new Basle proposal. However, problems remain, including the proposed reliance on credit rating agencies, given their poor record in identifying risk, and the fact that bias towards short-term inter-bank lending is not eliminated. More fundamentally, it is disappointing that the most important regulatory development since the Asian crisis may increase, rather than reduce, the risk of future crises and may discourage international lending to developing countries.

Codes and Standards are generally regarded as positive. However, the following concerns were raised: too little participation by developing countries in standard setting bodies, the 'one size fits all' approach, the assumption that developing countries have technical capacity and resources to implement them, despite clear capacity constraints, and the fact that C&S are now being used as conditionalities.

A further, key issue in the discussion of the international financial architecture, is liquidity financing. The contingent credit line (CCL) was proposed by the IMF three years ago to help countries avert crises caused by contagion, but no single country has applied for it. Many of these initiatives – on Basle II, C&S and CCL - are being taken by IFIs, but with very little degree of developing country participation. At the World Bank and the IMF Boards, the entire African continent is represented by only two Executive Directors (ED); Therefore, Africa participates in the Bretton Woods institutions, but has a very limited voice. The Financial Stability Forum (FSF) has only the participation of developing countries in working groups on an ad hoc basis. Only one African country participates in the G-20. These institutions are designed to oversee financial flows, yet are structured along lines that are fundamentally un-democratic. Unless we look for voice and representation, this generation will again fail to understand the true meaning of interdependence, and the institutions that must support it.

As regards global trade issues, the Monterrey Consensus speaks clearly about market access, and is very strong on the issues of support for the development round discussed in Doha. Yet, developed countries continue to support their agricultural sectors with large subsidies, and the recent evidence is that these are increasing rather than being reduced.

As regards HIPC, Uganda, the first country to pass the completion point, produced last year 4 million bags of coffee for which they earned 50% of what they had earned 5 years ago by producing much less. What they saved from debt service was therefore more than offset by the negative trends in their terms of trade, and the country cannot afford to repay its debt despite all adjustment efforts it has made. This shows the importance of the issue of declining terms of trade, which is especially true for small countries dependent on single commodities.

As regards ODA, of all the OECD countries, only 5 have met the 0.7% of GDP target, and a decline in ODA from OECD countries from U$ 53.7 billion to U$ 51.4 billion was observed between 2000 and 2001.

Trevor Manuel concluded by making reference to NEPAD. The initiative recognises interdependence and the fact that new institutional arrangements are needed to construct a new partnership. This new initiative also understands that even if 2015 targets are met, developing countries will be way below the global norms. This means that the challenges are enormous. Finally, Trevor Manuel asked the Commonwealth to be a vigorous partner in this initiative, and within that to contribute to development co-operation and technical assistance.