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The Search for a Stable and Equitable Global Financial System

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1. Introduction

This paper will start with a broad overview of progress on international financial reforms. It will then try to develop in some depth a conceptual framework to evaluate progress on crises prevention. This will examine key features of the financial sector and its' interactions with the macro-economy, leading to some policy proposals. This framework will also be applied to an analysis of proposals on Basle 2.

In the second part, the paper will look at issues of post-crises recovery, focussing especially on encouraging private flows in times of drought, and trying to ensure that resulting flows are more stable. As in the previous section, the need for counter-cyclical regulations mechanisms, incentives and policies will be stressed.

In the third and final part, issues of representation of developing countries in global financial governance will be examined, and concrete proposals will be made.

2. Aims of international financial policies and progress in international reforms

The financial crises of the late 1990s generated a broad consensus that fundamental reforms in the international financial system are needed to appropriately address the challenges of the 21st century: how to prevent financial crises and better manage them when they occur, and how to provide adequate net private and public capital flows to developing countries, in support of poverty eradication and sustainable development (Griffith-Jones and Ocampo, 2003).

Progress in improving the international financial system has nonetheless suffered a number of problems.

- First, there has been a lack of an agreed international reform agenda for crisis prevention and management. In this context, a few developed countries have set priorities that are not always explicit and that have varied over time. On development finance, the Monterrey Conference of March 2002 provided a full international agenda. But more action for implementation of key commitments is urgently needed, such as increasing significantly the volume of aid flows to poor countries, providing partial counter-cyclical financing to middle-income countries, making public funds to act as catalysts for new forms of private investment, and providing global and regional public goods.

- Second, progress made so far has been uneven and asymmetrical in key aspects. The focus of reforms has been on strengthening macroeconomic policies and financial regulation in developing countries. Specifically, advances in these countries have taken place via implementing codes and standards in data dissemination, monetary and fiscal policy transparency and banking supervision. However, far less progress has been made at the international and regional levels. Furthermore, as discussed in some detail below, crises prevention actions taken even at the domestic level do not sufficiently or appropriately reflect imperfections in financial markets and their interactions with the macro-economy.

- Third, at the international level a few important steps have been taken, such as the creation of the Financial Stability Forum (FSF), and IMF financial facilities, namely the Supplemental Reserve Facility (SRF) and the Contingent Credit Line (CCL). However, some reversals have occurred in this area. For example, the CCL, designed to provide quasi-automatic liquidity to solvent countries suffering from contagion effects from crises elsewhere, was eliminated in November 2003. Another problematic development has been the rejection by the IMF Board of advanced proposals for a structured orderly debt workout - the Sovereign Debt Restructuring Mechanism (SDRM), a proposal that had been strongly

endorsed by the IMF management, at the most senior level. It would seem that the main reason behind this rejection may have been the opposition by the private sector, which opposes rules, which they perceive would facilitate debt restructuring. Many analysts, however, believe that the main effects of a mechanism such as SDRM are to facilitate a more orderly restructuring, by overcoming collective action problems. Should the restructuring of the Argentine debt prove very intractable, the SDRM discussion however could return. A second reason that may have contributed to a rejection of the SDRM is that some emerging countries fear that the introduction of such a mechanism could further discourage private flows to them. Nevertheless, the recent quite widespread use of collective action clauses by developing countries is an important step forward.

- Finally, reforms have been characterised by insufficient developing country representation in key fora, such as the IMF, the World Bank and the Bank for International Settlements, and by their total exclusion in the cases of the Financial Stability Forum and the G-10 Basel Committees (Griffith-Jones and Ocampo, 2003). We will argue that this lack of or limited participation by developing countries slows down progress in reform of the international financial architecture, reduces efficiency and effectiveness of IFIs to achieve their goals and due to the implicit democratic deficits weakens the legitimacy of these crucial institutions.

There is thus a clear a gap between the consensus reached on the need for fundamental reforms in the international financial system, and progress made so far to ensure the achievement of global stability and increased prosperity that would help meet the Millennium Development Goals.

3. Crises prevention

Given the large number of crises in developing countries in recent years, their very high macro-economic and development cost for those countries, as well as

the potential and real costs to the international financial system of such crises, much effort since 1997 has focussed on crises prevention.

These efforts have been centered on development of international codes and standards for financial sector regulation, and their implementation in developing economies. Though they have problematic aspects (see, for example, Griffith-Jones and Ocampo, 2003 and Schneider, 2003) these efforts undoubtedly have many positive and valuable elements. There are however two important limitations. The first is that there has been far less and insufficient emphasis on improvements in global regulations, especially in sources countries. Equally or more worrying is the fact that the major international regulatory change being designed since the Asian Crisis (the new Basel Accord) runs the risk of having serous flaws, particularly from the perspective of development and developing countries (see below).

This leads us to the second, and perhaps least explored limitation of prudential efforts undertaken, since the Asian crises, that is their insufficiency by themselves to avoid unwelcome macro-economic costs associated with inherent imperfections of financial systems; there is growing evidence and support for the thesis that in a liberalized financial environment the risk of episodes of financial instability leading to large macro-economic costs is higher than in a more controlled regimes (for an excellent recent discussion, see Borio and White, 2004; see also Prasad et al (2003) for an interesting IMF endorsement of this position). The fact that banking crises were a recurrent feature globally before increased regulation in the 1930s suggests that these are not just one-off or purely transitional difficulties.

This second limitation arises partly from insufficient (though growing) understanding of the interrelationship between imperfections in financial systems, their impact on the macro-economy and the new regulatory needs. It also arises from insufficient application of existing understanding at the rapidly evolving frontier of knowledge in this field to the practice of regulation and of macro-economic policy due to implementation difficulties, bureaucratic inertia, or power of vested interests.

The new insights (which draw on a tradition that starts with Pigou and Fischer, and was developed more by Keynes, Minsky and Kindleberger) stresses the inherently procyclical nature of financial markets and their mutual interaction with the real economy. Indicators of risk perception decline sharply in good times (when in fact risk may be greatest) and increase sharply in bad times, overshooting both ways. Asset prices, risk spreads and provisions fluctuate sharply following risk perceptions. This partly reflects the fact that financial agents are far better at measuring the cross-sectional (in a moment of time) rather than the time dimension of risk, being on the whole rather bad at measuring and allocating risk over time (Borio and Crockett, 2000; Persaud, 2003; Borio and White, 2004). At the same time, there is a tension between individual rationality and desirable aggregate macro-economic outcomes, reflected in phenomena such as herding. This implies that recent slowdowns (both in developing and developed economies) may not mainly reflect tightening of monetary policy –though this may clearly play a role- but may result more from reversals of asset prices and levels of exchange rates, accompanied often by sharp reversals of capital flows in the case of developing economies, due to suddenly perceived imbalances; alternatively, the fear of financial distress or crises, or capital flow reversal (and not mainly of increased inflation) may force or persuade economic authorities to follow “excessively” tight macro-economic policies, which also discourage growth.

These new realities imply that in the prevention phase, far closer cooperation is required that exists until now between financial regulations and macro-economic authorities. This is because even a very well regulated financial system is unable to withstand major macroeconomic shocks, as illustrated clearly by the Argentinean experience in 2002. At the same time, imbalances or instability in the financial system often undermines macro-economic performance. Furthermore, financial regulation needs to have a far stronger macroprudential dimension (Crockett, 2000; Ocampo and Chiappe, 2003; Borio and White, *op.cit.*). This is due to the fact that the evolution of risk is partly endogenous with respect to the collective behaviour of financial players, and that risk perceptions are influenced by overall liquidity. By stressing pro-cyclicality of financial

markets, this approach emphasizes the need for countervailing or counter-cyclical measures in regulation (Griffith-Jones, Ocampo with Cailloux, 1999; Ocampo, 2002, Ffrench-Davis and Griffith-Jones, 2003).

Instruments such as forward-looking loan loss provisions for banks, or at least cyclically neutral provisions, have not only been amply discussed in the literature, but have begun to be implemented to a limited extent in countries such as Spain and Portugal. More generally, regulators could require prudential provisions (or capital) when the growth of credit –and key asset prices, such as stocks- either accelerate sharply or exceeds some long-term average measured over at least one cycle.

These types of measures at present raise a number of fairly difficult questions about implementation. More broadly, they raise the issue of potential trade-offs between sufficient and sufficiently (counter-cyclical) regulation of the financial sector for crises prevention and for enough credit to support economic growth (Stallings and Studart, 2003).

This is an important point both nationally and even more internationally, as many measures being taken (e.g. proposals for Basle 2, see below) or discussed (SDRM) internationally risk excessively discouraging private flows to developing economies (and thus reducing growth), in the interest of preventing or better managing crises.

An important under-researched issue is that procyclical and herding behaviour of financial actors (both domestically and internationally) lead to complex and problematic interactions between different actors and flows (Griffith-Jones, 2003). This implies that regulators need to look also at the interaction of risks between different actors as they affect one type of borrower or country, as well as the possibility of risk spreading across borrowers and countries. Increased coordination –or even better, integration, where feasible- between regulators in different financial sectors is increasingly essential, both domestically and internationally.

Additionally, the close interaction between the financial sector (Ocampo, 2003) and the macro-economy seem to require also changes in the way macro-policy is formulated, to make it more counter-cyclical and account of longer horizons, so as to allow for lack of predictability on the possible unwinding of financial imbalances.

Finally, to the extent that responsibility for preventing crises is not clearly allocated between national financial regulators and monetary authorities (and even more so internationally), there is a risk that problems can “fall through the gaps” with no economic authority taking appropriate responsibility. International institutional developments such as the creation of the Financial Stability Forum provide valuable step forward, but require much further advances.

The tasks and aims of policy-makers and regulators in developing countries have become more numerous and more complex, whilst the instruments are perhaps insufficient and have not been sufficiently adapted to the new realities. The aims include maintaining as high and as sustainable growth as feasible, avoid the emergence of financial imbalances that could threaten financial crises and growth and maintaining relatively low inflation. Therefore it is important to develop new instruments, for example of counter-cyclical regulation of the financial sector, to meet the challenges.

It is also important that the point of regulation coincides with the point of market failure. If as discussed above, financial markets are ill equipped at measuring systematic risk through time, a more radical critique of the new Basle Capital Accord can be posed; Basle 2, under the IRB approach, will determine capital based on banks’ own VAR models, thus internalizing into regulation the pro-cyclicality inherent in banks. Will the increased pro-cyclicality in international bank lending be damaging to developing economies? If not modified, how should they best protect themselves? Given that developing economies have thinner and more fragile financial systems, whose imbalances can have even stronger problematic impacts on growth than in developed economies, how large will be the problems of applying for their domestic banks such an implicitly pro-cyclical mechanism to determine capital, as the IRB approach; how will any

possible benefits of the IRB approach (possible lower capital costs, and therefore greater competitiveness and possible better measurement of risk across sectors) compare with the above outlined potentially large costs.

It seems essential to evaluate progress on crises prevention against the needs and challenges posed by the increasingly recognized above framework. To what extent, for example, do codes and standards being agreed internationally and implemented in developing countries reflect the interactions and complexities outlined above? Are they "best practice", given the state of knowledge? To what extent are the measures implemented internationally sufficiently robust and consistent with the main problems being faced? Why for example does the new proposed Basle Capital Accord increase likely pro-cyclicality, when at the BIS in Basle so much good research has been done arguing the contrary, that regulation should be counter-cyclical? Why is the Basle Capital Accord likely to prevent crises in developing economies mainly by inappropriately and excessively discouraging bank lending to developing economies, rather than encouraging sufficient and sufficiently stable banking flows?

4. Basle II

As noted earlier, it is important to encourage more private capital flows to developing countries. But it is equally important to avoid an international regulatory framework that may have an unintended negative impact on these flows. We strongly believe that Basle II, as currently proposed, may have such unintended consequences, such as inappropriately discouraging international bank lending and making it more costly, as well as making such lending more pro-cyclical; these consequences would not be coherent with the aims of the G-10 governments, to support private international flows so as to help achieve higher growth in developing countries, that would contribute to achieving the Millennium Development Goals.

It is true that that the third consultative package of Basle II has positive features: the removal of the OECD/non-OECD distinction, and the reduction of the bias towards lending short-term to developing countries (Griffith-Jones, 2003).

However, problematic issues especially from a development perspective can be found, especially in the Internal Ratings Based Approach (IRB):

The main one is that it overestimates the risk of lending to developing countries, as it does not take into consideration the considerable benefits of international portfolio diversification (see above). Given that some banks already take account of diversification benefits in their risk management practices, implementing the current proposals would imply a step backwards.

This may imply a significant increase in regulatory capital requirements for lending to developing countries, which in turn is likely to result both in less lending to these countries and an increase in the costs of the remaining lending.

It is noteworthy that several of the major international banks have stressed how negative it is that the Basle Capital Accord does not include the benefits of International diversification. Stanley Fischer, Vice Chairman of Citigroup (the largest international bank in the world) argues that:

Large international banks that are active in emerging market economies would probably consider Basel II well worth the price of admission if the new Accord took account of the benefits of global diversification in increasing these banks' risk capacity. But unfortunately, it does not – and this is a key point. Specifically, in its current form, Basel II requires capital requirements in each country to be calculated on a standalone basis. This could significantly increase the capital requirements for operating in these markets.

... In not taking into account the risk mitigation effects of international diversification, Basel 2 in its current form runs the risk of materially reducing the incentive for larger internationally active banks to maintain and expand their operations in emerging market economies. Given the economic and other benefits of such operations, not just for the host economies and for the international financial system more generally, this must be considered a significant shortcoming. [1]

In a more general sense, a variety of financial institutions, including representative industry bodies such as the Institute of International Finance

(which represents all major international banks) and The New York Clearing House Association (that represents several of the major banks), have argued strongly for the incorporation of the benefits of international diversification into the Accord. The latter commented as follows in its submission to the Basel Committee in August of 2003:

Under Basle CP3, the benefits of diversification of business lines, asset classes, geographical regions and risk types is not adequately recognized in assessing capital requirements. This is in contrast to modern economic theory, industry practice and empirical evidence. Diversification mitigates the possibility and extent of loss by allowing holding companies to rely on earnings from one area when another area slows or experiences losses and to benefit from diversification of risk. Diversification also allows strength in market or credit performance in some areas to offset weaknesses or problems in other without necessarily drawing on capital. The regulatory capital requirements should reflect the benefits of diversification.

In Griffith-Jones et al (2002), empirical work was presented confirming that the degree of correlation between the real and financial sectors of developed economies is greater than that which exists between developed and developing economies. This hypothesis of differential correlations was tested, first with specific regard to international bank lending and profitability and, secondly, in a more general but supportive sense. All of the results offered significant support for the validity of this position (see Table 1).

Table 1.

Variable	Time-Period	Frequency	Developed/ Developed Mean Correlation Coefficient	Developed/ Developing Mean Correlation Coefficient	Test Statistic (H0:Mx=My) Critical Value of 0.05% one-tailed test in parentheses
Syndicated	1993-2002	Monthly	0.37	0.14	3.33 (3.29)
ROA	1988-2001	Annual	0.10	-0.08	4.40 (3.29)
ROC	1988-2001	Annual	0.14	-0.11	6.92 (3.29)
GDP	1985-2000	Six-monthly	0.44	0.02	9.08 (3.29)
GDP HP	1950-1998	Annual	0.35	0.02	9.41 (3.29)
STIR	1985-2000	Six-monthly	0.72	0.23	11.09 (3.29)
STIRR	1985-2000	Six-monthly	0.66	0.22	10.93 (3.29)
GBI-EMBI	1991-2002	Daily	0.78	0.53	5.45 (3.29)
GBI-EMBI	1991-1997	Daily	0.90	0.74	4.64 (3.29)
GBI-EMBI	1998-2002	Daily	0.42	0.09	5.87 (3.29)
IFCI-COMP	1990-2000	Daily	0.58	-0.15	7.83 (3.29)
IFCG-COMP	1990-2000	Daily	0.58	-0.17	8.06 (3.29)

[1] Presented as the William Taylor Memorial Lecture at the International Conference of Banking Supervisors, Cape Town, September 19, 2002.

The fact that every statistical test performed, regardless of variable, time-period or frequency, has pointed in the same direction - and all are clearly statistically significant on a variety of tests - offers robust and unequivocal support for the benefits of diversification.

As a consequence, an internationally diversified loan portfolio, with a range of developed and developing country borrowers, would have a lower level of risk – in terms of the overall portfolio – than one which focused primarily on developed country lending. In order to test this hypothesis in the specific context of a bank's loan portfolio, a simulation exercise in Griffith-Jones et al (2002), was undertaken to assess the potential unexpected loss resulting from a portfolio diversified within developed countries, and one diversified across developed and developing regions.

The unexpected losses simulated for the portfolio focused on developed country borrowers were, on average, almost twenty-three percent higher than for the portfolio diversified across developed and developing countries. This offers more direct evidence that the benefits of international diversification produce a more efficient risk/return trade-off for banks at the portfolio level. In order to accurately reflect the actual risks that banks may face – Basel 2 should take account of this effect.

Further evidence using real data has been provided by the major Spanish bank, BBVA, in its document: *A practical proposal for improving diversification treatment in Basel 2*. This paper defines a "correction factor" which measures the error made when using a single factor model - such as that envisaged in Basle 2 - when in fact there are two (or three) factors affecting diversification of the portfolio. These factors could be geographical areas (emerging vs. non emerging economies), industrial activities or a combination. The correction factor is defined as the ratio between the capital calculated with the two (or three factor model) and the capital obtained with the single factor model. The authors calculated the following values for the correction factor.

Table 2. Correction factor for the two and three factor model

Diversification Index	Two factor model Correction factor	Three factor model Correction factor
35 %	-	79 %
40 %	-	81 %
45 %	-	82 %
50 %	84 %	84 %
55 %	85 %	86 %
60 %	87 %	87 %
65 %	89 %	89 %
70 %	90 %	91 %
75 %	92 %	92 %
80 %	94 %	94 %
85 %	95 %	96 %
90 %	97 %	97 %
95 %	99 %	99 %
100 %	100 %	100 %

The diversification index measures how diversified the factors considered in the portfolio are. A diversification index of 35% indicates maximum diversification and 100% indicates maximum concentration. In a situation of no diversification, the discrepancy between the one-factor model (to be used in the Basel 2 IRB framework, which does not take account of the benefits of diversification) and the two and three factor models is zero. As diversification increases so does the discrepancy between the Basel 2 one-factor model and the more sophisticated two and three factor models: as diversification increases the Basel 2 one-factor model becomes increasingly inaccurate in its overestimation of the capital required.

As shown in Table 2, the maximum capital saving in the BBVA empirical work (for both the two and three factor models) ranges from 16% to 21%. These figures coincide with the simulated calculations reported above, suggesting that something beyond a particular case is being captured here**.** In short, if a one risk factor model were used as proposed under the Accord, it would require capital requirements to be higher than the two and three factor models by between 16% and 21%, which can be seen as a proxy for the failure to take account of international diversification.

Given this evidence - as well as the widespread acceptance of the risk reducing benefits of international diversification, it is strange that these benefits have not

been incorporated into the Basel II proposals. This is particularly so given that the Basel Committee itself does not deny that these benefits exist. The new Chairman of the Basel Committee, Jaime Caruana, makes this explicit below:

Portfolio theory suggests that an obvious step to further enhance the risk-sensitivity of the capital framework would be to incorporate calculations of diversification benefits into the framework.[2]

The intention of moving Basel to full credit risk models is highly welcome. However, we think it is important that in a transition phase –whilst they are developed-, benefits of diversification are already incorporated in simpler ways (along lines we detail below). If this is not done, international banks may be inappropriately discouraged in the short term, from lending to developing countries, trend which may then take some time to reverse due to factors, such as the need of re-hiring expertise for such tasks. Such a reduction of international bank lending could have negative impacts on output and poverty reduction.

As demonstrated above, the failure of the proposals to date to take account of the benefits of international diversification suggests that, in this instance at least, risk has not been accurately measured. The fact that the proposals under Basel II will not allow these diversification benefits to be taken into account, suggests that the regulatory capital associated with lending to developing countries will be *higher* than that which the banks would – and currently are – choosing to put aside on the basis of their own models. This will inappropriately reduce lending to developing economies and increase its cost.

The specific manner that the Basel Committee –and later the European Commission for CAD3- might want to incorporate these findings is, of course, best left to them. However, BBVA has proposed a simple practical adjustment mechanism that enables the introduction of the benefits of international diversification into the current proposal. The mechanism proposed consists of using the previously mentioned correction coefficient (see Table 2) so that

[2] Speech to the British Bankers Association (BBA) on 9 October 2003 by Jaime Caruana, Chairman of the Basel Committee on Banking Supervision.

regulatory capital is defined from the one factor model currently proposed multiplied by this coefficient,

Capital adjusted for diversification = Capital defined by the one factor model x Correction coefficient

That is, a diversified bank would multiply its total regulatory capital by a coefficient to correct for diversification, with the coefficient being proportional to the degree of diversification. Adoption of such a correcting factor - at least as a transitional measure until full credit risk models are sufficiently robust to be used directly - would a) produce a more accurate measure of risk than under the current proposals, and b) prevent the overestimation of risk for international borrowers – particularly those in emerging and developing economies, that could be damaging to their economies.

A second problem is that Basle 2 is likely to accentuate the pro-cyclicality of bank lending, as banks would have to increase their capital requirements in bad times. This would harm developing countries, especially those most vulnerable to sharp fluctuations in bank lending (Griffith-Jones, 2003).

Lack of developing country representation in the Basel Committee is clearly an important reason why the proposed rules have been designed to benefit more internationally active banks based in developed countries, and benefit less developing countries.

Proposals to improve Basle II as currently designed should therefore include: 1) The incorporation of international diversification benefits in the IRB approach, so that risk is measured accurately, along the lines suggested above. To this end, a similar approach could be pursued to that recently adopted, of incorporating in the risk calculation the diversification benefits of lending to SMEs; 2) Mitigating the increased pro-cyclicality that would result from the adoption of the IRB approach with counter-cyclical measures, which may include making forward looking provisions and stress testing mandatory; and 3) A change in the representation of the Basle Committee to include representatives of developing countries.

5. Capital flows to developing countries

Private capital flows can be a vital financing source to support sustainable growth and poverty reduction in developing countries. However, they declined dramatically in net terms from 1996 to 2001, linked to the Asian and other crises, with a slight recovery in 2002 (UN, 2003; see Table 3). During this half decade there was a virtual drought of private flows going to developing countries, and the net transfers of flows to developing countries became increasingly negative (UN WEESS 2003; and Table 4).

Table 3. Net private capital flows to developing countries 1996-2002[a]

US$ billion

	1995	1996	1997	1998	1999	2000	2001	2002
Total	**157.0**	**208.1**	**96.6**	**38.9**	**66.2**	**18.2**	**17.9**	**51.8**
Direct investment	82.0	97.2	120.5	128.0	133.0	125.6	145.3	110.0
Portfolio investment	34.2	81.5	41.6	-3.7	39.0	9.7	-41.7	-40.0
Other net investment[b]	40.8	29.3	-65.5	-85.3	-105.8	-117.2	-85.8	-18.2

Source: UN World Economic and Social Survey 2003. [a] Excludes transition economies. [b] Includes commercial bank lending (short- and long-term).

Moreover, net transfers, which include all forms of financial payments, have been persistently negative since 1998, reaching -US$ 193 billion in 2002 (see Table 4).

Table 4. Net transfer of financial resources to developing countries 1994-2002

US$ Billion

	Average 1994-1997	Average 1998-2000	2001	2002[a]
Developing countries	30.4	-111.3	-155.1	-192.5

Source: UN World Economic and Social Survey 2003. [a] Preliminary estimate.

For the group of emerging market economies, net private capital flows also declined since 1996, decline which continued in 2002, reaching a 10-year low of

US$ 124 billion, according to the Institute of International Finance (see IIF, 2004).[3] In 2003, a partial recovery occurred (see Table 5). The recent increase in flows, projected to continue in 2004, has been associated with the current world economic recovery and low international interest rates, and to some extent to improvements in macroeconomic fundamentals and policies in emerging countries. Although the recovery reported by the IIF has been significant, the levels of private flows to emerging market economies are still well below those observed in 1996, when they peaked at US$ 325 billion.

Table 5. Net private capital flows to emerging market economies 2001-2003

US$ Billion

	1995	1996	1997	1998	1999	2000	2001	2002	2003[a]
Total	234.3	324.5	283.5	143.3	155.7	187.2	126.5	124.2	187.5
Direct Investment	75.5	92.7	118.0	122.3	151.6	138.8	139.8	112.1	93.6
Portfolio investment	29.9	33.1	22.2	11.2	14.5	13.1	7.7	1.1	30.3
Bank lending	96.8	118.0	59.6	-55.0	-48.4	-0.9	-26.7	-6.2	18.9
Bond flows	32.0	80.7	83.8	64.7	37.8	36.2	5.8	17.2	44.7

Source: Institute of International Finance (2004). [a] Estimates.

The recent increase in capital flows should be seen with caution. First, the recovery reflects primarily cyclical factors, and is based mainly on increases in portfolio equity and bond flows, and to a lesser extent bank lending, which tend to be the more volatile components of total flows. Foreign direct investment fell in 2003, reinforcing a moderately declining trend initiated in 2001. Second, the flows are concentrated mainly in Asia, which accounts for nearly 60% of the total flows to emerging markets, and for over 70% of their growth in 2003. This contrasts with the current share in total flows for Latin American and African/Middle East regions - currently at 14% and 2.6% respectively - and with

[3] The figures from the UN (see Table 3) and the IIF (see Table 5) differ markedly among other reasons for covering different categories of countries and, in the case of the UN, for taking into account outflows linked to investment by developing country central banks of their foreign reserves abroad. Despite these differences, trends are not dissimilar.

the year 2001, when shares for Asia, Latin America and Africa/Middle East corresponded to 40%, 39% and 7%, respectively.

Given the role cyclical factors have played in this recent recovery, and the fact that there seem to be structural factors (such as the fact that banks have "crossed the border" and established branches and subsidiaries in developing countries, from which they lend in local currency) that may be inhibiting international private flows, the level of private flows may remain relatively modest (Griffith-Jones, 2003). Furthermore, a large part of recent flows may be easily reversible.

Thus, two problems identified in the past regarding capital flows are still present in the recent upward trend: their potential reversibility and their geographical concentration, the latter implying that whilst some countries are facing surges of flows, others are still receiving insufficient flow levels. Moreover, a large group of developing countries, which includes the poorer ones, continue to be outside the radar of private capital flows, therefore remaining heavily dependent on aid flows for meeting their external financing needs. However, there is a consensus that to meet the Millennium Development Goals, these countries need to grow much faster, and for that they need to receive much higher levels of external finance (see UN, 2003).

6. Public-private links for increasing capital flows to developing countries in times of drought

In the current context of insufficient and still unstable capital flows to developing countries, it is important that industrialised countries take concrete steps to address these issues. This could be done through directly encouraging more private capital flows to developing countries, and through increasing significantly the level of aid flows, so that developing countries can grow faster thereby making the Millennium Development Goals more likely to be achieved.

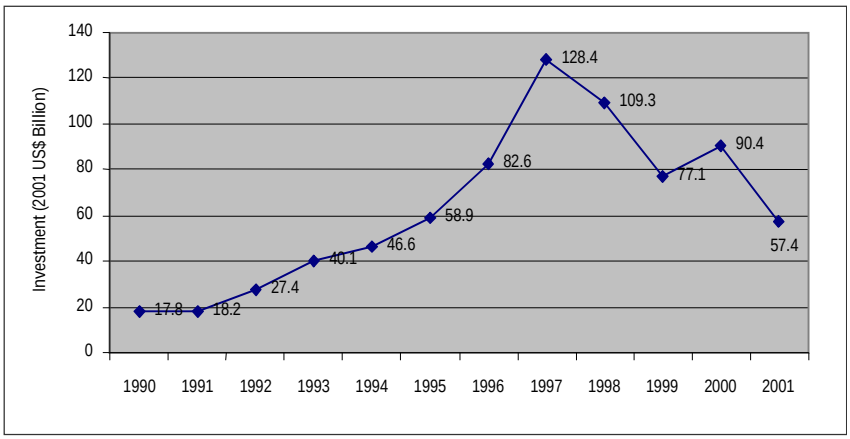
To encourage more and more stable capital flows, new public-private mechanisms could be created. In the case of private flows, in what follows we will discuss proposals for partial counter-cyclical guarantees, and public incentives for encouraging socially responsible investment (SRI) in developing countries. In the case of official flows, we will discuss the International Finance Facility (IFF) proposed by the UK Treasury; if implemented, this facility could double the current level of aid flows through raising private resources in the international capital markets.

In addition, we will discuss the proposed Basle Capital Accord. Addressing the latter is also crucial, as the way it is being currently proposed for implementation may have a direct impact on the issues of concern here: it may reduce the already low levels of bank loans to developing countries, and make these loans more costly and more pro-cyclical.

6.1. Guarantees for private flows, especially for investment in infrastructure

Following trends of increased private flows and encouraged by privatization, investment in private infrastructure in developing countries surged from 1990 to 1997 (see Figure 1). However, this investment was particularly badly hit by recent crises (see Griffith-Jones and Fuzzo de Lima, 2004).

Figure 1: Investment in Private Infrastructure Projects in Developing Countries 1990-2001

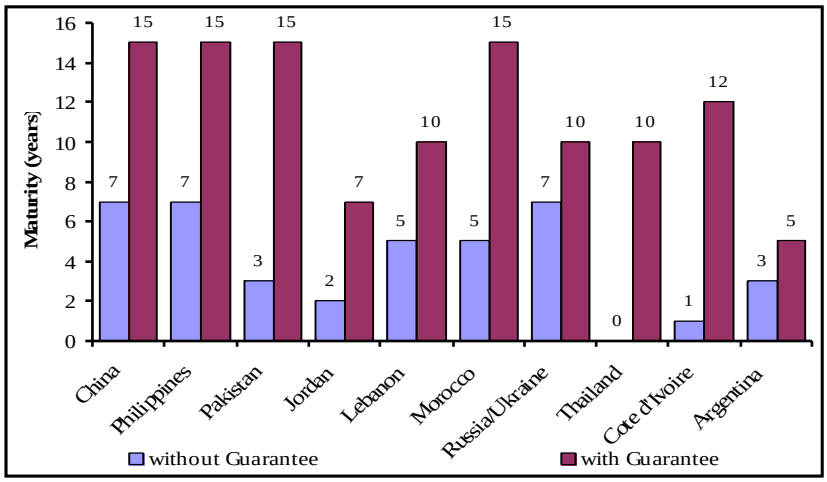


Source: World Bank PPI Projects Database

Existing public guarantee mechanisms (granted by the Multilateral Development Banks and Export Credit Agencies) play a positive role in mitigating risks of long-tern investment and loans to fund important activities, such as infrastructure investment.

Existing guarantees have positive features in that they increase flows and extend maturities of debt instruments in developing countries. According to the World Bank, this is up to twelve times what would have been without guarantees (see Figure 2). Nonetheless, this does not imply that the guarantees can lengthen the duration of private credits not covered by the guarantee.

Figure 2: Difference in maturities in infrastructure projects in developing countries



Source: World Bank (2001)

Another positive feature of guarantees is its ability to reduce spreads. Loan guarantees may also affect the interest rate pertaining to the non-guaranteed private credits. For example, in Thailand the interest spread over US Treasury for infrastructure finance was calculated as 8.5% without guarantees and 2.9% with guarantees. In other countries, there is also a difference, though a less dramatic one.

In spite of all the advantages of existing loan guarantee mechanisms, they deal more with overall risks, rather than with the cyclicality of risks and lows, which has emerged as such an important feature.

It is widely accepted that international financial and banking markets tend to overestimate risk in difficult times and underestimate it in good times. As a result, private lenders are prone to boom-bust patterns that are often more determined by changing global preferences for risk aversion and/or contagion between developing countries, and not so much determined by country fundamentals. This provides a strong case for public institutions to play an explicit counter-cyclical role to help compensate for the inherent tendency of private flows to be pro-cyclical, for example in long-term trade credit.

There could be two paths for increasing the counter-cyclical role of national or international bodies. One would be for public international bodies like the multilateral development banks to provide more counter-cyclical lending than already occurs eg in infrastructure. Another path, that if successful could provide more leverage of public resources, would be for multilateral development banks and export credit agencies (ECAs) to introduce an explicit counter-cyclical element in all the risk evaluations they make for issuing guarantees for lending to developing countries. This requires multilateral development banks and export credit agencies to assess risk for issuing guarantees with a more long-term perspective than is typically done by commercial banks; this would imply that when banks or other lenders lowered their exposure to a country, multilateral and regional development banks or ECAs would increase their level of guarantees, if they considered that the country's long-term fundamentals were basically sound. When matters were seen by private banks to improve, and their willingness to lend increased, multilateral development banks or ECAs could decrease their exposure, for example by selling such guarantees in the secondary market. This would avoid greater counter-cyclicality of guarantees, resulting in an increase in the long-term level of guarantees.

To the extent that multilateral development banks and ECAs increasingly use models to assess risks (as is the case of the UK ECGD) taking a more long-term view would require the use of more long-term models than those used by private lenders; these would be models that are presumably better at "seeing through the cycle", as they would use more measures of risk focused on long-term

fundamentals, that are less affected by short-term variations than market-sensitive measures typically are.

Alternatively there could be special stand-alone guarantee mechanisms for long-term trade credit, for example within multilateral or regional development banks, or even bilaterally, that had a strong explicit counter-cyclical element, this could be activated in periods of pre-crises, during crises or for countries facing a sharp decline and/or dramatic increase in cost of capital inflows as it or other developing countries emerge from crises; its aim would be to try to catalize long-term trade credit, especially linked to infrastructure broadly defined.

Indeed, once the need and positive role that explicitly counter-cyclical guarantees could play to catalize private long-term credit and investment to developing countries is accepted, it is important to define where institutionally such guarantees should be placed. ECAs have traditionally played quite an important role in providing such guarantees; however, for a number of reasons, including the emphasis in several ECAs towards a shift to a purely commercial basis, the role of several developed countries' ECAs in granting guarantees for lending and investing in developing countries is declining. If this trend were to remain, it becomes imperative both: a) to expand and b) to make explicitly counter-cyclical guarantees in multilateral and regional development banks, either by introducing counter-cyclicality as a general criteria for all guarantees or by creating a stand-alone facility for this purpose.

To ensure that there is an effective expansion of the level of guarantees issued by multilateral and regional development banks, existing guarantee mechanisms may need to be improved or enhanced and/or new mechanisms may need to be created. Existing problems, such as excessive restrictiveness of criteria for granting guarantees, approval processes of guarantees that may be too cumbersome, excessive costs of such guarantees may need to be overcome. Furthermore, mechanisms for increased leverage of development banks resources in providing guarantees need to be further explored and implemented, for example by guarantees being provided only for later maturities of long-term projects.

Another possibility is to develop further liquidity facilities, where guarantees can only be called after a big devaluation (up to a pre-established level of devaluation); the guarantee is provided for a fixed period (e.g. two years), after which the loan has to be paid back (for more details, see Griffith-Jones and Fuzzo de Lima, op.cit.). If studies are not carried out (and more policy oriented research seems urgent here), and – above all – action is not taken to ensure that multilateral and regional development banks increase the level of their guarantees, then the valuable introduction of explicit counter-cyclical elements in such guarantees would become far less meaningful. This would then imply the need for stand-alone counter-cyclical guarantees, either multilaterally or regionally, or even in individual developed countries.

If properly designed and implemented, counter-cyclical guarantees could provide an important policy instrument to help deal with a genuine market failure, the boom-bust pattern of private lending; the desired policy outcome would be to help smooth private lending.

6.2. SRI Investing Community in Developing Countries

SRI assets have grown dramatically in recent years, reaching US$ 2.7 trillion in 2001. In the US, they grew from just US$ 1.0 trillion to over US$ 2.0 trillion between 1997 and 2003. In the UK SRI growth has been even more dramatic - with asset values quadrupling from just about £50 billion in 1999 to over £200 billion in 2001 (Russell Sparkes, 2002).

Changes in the UK legislation on pension funds have been pointed out as a key factor behind this increase. In 2000 the UK government modified the 1995 Pensions Act to require that pension funds report to what extent their investment decisions take into consideration social and environment issues (Coles and Green, 2002). This seems to have propelled UK institutional investors to increase significantly their SRI investments. As a consequence, today over 80% of total UK SRI assets are held by institutional investors.

However, the strong growth SRI has exhibited in the recent past has been a phenomenon limited mainly to the acquisition of developed country assets. Of the US$ 2.7 trillion of total SRI assets in 2001, only 0.1% was emerging market assets (IFC, 2003). This is much lower than the share of emerging market assets held by mainstream investors, of around 2-3%. There is therefore an enormous potential for SRI growth in emerging markets.

An acquisition of EM assets can be justified both on moral and economic grounds. On the moral side, it is well demonstrated that developing countries face an enormous external financing gap, which, if not filled, will result in slow growth and poverty reduction patterns, and thereby will leave them farther away from meeting the Millennium Development Goals. SRI investors, especially if the flows are long term and fairly stable, could help developing countries grow faster, create jobs and reduce poverty by investing in these countries. This would lead to overall prosperity in developing countries and would therefore be coherent with SRI global sustainability concerns. On the economic side, investing in emerging markets can be justified by the fact that historically returns on EM bonds, equities and bank loans have been higher than developed country returns on each of these assets (Gottschalk, 2004). Furthermore, investing in EM assets may bring clear portfolio diversification benefits, in terms of risk reduction for a given level of return, to the extent the correlation between developed country returns and developing country returns is lower than within developed countries. This hypothesis has been empirically confirmed through a battery of statistical tests using a wide range of data (see below). Thus, acquiring EM assets can bring both moral and economic benefits.

Despite these potential benefits, the SRI investor community points to a number of barriers for acquiring EM assets in a major way. Most of these barriers are related to pure lack of knowledge about the opportunities EM can offer, and to informational gaps on environmental and social standards in EM. The latter can only be overcome if demand for EM increases to justify the establishment of research organisations that can provide systematic information on these standards (IFC, 2003).

The official sector in industrialised countries could provide incentives to encourage SRI investor community based in their countries to invest in EM assets. For example, they could follow the UK example by modifying pension funds' legislation to include a requirement on institutional investors to report on a regular basis their policies towards investing in EM. Indeed, U.K. legislation should be modified to specifically highlight developmental concerns in the required reporting by pension funds. They could even set a minimum developing countries' EM asset holding target to be reached over a certain time-frame. Moreover, they could facilitate the establishment by the SRI industry of a set of principles to guide their investment decisions towards EM, in the same way the IFC has done with major internationally active banks, in establishing the Equator Principles on social and environmental issues. Of course, it would be important that these principles are broad to include development elements. The Millennium Development Goals could serve as a basis for the establishment of these principles. They could include supporting economic growth and poverty reduction, by generating jobs and paying at least minimum wages of the country and at the micro level encouraging a company to engage in the provision of health facilities and primary educational programmes, and training to the working force (Gottschalk, 2004; Williamson, Griffith-Jones and Gottschalk, 2003).

Providing legislative and other incentives for the SRI investor community to invest in developing countries would certainly be developmentally coherent, due to their enormous potential as a source of long-term flows to developing countries, given the profile of their liabilities, mostly long term. Moreover, it would be coherent with SRI needs to match their liability structure with long-term investment in assets with high returns, which developing countries can provide due to their abundant and relatively young labour force and therefore long-term growth potential. More broadly, SRI investing in developing countries would be coherent with their global sustainability concerns, as global stability and prosperity can be only achieved if developing countries eradicate poverty and experience economic growth on a sustainable basis.

Particularly in this case, the development coherence sought involves especially private sector actors (investors, NGOs), as well as to a lesser extent public actors. New modalities of interaction need to be found, including new incentives. Further research seems to be required to make it successful.

6.3. The International Finance Facility

Having made a case for encouraging more long-term private flows to developing countries, and for this purpose explored possible public-private links, we will discuss in turn the proposal by the UK Treasury on creating an international finance facility (IFF), aimed at doubling the current levels of aid flows to developing countries until 2015.

The reason for discussing this facility is that, even if private capital flows to developing countries increase substantially (as a result, among other factors, of initiatives such as the ones suggested above), still it is very likely that a large number of developing countries, especially the poorer ones, will continue to lack access to private flows for a long time. There is therefore an urgent need to increase substantially the current levels of aid flows to these countries, as only if that happens they will contribute to achieving sustainable growth and eradicating poverty.

To double the current levels of aid flows, the IFF proposes to frontload aid flows by raising private resources in the international financial markets through issuing bonds. The operation would be secured by donors' commitment to multi-year streams of annual payments to the IFF (see HM Treasury and DFID, 2003).

The disbursements of resources raised would be concentrated in the years up to 2015, while the streams of donor's income to the IFF would be distributed over a 30-year period. Not all donors would have to agree to the facility for this to be implemented. And those donors agreeing to the facility would be able to allocate the resources raised linked to their contributions using the existing channels of aid disbursement. Moreover, they would be able to decide to which countries they would allocate such resources.

The levels of income commitment would be decided by each donor, and would be subject to 'high-level' financing conditions; these, if not met by the recipient countries, would permit donors to suspend their payments. However, to reduce bondholders' uncertainties thereby ensuring that the bonds issued by the facility achieve the highest possible rating, a number of rules would be imposed. 1) The conditions the recipient country would have to meet would be very general - e.g., not becoming subject to UN sanctions; 2) No country would be permitted to receive more than 5% of total disbursements, thereby diluting the possible impact of one country breaching the conditions on donors' income payments; and 3) The IFF would be limited to raising capital to the equivalent of no more than 85% of the net-present-value of its future income.

At the same time, donors would have to follow a set of principles in their disbursement programmes. These would probably include the following: the resources would have to be untied, used for poverty alleviation, provided on a multi-year basis, disbursed mainly in the form of grants, and concentrated in low-income countries (UK Treasury and DFID, 2003, p. 6).

The proposed facility and the conditions attached to it are fully consistent with the international consensus reached at Monterrey on the need to increase aid flows substantially in the years up to 2015, and to use these flows to help the poorer countries to achieve the international development targets. One could also expect that helping these countries to be on track to meet the international targets would make it easier for them to attract private flows.

The proposed facility is thus a very interesting mechanism to channel private capital towards financing development. In this sense, it is very similar to the ones suggested above, as their intended objective is to encourage more private flows to developing countries, albeit it would differ from them by necessitating a larger amount of public resources to secure the whole operation. A key feature is its flexibility in not depending on a high number of adherents to be launched, in the levels of resources donors would have to commit to it, and in how resources can be disbursed. More importantly, it is coherent with the

development commitments of the international community. If implemented, it would be able to fill the projected financing gap facing developing countries through targeting in an effective manner the poorest, most capital-needy, countries.

7. Modest proposal for increasing voice of developing countries to enhance development coherence

The case for increasing the voice of developing countries in the governance of International Financial Institutions (IFIs) is a compelling one. Current arrangements where developing countries are increasingly under-represented is highly problematic for several reasons. Firstly, inappropriate representation arrangements leads to a decline in the efficiency of these organizations, as decisions taken do not adequately reflect the needs and issues from the perspectives of the majority of the countries and peoples affected by them. A very clear example developed here is that of the Basle Capital Accord, where no representation of developing countries on the Basle Committee seems to be leading to an outcome neither technically correct nor coherent with development aims. Rustomjee (2003) gives similar examples, of inefficient outcomes linked to insufficient participation of developing countries in decision-making in the IMF (for example in the design of HIPIC and PRSPs).

Secondly, insufficient representation of developing countries is increasingly perceived as leading to a democratic deficit in those institutions. Given that democratic governance has rightly emerged as such an important value in the last decade, and that developed country governments rightly encourage democracy in developing countries, it is crucial that international finance governance is also democratic. This will be positive for the international financial institutions themselves, as it will clearly strengthen their legitimacy, which has been challenged in recent years. Therefore more democratic financial institutions would emerge as more legitimate and stronger ones, which is very positive in a globalized world that increasingly needs international financial governance and institutions.

Thirdly, increasing the share of developing countries in IFI governance is necessary to help modernize the IFIs, so they reflect the increased importance of developing countries in the global economy, as well as the increased role of the IFI in these countries. Thus, IFI governance has to better reflect today's new realities, rather than those that existed 60 years ago.

It is encouraging that the international community has increasingly focussed on this important issue. In Monterrey all governments committed to increasing the voice of developing and transition countries in IFIs. It is very important that the Development Committee is now carefully examining the issues, and will consider a road map on procedures and next steps, at the spring meetings of 2004.

There is widespread recognition in the literature that necessary changes would include: (1) An increase in the share of basic votes is desirable to allow meaningful representation for smaller economies, as was established at Bretton Woods. Once increased, the share of basic votes should be maintained in future quota increases, to prevent similar future erosion. With the nearly 37 fold increase in quotas over the past 60 years, the share of basic votes in the IMF fell sharply, whilst IMF membership quadrupled. This has shifted the balance in favour of large economies. The need to raise the share of basic votes is clearly a proposal that has obtained increased support.

(2) The quota formula needs amending to reflect appropriately rapid growth of some developing economies, as the current quota structure does not reflect properly the scale of countries' economies. As Table 6 and Buira (2003) point out, large countries like Brazil, China, Korea and Mexico have a share of quotas that are far below their share of Gross Domestic Product (GDP), whilst countries like Belgium and Switzerland have quotas for larger than their share of GDP. This is true for both GDP measured at market exchange rates and at purchasing power parity, particularly the latter.

Table 6. IMF quotas and gross domestic products for selected countries

Country	**Quota as of December 31, 2002**		**Share of world aggregate GDP in purchasing power parity, 2002**	**GDP, 2002** Billions of US dollars converted at market exchange rates
	Billions of Special Drawing Rights	As a proportion of total quotas		
Canada	6,369	2.99	2.01	728
China, People's Rep. of	6,369	2.99	12.67	1,237
Russian Federation	5,945	2.79	2.68	346
Netherlands	5,162	2.43	0.88	449
Belgium	4,607	2.16	0.59	247
Switzerland	3,458	1.63	0.45	268
Brazil	3,036	1.43	2.63	448
Mexico	2,586	1.22	1.90	642
Denmark	1,643	0.77	0.33	172
Korea, Republic of	1,634	0.77	1.78	462

Buira (2003:20), based on IMF World Economic Outlook Database

The case for the introduction of purchasing power parity GDP (PPP GDP) as the (or an important) basis for quota calculation –rather than market exchange rate-based GDP- is a strong one. Using only GDP based on market exchange rates, as the current quota formula does, substantially underestimates the GDP of developing countries, because it underestimates the value of the non-tradable sector that tends to be larger in developing countries.

(3) There is a need in the IMF and World Bank Boards, to add at least one seat for African countries. This would reduce the enormous burden and growth of workload in the two African constituencies, that represent jointly 45 countries, and would allow African Executive Directors to play a more active and effective role in broader policy discussions. This change would imply a very marginal increase in the size of the two Boards or some very small reduction of European representation. Procedurally, it would be relatively easy to implement, as it does not require a change in the Articles of Agreement.

To make such changes acceptable to industrial countries and to maintain credibility of the IFIs in international capital markets, it would seem that a

compromise solution should be sought. This would attempt to achieve the above suggested three changes, in a way that would increase the overall voting share of developing countries fairly significantly, but that would guarantee that –for a significant period, e.g. the next 10 years– the voting share of developing countries in the IMF and World Bank Boards would remain at below 50%. Also, to make it politically feasible, it should maintain the veto power of the US and the EU. This would be a win-win situation for all parties, in that developing countries would see their share increased fairly significantly, but creditors would maintain their majority. The AAA status of the World Bank would be clearly assured (indeed, the regional banks maintain AAA status even with 50% developing countries share of votes on their Boards).

Table 7. Present and Proposed Quota and Voting Power [1]

Country Category[2]	GDP-PPP 1997-99 Average	Present Quota Share	Proposed Quota Share on basis of GDP-PPP	Present Voting Share	Proposed Voting Share on basis of GDP-PPP (87.7%) and BV (11.3%)
	SDR billion	%	%	%	%[3]
Advanced Economies	16,303	62.763	55.492	61.768	50.950
Major Advanced Economies	13,375	46.030	45.523	45.146	40.811
Other Advanced Economies	2,929	16.732	9.969	16,622	10.139
USA	6,315	17.383	21.494	17.030	19.127
Japan	2,282	6.229	7.767	6.110	6.951
EU	5,900	30.106	20.083	29.647	18.740
Developing Countries	11,320	29.697	38.530	30.529	42.019
Africa	1,086	5.493	3.695	5.962	6.427
Of which Sub Saharan Africa	873	4.496	2.970	4.952	5.599
Asia	6,181	9.120	21.038	9.250	20.390
Western Hemisphere	2,504	7.456	8.523	7.666	9.536

[1] BV stands for Basic Votes; PPP refers to GDP valued at purchasing power parity
[2] Country Categories based upon IMF World Economic Outlook
[3] Does not add 100%, as transition economies not included.
Source: Kelkar et al (2003).

It is important to note that Kelkar et al (2003) have made a proposal for quota and voting power of the Board that would precisely meet the above criteria. A similar proposal could be applied for the World Bank. In the Kelkar et al

proposal, voting power would be determined by weighted averages for PPP-GDP (88.7%) and basic votes at the historic ratio (11.3%). As can be seen in Table 7, this would mean that the voting share of developing countries would go up in the IMF from 30.5% to 42%, thus clearly increasing their voice, whilst developed countries would reduce their voting share from 62% to 51%, but maintain their majority. Both the US and the EU would retain their veto power. Asian developing countries would also have veto power, if united.

Such a reform, or another variant, of voting power in the IMF and World Bank would allow both developing and developed countries to feel that they have achieved their main aims, the former by seeing their voice enhanced and the latter, by maintaining as a group their majority. The ultimate gainers would be the Bretton Woods institutions that would emerge stronger, more efficient, more democratic and more legitimate, whilst maintaining credibility with the markets. Greater coherence with development aims would clearly be achieved..

There are or course many other possible elements that could be included in such a package (such as the method of election of the Heads of these institutions, the possibility of different majorities for different issues, and others). The above formula seems to have the virtue of simplicity.

This could hopefully become the basis for constructive negotiations in the Development Committee and other appropriate fora. It would be valuable if developing countries could unite in support of such a formula, and that developed countries sympathetic to genuinely increased voice for developing countries would also back it.

It is important to stress that there are other international financial institutions where developing countries either have no representation at all on the Board, even though they are members (the Bank for International Settlements –BIS-) or are not members at all (the Financial Stability Forum -FSF- and particularly the Basle Banking Committee).

This is clearly negative in terms of efficiency, democracy and legitimacy of those important bodies. It is particularly problematic that developing countries have no participation in important standard setting bodies like the Basle Committee. The fact that, as presently proposed, the new Basel Capital Accord (Basel 2) may inappropriately increase the cost and reduce the level of international bank lending to developing countries, whilst ignoring the clear benefits of international diversification that such lending provides, again shows clearly how inappropriate (or in this case, no) representation of developing countries can lead to technically incorrect and economically damaging outcomes.

It therefore seems important that in the future the Development Committee –or other relevant bodies- also examine the issue of developing country participation in bodies such as the BIS, the FSF and the Basle Banking Committee.

The Basle Banking Committee members are from the G-10 plus Switzerland. Each of these countries is represented by their central bank, and by the authority responsible for banking supervision in that country, where this is not the central bank. The composition reflects the world political order in the middle of the twentieth century. There is no representation of emerging market economies and developing countries on the Basle Banking Committee. Thus, the Basel Banking Committee is one of the international ad-hoc bodies with the worst problem of representation of a large part of the world – the developing and emerging countries. We will therefore make some modest and very logical proposals to overcome this.

It seems to be no coincidence that the critical stakeholder in the international banking system not represented on the Basle Committee –developing countries– receive the rawest deal from the new Basle accord. Improving the governance of fora like the Basle Committee to give more voice to the unheard developing countries seems urgent.

Given that the Basle Capital Accord is a global standard that is likely to have a very large impact on emerging economies, and that emerging markets are critical to the global economy, the composition of the Basle Committee needs to

be changed. A more sensible composition would reflect global GDP. The ten largest economies would bring in China, India, Brazil and either Mexico or Russia to the Committee to join the US, Japan, Germany, UK, France and Italy. The new countries are critical to the global economy and to cross-border bank lending.

Another possibility is that current membership could remain and India, China and Brazil could be added. Alternatively, one or two representatives per each developing country regions (Asia, Latin America and Africa) could be added for a four year period. There could then be rotation for different countries to be represented (from each of the three regions). The principle would be similar to the one under which the Executive Boards of the IMF and World Bank operate. Particularly, but not only, if the latter formula is adopted, developing country representatives could be supported by a small permanent technical secretariat, that would contribute both expertise and continuity. In fact, the lack of such a secretariat at present, is an important institutional gap.

Whatever the solution, concrete steps need to be taken as soon as possible to start changing the composition of the Basle Banking Committee to increase its legitimacy, especially in the light of the recent serious problems of Basle II. Indeed, we suggest that the Basle Committee start meeting with a representative group from emerging countries (such as its own consultative group or members of the G-24 that represent developing countries at the IMF) to establish a process whereby emerging countries can quickly become full members of the Basle Banking Committee. This is urgent. A Basle Committee with appropriate representation from the world economy would not just result in fairer system, but also in more stable financial system with welfare enhancing effects for all, and with greater coherence with development objectives.

8. References