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Global Crisis Prevention and Liquidity Provision

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The original Washington Consensus was about a set of policies that most people in Washington, and probably most policymakers in our region, believed Latin America ought to be undertaking as of the late 1980s. The chapter by Amar Bhattacharya and Stephany Griffith-Jones makes it clear that the search for "stability, growth and a new development agenda" for the region must involve not only thinking about national policies, but also about the challenges for the international financial institutions and the advanced economies. I very much agree with this key message.

Bhattacharya and Griffith-Jones provide a very useful presentation of a number of issues in this area, many of which have been analysed and discussed by the same authors elsewhere. In the remainder of this comment I will address some of the specific topics they raise.

Progress in International Reform

The authors start by assessing the progress that has been made in international financial reforms. Their evaluation is that, while there appears to be consensus that fundamental reforms are needed to improve crisis prevention and management and to provide adequate capital flows to developing countries, there clearly has been insufficient progress. They relate this outcome to a number of problems, including:

- a lack of an agreed agenda for crisis prevention and management;
- uneven and asymmetric progress, with an unbalanced focus on national policies and on standards and codes, and much less emphasis on global regulations, especially in source countries;

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- reversals in important steps such as the Contingent Credit Line (CCL) and Sovereign Debt Restructuring Mechanism (SDRM);[1]
- insufficient developing country representation in key fora, such as the IMF, BIS and the Financial Stability Forum.

I agree with all the elements of this diagnosis. However, I would add that in recent years the agenda on the international financial architecture has also been characterised by too much emphasis on crisis resolution relative to crisis prevention. While substantial time and effort were devoted to discussing the SDRM and collective action clauses (CACs), the CCL, the main tool designed to provide liquidity to solvent countries to avoid the effects of contagion and provide incentives for good policies, was never used and expired almost unnoticed in November 2003.

The focus on crisis resolution has been unfortunate, for it has absorbed time and effort of the international financial community on discussing solvency crises, rather than liquidity crises. The latter are, by far, the most typical crises faced by emerging market economies. Moreover, the focus on crisis resolution has diverted attention from the fact that globalisation and integration of financial markets requires more, rather than less, resources to deal with liquidity shocks.

Of course, the focus of the international financial architecture agenda can at least partly be attributed to the dominant role played by actors in advanced economies who are concerned about the moral hazard created by the international financial institutions (IFIs). They seem to have seen the development of the SDRM and CACs as means to reduce lending by the IFIs.

Crisis Prevention and Liquidity Provision

On the crisis prevention agenda, a top priority issue should be the development of improved liquidity instruments to confront capital flow reversals and other shocks. This points to the need for putting back into centre stage the IMF's purpose of giving confidence to members by making resources available to them in order to correct

[1] Incidentally, the authors claim that the widespread use of collective action clauses (CACs) is an important step forward. It may be too early, however, to assess how important it has been. Unlike the SDRM, CACs do not solve the problem of aggregating the interests of creditors across jurisdictions and debt issues. It would not be surprising if, following the first debt restructuring process of bonds with CACs, the SDRM proposal resuscitates.

maladjustment in the balance of payments without resorting to measures destructive of national or international prosperity.

In practice, the above implies giving priority to initiatives such as the search for alternatives to the CCL, which did not work for design reasons, either by enhancing current instruments, or creating new ones. Similarly, the examination of the role that the IFIs can play in fostering the development by private financial markets of financial securities to provide hedging and insurance against capital flow reversals should be high on the agenda. Another priority issue is to develop initiatives for increasing the amount of resources that can be made available in times of liquidity crises, in order to deal properly with such crises in the context of increasingly more globalised and integrated financial markets.

The importance of reviewing the provision of liquidity by the IFIs, as well as its conditions and amounts, is also borne out by the point emphasised by the chapter that financial markets are inherently pro-cyclical and that progress on crisis prevention should be evaluated taking this into account. Historical experience shows that financial markets tend to be pro-cyclical, due to factors such as herding and contagion. Capital flows to emerging markets, in particular, are volatile and pro-cyclical. This reality stands in sharp contrast with the theoretical role of financing in order to smooth consumption through the economic cycle.

Basel II

Turning to the issue of Basel II, which is more extensively discussed in the chapter, the authors argue that it may inappropriately discourage international lending and make it more pro-cyclical. They note that there has been improvement, but that there are still problems in the internal ratings based approach.

One particular aspect they discuss in the chapter is that Basel II does not take into account the benefits of international diversification. This is well substantiated by the authors. They provide, for instance, evidence that the correlation between real and financial sectors of developed economies is greater than that between developed and developing economies. This point persuades me. Most important, as the Institute of International Finance (IIF), major banks and the chairman of the Basel Committee also agree, we should not lose hope that positive changes will eventually be made.

The authors also argue that Basel II is likely to accentuate the pro-cyclicality of bank lending, which would be especially adverse for the most vulnerable developing countries, and thus, that there is a need for counter-cyclical measures, such as forward-looking loan-loss provisions. My feeling is that this point is right, but I missed a fuller discussion in the chapter substantiating it.

One general caveat on this issue is that the pro-cyclicality of bank lending does not necessarily mean that their internal risk management is inadequate. In principle, proper risk management would take this fact into account. If there is an externality in their decisions, however, so that they do not take into account how individually they contribute to exacerbating pro-cyclicality, this observation could lead to a different type of regulation.

Increasing Capital Flows to Developing Countries in Times of Drought

The authors also discuss a number of ideas about what industrial countries could do to encourage increased and more stable capital flows. One is the establishment of guarantees for private flows, especially for investment in infrastructure. The idea is to introduce a counter-cyclical element in guarantees for lending to developing countries. In this regard, just as loans and credit guarantees offered by the World Bank are instruments to promote development rather than to deal with pro-cyclicality, the proposal would seem to put the World Bank and others in the business of the IMF. On this matter, I am not convinced. In principle, if one could change IMF governance in order to make it a more effective institution, I would not go that route. The whole idea of international initiatives for liquidity provision is to pool the resources, since that is cheaper and more effective.

Representation

The authors make, in their own words, a "modest proposal for increasing the voice of developing countries" in the Governance of IFIs, which would build on the agreement reached in Monterrey. The changes would include an increase in basic votes in both the IMF and the World Bank, amending the quota formula to reflect the rapid growth of some developing economies, and add at least one seat for African countries, while the voting share of developing countries would be maintained at below 50 percent, with veto power for the US and Europe. Also, the changes would include enhancing developing country representation in other international fora such as the BIS, the Basle Committee, and the Financial Stability Forum.

Given the agreement reached in Monterrey, this is a theme worth working on, and, while there may be similar or better variants, this proposal seems a reasonable starting point to me. On this matter, one point that I would like to emphasise is that proposals should not focus exclusively on representation at the IMF and World Bank, but also on the other above mentioned international fora. The fact is that the representation problem today is indeed much larger in the latter than in the former.

More broadly, I certainly agree that "the search for a stable and equitable global financial system" must involve finding ways to increase developing countries representation in international fora. This would give greater democracy and legitimacy to the IFIs, and through improved ownership and better-informed discussions, contribute to improving financial stability and fairness. Moreover, in my view, it would also contribute to making the global financial system more efficient.