WHAT IS THE ROLE OF THE REGIONAL DEVELOPMENT BANKS IN REBUILDING THE INTERNATIONAL FINANCIAL ARCHITECTURE?

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INTRODUCTION

1) This paper proposes a role for the regional development banks (RDBs) in the implementation of a modern worldwide financial. The paper is organized in three chapters. The first one assesses the problems that are leading to a redesign of the worldwide financial architecture and proposes a role for the RDBs in their solution. The second chapter proposes the instruments and policies that the RDBs can use to play this role. The third summarizes the proposal and raises some issues for discussion.

I. Assessment of the problem

2) Two problems have become evident in the global financial architecture in the recent past: the protracted instability of development countries and the volatility of their access to the international financial markets. Although related primarily to the developing countries, these problems also affect the developed economies and the rest of the world in general. The participation of developing countries in the international financial markets is still small relative to the worldwide transactions. It, however, is already large enough to create severe disruptions in the global system when they fall into financial crises. Also, the lack of a sustainable integration of the developed and developing financial markets is an important factor deterring progress in the developing economies. It also reduces the efficiency of the worldwide allocation of resources. The following sections discuss these two problems and identify the roles that RDBs can play in their solution.

[1] The author appreciates comments provided by Roberto Zahler.

A. Instability

3) Developing countries have been traditionally prone to financial instability as a result of the combination of extreme dependence on commodities with volatile prices for foreign exchange earnings, lack of monetary and fiscal discipline and weak financial institutional settings. This tendency has become more marked in the last two decades as a result of several developments that have taken place in the world economy.

4) First, value added is increasingly a function of the amount of knowledge imbedded in production. As a result of this trend, the real prices of non-oil commodities—which embody low levels of knowledge in their production—have been declining for the last thirty years, straining the developing countries' ability to finance their imports. Since, with some exceptions, the industrial sectors of developing countries operate behind high rates of protection, they are not competitive enough to sell in the international markets and therefore cannot compensate for the fall in foreign exchange revenues. On the contrary, the industrial sectors of these economies tend to be net importers as a result of their need for foreign raw materials and intermediate inputs, so that the declining commodity export revenues introduce recessive tendencies in the industrial sectors and the economies in general. To counterbalance this trend, many developing countries have resorted to monetary creation, currency overvaluation and foreign borrowing to keep the economy growing. Without expanding the exporting basis, this has resulted in the classical cycle of overborrowing, financial crises and default. Through these mechanisms the lack of competitiveness becomes manifest in the capital account of the balance of payments in both the borrowing and the defaulting phases of the boom, even if the root of the problem is the lack of a diversified exporting basis that could support the service of foreign debts.

5) Second, the long-term solution of these problems, opening the economies to increase their competitiveness, also creates transitional instability. In the 1990s, most developing countries, though still remaining heavily protectionist, made progress in liberalizing their trade regimes. The increasing competition from abroad initiated a structural transformation that necessarily implies the disappearance of inefficient activities to be replaced by more efficient ones. The process, while necessary for the solution of the problem in the long term, worsens the instability in the short run as banks experience losses when the assets they have financed become obsolete as a result of foreign competition. Other liberalizing measures, such as the opening of the capital account in the balance of payments and the liberalization of the financial system (including the removal of interest rate controls as well as the facilitation of the entry of new competitors) have resulted in increased instability in the short term—particularly when these measures have been taken precipitously, without other measures that should accompany them, without analyzing properly sequencing issues or without the necessary institutional support. For example, liberalizing the capital account while keeping in place imprudent monetary, fiscal and foreign exchange policies is a recipe for disaster. A prime example of the missing institutional de-

velopment is the liberalization of the financial system without an adequate regulation and supervision.

6) Third, protection in the developed countries has become a substantial obstacle for the diversification of the developing economies, even for those that have made great progress in liberalizing their domestic markets. While the trade policies of developed countries are relatively liberal in the complex goods and services that they trade among themselves, they are highly restrictive in those areas where the value added per worker at international prices is low, such as textiles and other goods and services where the developing countries could compete.

7) In combination, these problems have worsened the instability of these countries to a point where it has become the most urgent problem to resolve. Financial crises sweep the gains obtained for many years in terms of economic activity and reduction of poverty. The solution is not to close again the economies—this would lead to even more instability and a rapid impoverishment of these countries—but to complete the reforms and deal with the temporary instability they prompt. Completing the modernization of the developing economies requires heavy investment in more efficient activities, which, in turn, requires not only eliminating the distortions in relative prices that protection creates in these economies but also obtaining access to the international financial markets, so that resources can flow to the new efficient activities that undistorted price systems would spur.

B. Lack of access to financial markets

8) The volatility of their access to the international markets is the other fundamental financial problem of developing countries. Sustained access is essential because the magnitude of the investment needed is much higher than both the current savings potential of developing countries and the lending capacity of the multilateral institutions. In many of these countries, the multilateral and bilateral development institutions are the only sources of long-term financial funds. This dependency should be overcome to open the opportunities for growth for those countries. This does not mean that multilateral institutions should disappear. They are the equivalent of international credit unions where countries can borrow under more favorable terms than if they borrowed individually in the markets. By enabling their members to access the market directly, the multilateral institutions would be able to concentrate on the needs of long–term financing for social purposes that cannot be funded in the markets.

9) The problem of access is closely related to the instability discussed in the previous subsection. The high moral hazard caused by insufficient fiscal and monetary discipline and the volatility and long term decline of foreign exchange revenues produced by commodities pose major obstacles to the development of financial markets in the developing countries and to their integration to the world markets. In combination, these trends have

resulted in a strong reluctance of the international markets to finance the transition of the developing countries into an integrated world. These problems prevent not only the access to the global financial markets but also deter the development of the domestic financial system, which remains small in most developing countries, and retards the development of regional financial markets, which are practically inexistent in those countries.

10) While all developing countries share these problems, there are substantial differences between them. Some countries have been able to stabilize their economies fiscally and monetarily and have aligned their domestic prices with those prevailing in the international markets through the reduction of protection and the dismantling of asphyxiating regulations. Yet, the international markets tend to see the developing countries as a whole when analyzing risks. Even if they have become more discriminatory in the recent past, a crisis in one developing country tends to lead to a withdrawal of financing to all of them. Thus, where it exists, access to international markets has been fragile even for the most disciplined of developing countries. If this problem is not resolved, the end result might be a vicious circle, in which the long-term transformation of the economy that is needed to eliminate volatility would be prevented by the lack of access to the international markets. In such a scenario, instability would tend to increase, exerting unmanageable pressures on the global financial system and making increasingly difficult for the IMF to keep the global financial stability in place.

11) Thus, resolving the long-term problems that lead to financial crises and lack of access of the developing countries is essential to have a stable and efficient global financial architecture. The multilateral financial institutions, including the World Bank and the RDBs, have a comparative advantage in resolving those problems.

C. The competitive advantage of RDBs

12) Integrating developing countries into the global financial architecture would require dealing with four problems.

?? First, the developing countries must carry out several tasks to stabilize their economies—including imposing discipline on their fiscal and monetary policies, strengthening their financial systems and diversifying their exports through trade liberalization.

?? Second, carrying out what is called "second generation" reforms to create an institutional setting adequate for a modern economy, including ensuring the rule of law, facilitating the creation of property rights and properly enforcing them, giving transparency to economic and political activities, improving financial regulation and supervision, strengthening their banks, and similar structural reforms.

?? Third, countries where those tasks have already been accomplished or advanced substantially need to overcome the resistance of the markets to finance developing countries on a sustainable basis.

?? Fourth, although carrying out these tasks would reduce significantly the risk of financial crises, they are not likely to disappear. Mechanisms to deal with them should be established, aiming at reducing their negative impact on the countries suffering them and on the rest of the developing community.

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

?? First, they deal with the entire range of factors influencing the financial markets—including not just activities in the financial sector itself but also those in the real economy and the social sectors. Since many financial events are rooted in the non-financial parts of the economy, this is a clear advantage.

?? Second, they operate in the long-term end of financing, which is essential for the long-term solution of the problems now affecting the global financial architecture.

?? Third, they work on the structural and institutional aspects of development that should be resolved to provide access to, and reduce the instability of, developing countries.

14) Since either the World Bank or the RDBs could play this complementary role to the IMF's, three questions must be answered to fully design a new global financial architecture. First, can the RDBs provide a value added to the new financial architecture in addition to that which could be provided by the World Bank? Second, should the tasks associated with the global financial architecture be formally split between the World Bank and the relevant RDB in each of the regions of the world? Third, what kind of coordination should exist between these institutions?

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

16) The financial problems discussed in the previous sections tend to have strong regional connotations. While common to all developing countries, they tend to take different specific shapes in the different regions. In this way, for example, countries in Latin America tend to be more unstable and prone to crises than those in Africa, while the problems of lack of access to international markets tend to be graver in the latter. The levels of in-

come, and therefore the problems that must be resolved to integrate the countries in the global financial architecture, also tend to diverge across regions. Furthermore, integration to the global financial architecture means not only bringing the developing countries to the international developed markets but also integrating the financial systems of the developing countries with each other—a task that is easier to carry out regionally because international trade across developing countries tends to develop first among neighboring countries. For these reasons, RDBs are ideally positioned to help in the solution of these problems.

17) Regarding the second question, it would not be in the interest of the developing countries to allocate tasks in a rigid manner to each of these institutions. Overlapping between the World Bank and the RDBs is unavoidable. Regional and global issues are inextricably linked, so that the comparative advantages of both the World Bank and the RDBs are needed. Moreover, overlapping is desirable for three main reasons: first, it spurs creativity by mixing the global and the regional approaches; second, it introduces a healthy competition; and, third, it allows for compensation of the shortcomings of some institutions by the strengths of the others.

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

19) If this argument is accepted, RDBs should prepare formally to help in the building of a more efficient and secure global financial architecture. In fact, since the problems that the paper addresses have been present for a considerable time by now, all multilateral institutions have tried many ideas to resolve theme, most of which have proven useful or may be so with some modifications. These instruments, however, have been created in ad-hoc ways to deal with specific crises and they have not yet coalesced into institutionally defined instruments and policies. The aim of the paper is putting these well-tried ideas into a consistent whole that would result in a more coherent financial architecture.

II. Towards an improved international financial architecture: proposals for the RDBs

A. Objectives

20) Regarding the issues discussed in this paper, the main objectives of the RDBs would be

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

21) Meeting these objective would have implications in several dimensions for the RDBs. They would have to:

- Develop new instruments;
- Design special lending policies; and
- Improve their capacity to generate and disseminate knowledge and best practices.

22) The next three sections develop each of these aspects of the proposal. Subsections B discusses the policies and instruments that RDBs could use to integrate their member countries to the international markets and managing financial crises, dealing first with the public sector and then with the private sector. Section C proposes policies and instruments that RDBs can use to integrate the private sectors to the global financial markets. Section D proposes policies to mitigate the pro-cyclical behavior of private financing. Section E discuses the role that RDBs can play in the generation and dissemination of knowledge and experience.

B. Instruments and policies to integrate the public sector to the international markets

23) There are two issues in this subject: improving access to financial markets and dealing with financial crises. This subsection discusses both of them.

1. Improving access to financial markets

24) To help countries to acquire financial resources adequate for their needs, lending policies should be geared to two main objectives: developing the domestic financial mar-

kets of their member countries and bringing them to the global markets, thus reducing their dependency on the development financial institutions. The design of the operations and their conditionality should be framed within this principle. As emphasized before, this would entail working on resolving the structural issues that give raise to instability as well as helping them to get actual access until the developing countries became able to get such access on their own. Thus, the multilateral institutions as a whole, and the RDBs in particular, should work to reduce their own *participation* (not necessarily their lending) in the financing of the developing countries, bringing their members to a more plentiful and more sustainable source of financing for development needs. This would allow them to concentrate their operations on social projects with long maturity of benefits. As also mentioned before, the justification for this recommendation is simple and pragmatic: the lending power of all the multilateral institutions combined represents only a minor portion of the financial needs of the developing countries. If countries did not develop their own domestic markets and were not brought to the markets, they would be condemned to under-financing to perpetuity.

25) To accomplish this objective, RDBs would have to deal with three problems. One, working closely with governments and the World Trade Organization (WTO) to liberalize trade in both developed and developing countries, aiming at reducing the current dependency of the latter on a few commodities for foreign exchange earnings. Two, improving the quality of their macroeconomic management and their institutional setting (including the "second generation" reforms mentioned before) to make the debt of the country attractive in the financial markets and allow for the development of a solid local financial system. Three, help countries to carve a niche for themselves in the global financial markets.

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

27) Regarding the second problem, development financial institutions have lent substantial amounts to help countries to attain stability and have conditioned loans to attaining it since the early 1980s. In spite of this, and after uncountable operations, true policy reform to ensure stability has not been attained. Partly, this outcome is the result of political pressures imposed on the development institutions to lend as much as possible to all countries and, in some specific cases, to lend to some of them. This puts pressure on the staff to be overoptimistic in their appreciation of the effectiveness of the measures proposed in the operations to overcome the instability problems or the willingness of the governments to put them in practice. A solution would be to give more weight in the lending decisions to the credit ratings of the professional rating companies, which, in any

case, are essential to access the markets. Such ratings provide a quantitative assessment of the well-informed perceptions of the market. The role that private ratings could play would be the following:

?? Requiring a grading from a recognized credit rating agency as a precondition for any lending operation to any country.

?? Such rating, which would have to be updated from time to time, would serve as a benchmark of the success of the RDBs' in enabling their member countries to access the private markets.

?? Failure to obtain progress toward good ratings should be a major obstacle in getting further financing.

28) Giving such a predominant role to private ratings could be opposed on the argument that their record has been less than flawless. The recommendation, however, is a purely pragmatic one. Ratings are the main piece of information that investors use in the markets. If one wants to go to the market, one has to be rated and the rate of interest one gets is largely determined by the rating. This is a fact of life. Thus, tracking the ratings of developing countries gives a good, objective, measure of progress in bringing the countries to the markets because if they do not get good ratings they will not be able to go to the markets.

29) Regarding the third problem, that of actually helping countries to float instruments in the markets, RDBs should reach an agreement with each of their member countries on a long-term strategic program aimed at bringing them to the global markets and evaluate the performance of their operations using this program as a benchmark. Domestic financial markets would be taken as part of the global system and the proposed programs could start with issues of debt in the domestic and then in both the domestic and international markets.

30) To induce countries to access the markets, the program should also include a down sliding schedule of the proportion of loans that the RDB would finance in full. This is necessary because in the short run it is more comfortable for governments to borrow from a single multilateral. The loans that RDBs would finance in full would include all loans for social projects and a diminishing portion of the other financial needs of the state. The remainder would be co-financed in the market with the assistance of the RDB. These programs should be flexible within certain reasonable limits but should be seriously enforced. Countries approaching graduation would include their social projects in the sliding program

31) . Complementing this policy, RDBs could provide enhancements for the instruments issued by the countries in the international markets, so that their exposure in these operations would be higher than the amount in which they participate in the co-financing. In this way, for example, an RDB could finance 50 percent of an operation and guarantee an additional 25 percent. The guarantees could take any shape—for example, that of the

well known rolling guarantees of the subsequent two years in longer term operations, or those that guarantee the outer years, and their variations. Co-financing can also take several forms, including financing the outer years of long-term loans and many other variations.

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

2. Helping in the prevention and management of financial crises

33) There are four aspects to this problem: the prevention of crises; dealing with them; dealing with the contagion through the financial markets to other countries and managing the increased risks that these operations present in the portfolio of the RDBs. This section discuses all these aspects, beginning with the fundamental problems caused by financial crises. The needs posed by the crises then illuminates the discussion of the ways to preventing them and dealing with their consequences.

34) **Dealing with financial crises:** Multilateral institutions have participated in the resolution of most of the recent crises with varying degrees of success. In general, the banks' performance has been timely and effective. However, there are three issues that should be resolved to prevent future problems. One is the definition of the roles of the banks—including the World Bank and the regional institutions—and the IMF in the provision of liquidity funds. The second is the potential conflict imbedded in the twin objectives of providing short-term liquidity and funds for the long-term restructuring of the banking system.

35) Regarding the first issue, it has been recognized for long that the provision of emergency liquidity is an IMF responsibility, while the provision of financing for the recapitalization of the system—plus all the required technical assistance—is within the purview of the multilateral banks. The size of recent crises, however, has exceeded the IMF's financial capacity, and other institutions – the World Bank, the Inter-American Development Bank, the Asian Development Bank and the United States Government among others—have been called to complement the IMF in the provision of emergency liquidity. This was the case of the Tequila and the Asian crises of the 1990s. As a member of the

international community, the development banks had no other option than complying with such calls.

36) Many critics of the current financial architecture point out that the provision of liquidity help should be the exclusive function of the IMF. This may be a solution to the problem. However, if the development institutions are to stay away from this kind of operations, the liquidity of the IMF should be increased substantially in preparation for contingencies. If the international community does not increase the IMF's liquidity, the development banks—including the RDBs—would have to help with their much larger liquidity in cases of emergency. Since it is difficult to anticipate the magnitude of crises, it is important that RDBs be prepared with policies and instruments for an emergency. If RDBs are to continue helping to resolve liquidity problems in financial crises they should design an instrument specific for this purpose.

37) Governments of countries experiencing financial crises need financing for two purposes: (a) emergency liquidity, needed to restore the confidence of depositors and lenders in the domestic financial system and the government's ability to repay its obligations; and (b) funds to carry out structural reforms aimed at preventing the repetition of the crises, mainly by recapitalizing or liquidating failed financial institutions without loses to depositors and improving supervision and regulation. The financial needs posed by these two problems are different from each other. Loans for the first purpose should be provided with short maturities, under the assumption that, as soon as confidence is restored, the country's government and financial system will recover the necessary liquidity and will repay them. The maturity of loans provided for the second purpose must be long to allow governments to spread in time the losses it incurs when absorbing the losses of the financial system.[2] Also, carrying out the recapitalization of banks is a difficult task that requires substantial technical work of the highest quality.

38) Up to now, for lack of an instrument to convey liquidity, the multilateral banks have used loans aimed at the subsequent recapitalization of the local institutions as conveyors of liquidity assistance, creating severe tensions in the resulting operations. These tensions arise because the purposes of providing liquidity to restore confidence and providing resources for the recapitalization of the banking system can easily become contradic-

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[2] These funds, however, are not needed in all cases of restructuring: the government can cover the losses with long-term interest-bearing bonds issued to the failed banks, replacing with them the non-performing assets in the institution's books. Liquid funds are needed only to liquidate institutions and, in some cases, to facilitate the sale of failed banks. This is so because the problem of failed banks is that their assets do not generate enough income to pay for the expenditures of their liabilities. Substituting the bad portfolio with interest-bearing bonds resolves this problem—provided, of course, that the interest payments are calculated so as to cover the expenditures of the liabilities. Buying the bad portfolio with cash may be counterproductive because it would give too much liquidity to the banks, which then would have to lend fast to turn it into income-earning assets. This precipitation could lead to more bad loans as well as to inconvenient expansions of the money supply. The problem is different when what is desired is to stop a run on the banks, which requires fast injections of liquidity to restore confidence.

tory. Because of their nature, loans to recapitalize banks have to include conditions that should be met before disbursements are made—basically that the banks have been recapitalized and that sufficient provisions have been taken to prevent the repetition of the crisis—while the only conditions for the disbursement of an emergency loan should be the existence of a program guaranteeing its repayment. By mixing these two objectives in one single instrument, the development banks place themselves in a potentially difficult position. If a country has not complied with the conditions for disbursement but is in need of the emergency funds, any decision is bad. If the banks refuse disbursements, they are reneging on their commitment to help in the emergency. If they disburse, they are reneging on the seriousness of their developmental commitment to help in the recapitalization of the domestic financial system and improve the resilience of the system.

39) Thus, the RDBs need an instrument to convey liquidity help in cases of financial crises, which would have similar features to those used by the IMF in terms of maturity and conditions of disbursement. To complement this instrument, the RDBs should redesign the instruments used for the recapitalization of the financial system, making disbursements contingent on the occurrence of actual expenditures by the government for this purpose. Shaping these operations as classical adjustment loans, disbursed against general imports on the fulfillment of some conditions, weakens the connection that should exist between disbursements and actual project costs and may result in cases where the loan is disbursed while the banking system has not been yet recapitalized.

40) **Preventing crises:** The tasks outlined in connection with the integration of the developing countries to the international financial markets would go a long way to prevent crises. Additionally, RDBs can further this objective by supplementing an instrument already created by the IMF. This instrument, called the Contingent Credit Line Facility (CLL) aims at providing contingent lines of credit to be disbursed in case a crisis developed in a country for causes different to fiscal or monetary indiscipline—which the IMF interprets as caused exclusively by contagion.[3] RDBs could enter the field of contingent operations for three main reasons.

- First, as in the case of emergency loans, the size of the IMF facilities is too small to provide comfort to the markets. The CCLs are limited to 3-5 times the countries' quota.
- Second, emergencies not rooted on fiscal or monetary indiscipline might arise from reasons different from contagion. A natural disaster or a terrorist attack are just examples of the many events that could unravel a liquidity crisis in a prudently managed country. RDBs and the World Bank have facilities for this kind of need; they, however, are not pre-approved and therefore cannot provide the confidence that automatically disbursable contingent loans would provide.

[3] How does the IMF lend? A fact sheet, IMF, September 2001, available in www.imf.org

- Third, and related to the former, only a third of the approved amounts for CCLs can be disbursed automatically. The rest must be subject to a review of the situation at the moment of disbursal. This effectively reduces the size of the contingent loan to a third of its nominal value, or about 1-1.6 times the country quota with the IMF.

41) Thus, RDBs could make a substantial contribution by increasing the funds available for contingencies and by including emergencies different from contagion as justifications for disbursements. In these operations, the RDBs would closely coordinate with the IMF although their instruments would not be exactly like the CCLs. The promise to disburse would be provided based on a program approved by the IMF and would be binding only if the government actions coincide with what it promised when contracting the contingent facility. Thus, the conditionality of these operations would refer to policies and not to outcomes. A country would be able to withdraw from these facilities regardless of the depth of a crisis only if it has followed the prudent policies agreed with the RDB when contracting the loan. Symmetrically, if the conditions established in the contract—which would be designed specifically for each country to take into account particular features of each of them—the country would have the right to disburse the entirety of the loan.[4]

42) **Dealing with contagion:** Ripple effects tend to happen as a result of the sudden panic that overtakes international markets when one developing country falls into a financial crisis and default. As a result, even well managed and secure developing countries find that they cannot access their private sources of financing. This problem is one of insufficient information. The CCL is aimed at ameliorating them. A quick facility should be open also for countries not contracting contingent lines of credit. Being close to their member countries, RDBs can play a decisive role by providing fast credit to countries in this situation and, through this and other measures, encourage the private sector to keep on providing credit to them.

43) **Managing the risks of liquidity operations:** In summary, RDBs would create three liquidity facilities to deal with the problem of financial crises:

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

44) Even if carried out prudently, these operations would be much riskier than the traditional operations of the RDBs. For this reason, they should be priced at interest rates higher than those applied in normal operations. This is the solution that RDBs, the World

[4] For the need to have different indicators in the contracts with each country, see Stanley Fischer, Reducing Vulnerabilities: The Role of the Contingent Credit Line, IMF, April 25, 2001, available in www.imf.org

Bank and the IMF have applied in the small number of operations they have carried out with instruments similar to these. In addition, RDBs should avoid a situation in which these operations would crowd out their traditional development operations. A quantitative limit should be imposed on these operations and the costs of the staff working on them should be covered by the operations themselves, so that there is no crowding out of the staff working in traditional operations.

45) One alternative to these measures would be allowing RDBs to invest in detached subsidiaries that would rely on their own capital to mobilize resources and manage their risks, and assigning the riskier operations to these subsidiaries. Since their operations would not be consolidated with the RDB, the increased risk would not affect its own credit rating. This idea is worth considering.

C. Bringing the private sector to the international markets

46) The main reasons for the lack of financing for the private sources are to be found in the unstable fiscal and monetary policies as well as on the inadequate regulation and supervision of the local financial system. For this reason, the main efforts should be directed toward the solution of these problems. In the meantime, RDBs could help in the financing of the private sector. The objective of these operations should not be that of substituting for private financing but that of catalyzing its development. Meeting such objective might be difficult because the presence of officially backed financing may stifle the development of domestic sources, defeating the ultimate purpose of the exercise. As in the case of the public sector, the needs of the private sector exceed by several orders of magnitude the capacity of the multilateral institutions and creating a dependency on these institutions for the financing of the private sector would be damaging for the countries.

47) There are three main issues that should be resolved to ensure that financing the private sector would not damage the development of the local financial systems. First, there is the issue of lending to the private sector with sovereign guarantee. Such lending introduces a distortion in both the local and the international markets because other potential lenders do not enjoy such an advantage. Since governments do not have the capacity to guarantee all potential lending to the private sector, the only solution to this problem is to deny such guarantee to all of them. The World Bank, cannot lend without a sovereign guarantee but its subsidiary the International Finance Corporation not only can do it but can also invest in equity holdings. Some of the RDBs, like the Inter-American Bank for Development (IDB), and some sub-regional institutions, like the Central American Bank for Economic Integration and the Andean Corporation of Finance, lend directly to the private sector and can even invest in equity holdings. In addition, the IDB has a special subsidiary aimed at lending without sovereign guarantees and also invest in equity holdings.

48) Operations carried out without government guarantees have, in general, been financially successful but, up to this moment, the volume of resources intermediated in this form remains small. The growth of these institutions is constrained by the very same reasons that prevent the access of developing countries to the private international markets. Naturally, they can lend only in dollars, which poses almost intractable foreign exchange risks except for a relatively small group of companies that generate dollars in their normal operations, which tend to be big companies with a good credit rating. In these cases, they face the competition of private international banks. RDBs are at a disadvantage in such competition. Their credit analysis tends to be lengthy and cumbersome because, lending from afar, their knowledge of potential borrowers is scant and because their procedures tend to reflect their ultimately public sector nature. In many cases, the role of these institutions is to provide comfort to big international private investors, who have access to other sources of funds but trust that having a RDB as a partner would reduce the risks of their investments. To the extent that those investments would not take place without their participation, the RDBs' private sector subsidiaries play a useful role in those operations.

49) RDBs and their private sector subsidiaries have also lent to private banks, which then onlend the proceeds to private companies, thus resolving the problem of local knowledge. However, other problems conspire against these operations, particularly that of the foreign exchange risk, which reduces their market considerably. Overall, experience has shown that they cannot become large providers of funds to the private sectors of developing countries.

50) Still, the private sector subsidiaries of RDBs can keep on playing a useful role mainly through demonstration effects in innovative projects. Regional initiatives provide new opportunities for this kind of operation, particularly in cases of private international infrastructure projects, such as international electricity transmission lines, water pipes, toll ways and other transportation works. The presence of subsidiaries of the RDBs in these investments would provide a comfort that is more needed than in cases of purely national undertakings.

51) One area in which these operations are badly needed is the development of credit to the small and micro enterprises, an area in which the corporate private financial institutions are reluctant to cover because it is costly and risky. As in the case of the other operations with the private sector, RDBs should focus on transferring best practice while helping the countries to develop their own sources of financing.

52) Developing countries may also pool financial operations in certain sectors and gain in a reduction of their overall risk. One example of this is mortgage financing. Private or public financial institutions in countries with sensible monetary and financial policies can pool their mortgages and sell them in the United States and the international markets. RDBs can help in creating vehicles to carry out these operations. Their private sector subsidiaries could enhance the instruments with properly priced guarantees. Of course,

these operations are more viable in countries with stable monetary and fiscal policies that make catastrophic devaluations unlikely. Otherwise, the costs of covering the foreign exchange risks would be prohibitive.

D. Helping to ameliorate the pro-cyclical behavior of private financing

53) The volatility of international financing to developing countries has already been discussed in relation to the declines in lending that tend to take place after a serious crisis affects one of them. Declines may also take place as a result of global cyclical movements. The role that they can play in this respect, however, is quite modest, unless they succeed in convincing the markets to lend more than otherwise in times of decelerating or contracting global economic activity. It is important to note, however, that engaging in these anti-cyclical lending activities would mean that RDBs would necessarily have to maintain "excessive" capital during the expansionary parts of the cycles to accumulate the financial resources needed to inject liquidity during the downturns. In fact, RDBs keep high levels of liquidity at all times, and there is no evidence that they have been unable to increase their lending during the downturns as a result of lack of resources. However, the issue should be studied in detail, to determine if RDBs could have lent more during contractions and devise policies to deal with this problem. Within the approach recommended in this paper, RDBs would have to:

- Increase their share of co-financing in times of global deceleration; and
- Reduce their share in times of global expansion.

E. Knowledge exchange

54) This is one of the most important roles that development institutions may play and the one with more lasting effects. It has two dimensions, acquisition and dissemination. The staff of the institutions naturally acquires knowledge through the normal operations. However, such knowledge is not necessarily acquired and systematized by the institution. To do so, the institutions need small research units and, quite importantly, an independent system to evaluate the operations. While some of the RDBs already have research units, they need to develop further their auditing systems, which are essential not just to control quality but also to learn what works and what does not. Areas where RDBs can help include compliance with the Basle Committee Recommendations as well as presenting to the Committee the problems that some of these regulations may cause to their member countries.

III. Issues for discussion

A. Summary

1. Instruments

55) This paper recommends that the RDBs create five new instruments or series of instruments in their core institutions, with the following characteristics:

?? A series of instruments aimed at enhancing debt issued by member countries. The purpose of these instruments would be to ease the access of *solvent* governments of developing countries to private markets through eliminating the asymmetry of information that frequently prevents it.

?? Contingent lines of credit, to be contracted with countries in fully stable conditions, disbursable if those conditions deteriorate for reasons different from lack of fiscal or monetary discipline. If not disbursed, there would be a commitment fee, calculated like an insurance premium. If the loans are disbursed, the rate of interest would be substantially higher than the normal rates of the institutions, by an amount that would fully compensate the increased risk of the institution. The rates, however, must be lower than the rates charged for emergency lending.

?? Emergency loans to be contracted in the midst of financial crises if and only if the country in question is putting in place a program, approved by the IMF, to resolve its problems. The approval and disbursement of each of these operations would require the approval of the IMF. They would have short maturities and high interest rates.

?? Liquidity loans aimed at ameliorating the effects of contagion on financially healthy countries. These loans would have short maturities and would have interest rates lower than those of emergency loans but higher than those contracted under contingent arrangements.

?? Loans specifically designed to finance the cash costs of revitalizing banks after a financial crisis. These loans would be different from the loans that currently are granted for this purpose in that they would be disbursed not against policy reforms but against actual transactions carried out to revamp the financial system. The loan amounts would be determined based on estimations of those costs.

2. Lending policies

56) Regarding lending policies, the paper recommends:

?? Requiring a grading from a recognized credit rating agency as a precondition for any lending operation to any country. Such rating, which would have to be updated from time to time, would serve as a benchmark of the success of the RDBs' in enabling their member countries to access the private markets. Failure to obtain progress toward good ratings should be a major obstacle in getting further financing.

?? Establishing and enforcing strict limits on the maximum exposure that any RDB can take with individual countries, with an extra margin left for increasing it in case a major financial crisis develops. A maximum period to return to levels below such exposure should also be established for countries exceeding it during a crisis.

?? The staff needed to manage the contingent and emergency loans should be funded with the proceeds of these operations exclusively, so that their appointment does not crowd out staff working on traditional projects.

?? A schedule for graduation should be established for countries with an income level that should assure them access to markets on their own. Graduation, however, should not be a one-step process. To entice countries to go to the market, RDBs should have a sliding schedule of the portion of financing that they would provide on projects not associated with social development and offer help in accessing the markets for the difference. Without such schedule, there would be no short-run incentive for the countries to make the extra effort needed to integrate into the world's financial markets.

3. Private sector operations

57) Expand the non-sovereign lending to the private sector, preferably through the subsidiaries dedicated to these operations, aiming at enhancing the access of private firms to private markets, giving emphasis to the development of regional financial markets, the participation in the development of private infrastructure projects with a regional dimension and the creation of markets for the financing of small and micro enterprises.

4. Creating hubs of information

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

B. Questions

?? Should the objective of bringing developing countries to the private markets have a first priority?

  - o Setting such objective would increase the workload of both the RDBs and their borrowing members because it is always simpler to deal with one single lender than with several ones, particularly if they are private.
  - o Introducing a market test in the shape of private ratings may reduce the flexibility of the RDBs.
  - o On the other hand, bringing them to the markets and introducing the tests that the markets use is the most direct way to provide the amounts of resources that the developing countries need.

?? Should the RDBs take the lead in the integration of their member countries to the private financial markets?

  - o Doing so would be natural because the integration to regional markets is part of the integration to the global markets and the regional institutions have a comparative advantage in this area.
  - o On the other hand, some RDBs may lack the abilities needed to carry out this task and therefore may need substantial assistance from the World Bank to assume such responsibility.

?? Should RDBs participate in the provision of liquidity loans associated with financial crises? Should they impose quantitative limits to them?

  - o Participating may be unavoidable in cases of large crises. If they are to participate, it is better to have in place well designed instruments and policies dealing with these problems.
  - o On the other hand, participating in these operations would increase the risk of the institutions, a problem that can be ameliorated but not eliminated by charging higher rates of interest in those loans. In some cases, not even prohibitively high interest rates cannot cover the risks of emergency financing and may, by their magnitude, actually increase the risk of the operation.
  - o Also, these operations are naturally large and, therefore, they could easily crowd out the traditional operations of the RDBs as well as other, more prudent, countries. This can happen in terms of both financial resources and staff.
  - o Imposing quantitative limits may become unrealistic in cases of grave financial crises affecting, directly or through contagion, several countries in a region. Countries coming first to get aid would preempt the subsequent help to other countries.

?? Are the instruments and policies recommended for dealing with financial crises adequate? How could they be improved?

?? Should RDBs spin off their riskier operations to detached subsidiaries with independent capital and risk management?

?? Should RDBs engage in anti-cyclical operations, lending less than their potential during the upswings to accumulate resources that they could lend in the downswings?

See comments on this paper by Roberto Zahler <link to comments on 4>