The fifth multi-stakeholder consultation on systemic issues organized by the New Rules for Global Finance Coalition in cooperation with the Financing for Development Office/UN DESA, at India Habitat Center in New Delhi, India on 29-31 August 2005.

The fifth of a series of multi-stakeholder consultation on systemic issues organized by the New Rules for Global Finance Coalition in cooperation with the Financing for Development Office took place at the India Habitat Center in New Delhi, India on 29-31 August 2005. Local co-organizers were the Institute for Human Development, UNDP, Network of International Development Economics Analysts (IDEAS), and Friedrich Ebert Stiftung.

The multi-stakeholder consultation was concerned with concrete proposals for reforming the International Financial Architecture (IFA) with a regional focus on Asia. The event was structured around the following sessions and topics:

- Session I: Trade and Development  
  o Efficacy of export led growth; trade liberalization and public sector revenues
- Session II: Managing Risk  
  o International Borrowing in Local Currency; Prudential Regulation of Financial Markets and Counter-Cyclical Policies
- Session III: Healthy Financing for the Real Economy  
  o State Intervention in the Market for Social Ends
- Session IV: Regional Priorities  
  o Prudential Regulation of Microfinance
- Session V: Recommendations: When Crises Strike  
  o A Comprehensive Framework for Sovereign Debt Restructuring in Middle-Income Countries
- Session VI: Governance  
  o Governance of International Rule-making Bodies; Governance of Regional Bodies

A brief summary of the main presentations and discussions during each one of the sessions with a clear focus on issues, proposals and recommendations is given below. The meeting was held according to Chatham House Rules, i.e., neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed in any final official report.

Session 1: Trade and Development

The session was divided into three subsections. The first focused on the effects of trade liberalization on developing countries; the second on the impact of short-term price fluctuations and the long term decline of terms of trade on commodity producing countries; and the third on the role of derivatives in hedging against commodity price risk.

(a) The first speaker stressed that the widespread orthodox belief in long-term benefits of trade liberalization for developing countries is questionable. In its current form, trade liberalization appeared to be biased against developing countries. Industrial countries’ tariffs were often punitive to poor nations. These negative effects would be exacerbated through the prevailing agricultural subsidies in the
industrialized world. Flooding developing countries markets with subsidized products would hit them especially hard as these were mostly goods where they would normally have a competitive advantage. Moreover, the proliferation of free trade agreements (FTAs), in particular those promoted by the European Union and the US, had shifted the international system from most favored nation (MFN) based trade to one based on preferences. This would further challenge the success of a fair and equitable multilateral approach that would leave sufficient room for policy space and ownership of development strategies.

(b) The second presenter identified the violence of short-term price fluctuations and a long term decline of terms of trade as the two major challenges for developing countries that rely on primary commodities exports. According to the presenter there were various reasons why primary commodity producers would find themselves in a difficult position. For instance, many small commodity producers would often depend on very few processors. Moreover, competitive pressures were intense as barriers of entry were low and new producers were often willing to accept lower standards of living and thus lower revenues. In more general terms, the Prebisch-Singer hypothesis claimed that the relative prices of primary products would decline over the long term. Consequently, developing countries that were led by comparative advantage to specialize in them would find their prospects for development diminished. For several decades, the international community had debated possible solutions confronting this issue ranging from Keynes’ call for an international currency board to prevent the violent fluctuations in the prices of exported primary commodities, to market-based instruments as promoted by the International Task Force on Commodity Price Risk Management1. The presenter also recalled some key recommendations put forward by the Group of Eminent Persons on Commodity Issues2, such as enhanced, equitable and predictable market access for commodities of key importance to developing countries, addressing the problems of oversupply for many commodities, making compensatory financing schemes user-friendly and operational, strengthening capacity and institutions and pursuing the possibilities for the creation of a new International Diversification Fund

(c) The third speaker focused on the role of derivatives in hedging price risk in India. He gave a brief overview of the structure of Indian Commodities and Futures Exchange Markets and stressed that the trading volume of Indian commodity exchanges had grown 341% between 2003 and 2004. NCDEX, a national-level, technology driven de-mutualized on-line commodity exchange, currently facilitated trading of thirty six commodities. Some critical benefits the NCDEX brought about for commodity producers were increased holding power and a better position in the value chain through cost unbundling, improved price information, as well as the lowering of transaction costs through electronic trading. Additional financing would be needed to further develop technology, build warehouses, grade enterprises and support general training and development.

Discussion

In the course of the ensuing discussion many participants stressed that success in export-led growth depended on internal industrial policy and, more specifically, on import substitution. This was particularly important for least developed countries (LDCs) who were exceptionally disadvantaged by trade liberalization. Several speakers reflected on the various domestic interventions and international agreements since the early years of the twentieth century that were introduced to mitigate adverse effects of commodity price fluctuations. They emphasized the potential benefits of many international commodity agreements and compensatory financing schemes. Regrettably, however, most of these mechanisms had gradually ceased to function or were abolished with the arrival of a market-based approach promoted through the Washington Consensus. A major challenge was to increase the position of

commodity producers in the value chain, which could be achieved through a move towards production of high-value brands and the strengthening of local markets through training and exchange of best practices. While derivatives could play a useful role in hedging against short-term price volatility, regulation and oversight would be crucial to ensure their efficiency. Some discussants pointed out that regional and bilateral free trade agreement would often jeopardize an equitable and multilateral trading system.

Session II: Managing Risk-International Borrowing in Local Currency; Prudential Regulation of Financial Markets and Counter-Cyclical Policies

The conversation starter for this session proposed a mechanism to improve the ability of developing countries to reduce their exposure to other countries' interest rate and exchange rate volatility and to lower their cost of raising capital abroad. Developing countries would borrow in their own currencies and investors lend by creating portfolios of local-currency government debt securities that employ the risk management technique of diversification. The speaker highlighted that historical estimates showed that portfolio of domestic currency denominated emerging market debt, with equal weight to all countries, could generate rates of return relative to risk that competed with those of major securities indices in international capital markets. While any one local currency assets may offer a high enough rate of return to economically warrant the risk, many investors just could not bear that much risk. A diversified portfolio of such assets could yield the average of these high rates of return while exhibiting a low level of risk.

Discussion

Several issues were raised in the subsequent discussion. Some participants expressed their concern that the proposal did not tackle the question of how the private sector could be encouraged to borrow in local currency. Others, referring to experiences in Indonesia during the Suharto regime, reminded discussants that the distinction of public and private debt was often blurred in corruptive government settings. While many participants acknowledged the potential benefit of promoting local currency borrowing some wondered whether the proposed technique would address the heart of the problem. In this regard, discussants pointed to systemic failures as there would be insufficient funds at the global level to finance the needs of the developing world.

Several participants warned that the effect of less risk exposure could be an increase in government borrowing. Moreover, the proposal encouraged investors to buy a larger amount of local currencies than before which might lead to local currency appreciation. Others disagreed with the thrust of these arguments. The proposal should not be understood as an encouragement for irresponsible government borrowing but as a tool to substantially reduce risky exposure to foreign currency movements. As alternative instruments with similar effects, participants referred to GDP-indexed bonds and inflation-indexed securities. The former was met with some skepticism by several discussants. The release of GDP data was heavily delayed and would have to be revised constantly. As a result market investors would be uncomfortable with financial instruments that were not based on quickly accessible, timely and reliable figures.

There was a general consensus among participants that the feasibility of the proposal would depend upon the level of sophistication of the domestic financial markets. This, however, was not necessarily seen as a negative aspect of the proposal. Many discussants concurred that the potential benefits of local currency borrowing might indeed be an additional motive for financial deepening and further advancement of the appropriate regulatory and supervisory framework.
Session III: Healthy Financing for the Real Economy- State Intervention in the Market for Social Ends

This session involved two presentations. The first was on the effects of the Basle II banking standard on lending behavior. The second focused on two opposing views of the role of government intervention in the financial sector.

(a) The first presenter expressed serious concerns about Basel II, which aimed at setting out the details for banks to adopt more risk-sensitive minimum capital requirements. The new rules, due to their complexity and costs of compliance, would raise the cost of capital for borrowers beyond what could be considered reasonable. Measuring credit risk was not a mere technical problem but a subjective process that could not be translated into objective definitions usable by regulators. Compliance for developing country banks would be too complex and costly. Moreover, loans may become more expensive and lending to the poor and less creditworthy severely curtailed. Indeed, in India and Brazil the adoption of Basle II resulted in less credit to the poor and decline in total credit, respectively. Hence, there was an urgent need to start a critical debate on the development effects of Basle II.

(b) According to the second presenter, there were two trajectories, or two ways of thinking about financing for development. One was to augment domestic savings through foreign investment, and the other was to create an institutional framework to use markets as an instrument of the state for financial intervention. Within the concept of the latter approach the state would redirect capital flows to areas with those in need. Tools to redirect capital flows would include monitoring of the credit/deposit ratio in order to avoid draining certain regions of credit, the use of interest rate differentials and prices to direct credit to targeted sectors and channeling credit into rural and regional areas. The presenter stressed the importance of appropriate government interventions in the financial sector but deplored that financial liberalization, i.e. the increasing reliance on foreign investment, had reduced their potential.

Discussion

In the ensuing discussion, there was broad convergence on one point, namely, the need to build an inclusive financial sector. One discussant proposed the slogan: “No globalization without universalization”. A concrete recommendation of another discussant captured the thrust of the discussion. It reads as follows: “All countries should require their central banks and other financial regulations to systematically gather and disseminate data on the proportion of their citizens who have access from formal financial institutions to the following eight fundamental financial services.

1. savings
2. pension
3. credit, short-term
4. credit, long-term
5. insurance
6. derivatives
7. money transfers
8. investment instruments, equity, etc.

Furthermore, all countries, as well as multilateral institutions should evolve concrete programs towards universalizing access to financial services to all their citizens.”

Regarding Basel II, one speaker pointed out that it was not intended to protect Emerging Markets but was tailored for banks in developed countries. As a positive example for effective government intervention in the financial sector a discussant referred to the US Community Reinvestment Act which
would redirect credit flows by measuring deposit-loan ratios. The debate also ventured into the role of National Development Banks. It was widely agreed that they could play a useful role if they were well-managed.

Session IV: Regional Priorities- Prudential Regulation of Microfinance

The session was opened by two presenters. The first elaborated on adequate prudential regulation in the microfinance sector and the second highlighted some unique aspects of India’s challenge to regulate its financial sector at the micro and macro level.

(a) The first presenter stressed that the subject was extremely difficult due to the nature of the many heterogeneous, informal and non-market institutions that comprised the microfinance sector. There was an inherent tension between banks and microfinance institutions (MFIs). While many commercial banks were trying to get into the market, MFIs were not entirely welcoming. The presenter further elaborated on possible areas of adequate regulation and reporting requirements for the microfinance sector. These included: customer segregation; due diligence to customers; disclosure of loan size; truth in lending that reflected the true cost of borrowing; disclosure of costs of funds and the cost of delivering services. However, there was only a limited bandwidth for regulation of microfinance due to the heterogeneous nature of the sector. Furthermore, it was not clear who should be the regulator (Reserve Bank of India, self-help groups (SHGs) or hybrid of these two institutions?).

(b) In turn, the second presenter highlighted that the Indian National Bank for Agricultural and Rural Development followed a multi-stakeholder approach as it cooperated with a wide variety of institutions. In order to illustrate the unique nature of India’s microfinance sector the speaker compared it with Bangladesh’s situation. Whilst in India commercial banks were cooperating with self-help groups, MFI’s would be the dominant institutions in Bangladesh. Moreover, development banks would play a dominant role in India (196 were currently operating) but they played no significant role in Bangladesh. India’s challenge would be to turn the existing array of SHG’s into an effective micro-enterprise programme. The ongoing debate should therefore focus on how the state could help develop SHG promoting institutions.

Discussion

Several discussants posed the fundamental questions of when, where and to what extent the microfinance sector would be in need of prudential regulation. Some voiced their concern that regulation could be an impediment to expansion of more universal financial access. Furthermore, in many cases there were insufficient data and analysis to establish an effective regulatory regime. A considerable part of the debate centered on the question of who should be considered the rightful owner of the profits made in the micro lending process. While in the case of India SHGs would retain profits, earned profits were not being redistributed by MFIs in Bangladesh. Several discussants labeled the Bangladesh approach “bad economics”. Borrowers were the real stakeholders and should have access to profits. There was widespread agreement that macropolicies needed to be aligned with microfinance sector regulation to support and strengthen delivery mechanisms. Moreover, any meaningful prudential approach would have to be comprised of a tremendous diversity of inter and intra community regulations.
Session V: Recommendations: When Crises Strike—A Comprehensive Framework for Sovereign Debt Restructuring in Middle-Income Countries

The session was opened with a presentation on “A proposal for a new International Debt Framework for the prevention and resolution of debt crisis in middle-income countries.” An International Debt Framework (IDF) was proposed that would present a middle ground between a legally binding insolvency procedure and a voluntary code of conduct. The proposal also departed from prior discussions of such mechanisms by locating it in the G20. The proposed IDF would satisfy two needs of international financial stability: crisis prevention and crisis resolution. Permanent debtor-creditor dialogues, the provision of transparency, and information on emerging market debt would be ensured through the creation of a permanent IDF-Secretariat. An IDF Commission would aim for a coherent and comprehensive debt restructuring when requested to do so by the debtor country. It would also propose the amount of necessary financial support and an economic adjustment path that could guarantee long-term debt sustainability. These recommendations would then apply to all creditors.

The lead discussant in this session reiterated the intense social costs external debt crisis imposed on affected countries. There was an urgent need for an impartial debt work out mechanism. Currently, there was no continuous and orderly dialogue between debtors and creditors because of interference of various groupings and institutions such as the Paris Club, the London Club and the IMF. Establishing a dialogue would help avoid wrong market signals that were unnecessarily costly for developing countries. The biggest challenge would be to make an initiative such as the IDF operational.

Discussion

During the discussion participants once again pointed to the fluid distinction between private and public debt in some middle-income countries, which were due to specific, often corruptive, governance structures. Some criticized the IDF as an ex post statutory mechanism that would have to compete with IMF bail outs. Others stressed that the IDF would establish a continuous dialogue between debtors and creditors and hence contain an ex ante crisis prevention feature.Uniting different types of creditors was generally seen as a big challenge. Many concurred that debt work out mechanisms could be helpful and in some cases necessary. However, the critical challenge remained the need to correct the tendency that created the crisis in the first place. Several discussants expressed their concern that debt problems of least developed countries were left out in the discussion.

Session VI: Governance—Governance of International Rule-making Bodies; Governance of Regional Bodies

The lead presenter in this Session called for enhanced voice and participation of developing countries in international financial institutions, in particular the International Monetary Fund and the World Bank. His main suggestion to achieve this goal was to raise the number of basic votes to 1/5 of total votes. He did not agree, however, with the widespread demand to replace GDP based on market exchange rates with GDP adjusted by purchasing power parity (PPP). While this type of adjustment might give poor countries a majority of the vote it would be unrealistic to expect them to contribute the bulk of IMF and World Bank resources. The presenter also stressed the importance of regional initiatives such as the various “Gs” (G10, G20, G24 etc.) in increasing the role of developing countries in international decision-making processes.

Discussion


Participants agreed in the ensuing debate that regional initiative would play an important role. They recalled that India had been playing a decisive part in many of these grouping, one of which had brought about the collapse of the WTO negotiations in Cancun, Mexico. However, several discussants voiced their concern that LDCs would not be adequately represented in these groupings. It was recommended to make the Executive Boards of the IMF more effective and accountable. A simple first step to improve the governance structure of the Bretton Woods institutions would be to replace the current practice of exclusively assigning the heads of the organization to US and EU representatives with a fair and inclusive selection process. Many speakers also stressed the need to revisit the current IMF and World Bank quota formula. The formula needed to reflect the realities of today and place a stronger emphasis on financial flows. Moreover, it should not strive to determine financial contribution, financial access and voting power at once. Three separate formulas were needed for these three concepts according to some participants. All needed to be based on reasonable indicators. There were calls to solve resources and governance issues of the IMF simultaneously by increasing and reallocating Special Drawing Rights. With regard to international trade, discussants stressed the need for coherence and consistency. Bilateral and regional trade agreements should be complementary to multilateral trading rules established within the context of WTO negotiations.