FROM POVERTY TO POWER **BACKGROUND PAPER**

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Financial Markets

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Private capital flows have the potential to bring important investment benefits to developing countries. In reality, however, capital flows are concentrated towards a few countries, and are highly volatile. The first part of this paper discusses the latest developments in international capital flows and financial market regulation. The second section considers the impacts of capital instability and lack of regulation on poverty reduction. It argues that poor people are disproportionately affected by financial crises, while a lack of global governance of taxation and banking deprives governments and citizens of essential resources for development. The final section analyses the drivers and incentives underpinning financial market behaviour, which tend to undermine investment in developing countries. Throughout, the author makes proposals for policy change in support of enhanced volume, quality, and stability in private capital flows to developing countries. These include improved global regulation of capital flows and taxation, changes to the incentive structures governing capital investment, and swifter, more effective response to financial crises.

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Part I: What are the latest developments in international capital flows and financial market regulation?[1]

1 Capital flows to developing countries

Global economic integration accelerated significantly towards the end of the last century. The 1990s saw a huge increase in the level of international private capital flows, including flows to developing countries. Private capital flows, in theory at least, should offer considerable benefits for development if they flow from capital-rich to capital-scarce countries. In developing countries, capital inflows have brought much-needed capital for investment as well as technology transfer. Under the right conditions, capital flows can also help to smooth the business cycle in recipient countries.

However, the relationship between private capital flows and development is far from simple. First, private flows to developing countries tend to be highly concentrated with the vast majority of flows going to large, middle-income developing countries while smaller, low-income countries receive very little. Secondly, private flows have been shown to carry significant risks for the countries that receive significant levels.

From the Mexican peso crisis of 1994/1995 onwards, private flows have been shown to be highly volatile and easily reversible. These characteristics have made private capital inflows very costly for a number of developing countries. This was most evident in the financial crises that afflicted Mexico, East Asia (Thailand, Malaysia, Indonesia, South Korea, and the Philippines), Russia, Brazil, and Argentina.

One way for developing countries to avoid crises such as these would be to repress capital inflows. But this would mean foregoing the benefits as well as the risks of receiving private capital. It is important, therefore, to identify the conditions under which international private capital flows can contribute towards sustainable development. This would involve both increasing the flow of private capital to those countries, which currently receive little or none, and, importantly, ensuring that all flows to developing countries are more stable.

The first section of this paper presents an overview of recent trends in private capital flows to developing countries and traces the shifting views on the benefits and risks they represent. It then takes a closer look at the various types of capital flow, analysing their characteristics and relative stability. The second section examines recent developments and current issues in financial market regulation looking at the public sector bodies and regulatory authorities that play a role in governing international financial flows. The third section presents a variety of policy proposals designed to ensure a more stable flow of private capital to developing countries.

1.1 Private capital flows to developing countries: an overview

Private capital flows to developing countries increased dramatically during the 1990s. To give some idea of the scale, net capital flows to all developing countries averaged $30.5 billion a year between 1977 and 1982. This figure dropped off sharply during the 1980s debt crisis, before soaring to an annual average of $105 billion between 1990 and 1994.[2]

The reasons for this surge of private capital flows to developing countries exist in both the recipient and source countries. In many developing countries, pro-market economic policy reforms (that is,

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[2] IMF, 1995

capital account liberalisation, trade liberalisation, and deregulation and privatisation in the domestic market) gave foreign investors more confidence to invest in these markets and opened up new areas of their economies to inflows.

Source country factors were both structural and cyclical. First, financial sector reform in industrialised countries and the increasing tendency of institutional investors to diversify their portfolios internationally encouraged higher levels of flows to developing countries. Second, the cyclical position of developed countries – with low interest rates – meant that investors were seeking higher yields elsewhere. These factors combined to produce an abundance of liquidity in international capital markets, which allowed developing countries to attract private capital flows fairly easily.

Not only did the scale of private flows increase, but also the composition of those flows also changed significantly. Whereas previously, bank loans and foreign direct investment had made up the lion's share of capital inflows to developing countries, by the early 1990s bonds and other securities (e.g. stocks) had become more important. Also, whereas previously most inflows were directed towards governments, the private sector in developing countries became the largest recipient during the 1990s.

These changes to the levels and composition of private flows to developing countries had some advantages but also brought many problems. Short-term capital inflows particularly have proven to be extremely volatile. Most of the countries that received high volumes of short-term flows during the 1990s experienced some form of financial crisis, caused by the swift exit of short-term capital (that is, Argentina, Brazil, Indonesia, Korea, Mexico, Russia, Thailand, and Turkey).

Following this series of crises, lending to and investing in developing countries fell off sharply. As can be seen in Table 1, net private flows to all developing countries averaged $151.5 billion per year between 1993 and 1997 – the boom years leading up to the crisis in East Asia – but plummeted to just $48.3 billion per year between 1998 and 2002. Net private flows to Eastern and Southern Asia saw the largest falls (see Table 2).

Since 2003, there has been a recovery in private capital flows to developing countries driven by improved economic conditions within those countries as well as better conditions at the global level (that is, higher global growth and low interest rates). By 2004, net private capital flows to all developing countries had reached a level comparable with the annual averages seen in the period 1993 to 1997 (see table 1) with flows to Asia responsible for much of this recovery (see table 2).

Table 1: Net Private Capital Flows to Developing Countries (billions of $)

	Average 1993-1997	Average 1998-2002	2004
Total private flows, net	151.5	48.3	152.3
Net direct investment	87.7	141.1	158.3
Net portfolio investment (including portfolio debt and equity investment)	65.0	-8.5	13.1
Other net investment (including bank lending)	-1.2	-84.3	-19.1

Source: DESA, 2005

Table 2: Net Private Capital Flows to Developing Countries by Region (Billions of $)			
	Average 1993-1997	Average 1998-2002	2004
Africa	6.0	8.9	9.0
Eastern and Southern Asia	73.4	-1.4	133.0
Western Asia	12.4	4.6	-2.3
Latin America and the Caribbean	59.6	36.2	12.7

Source: DESA, 2005

However, the recovery in the level of private flows to developing countries should be viewed with caution. The recovery reflects mainly cyclical factors as mentioned above and is also based chiefly on increases in portfolio equity and debt flows (and to a lesser extent bank lending) which tend to be the more volatile components of private flows. In addition, the recovery in flows is mainly concentrated in Asia. Two of the key problems that have led to the negative impact of private capital flows in the recent past are still therefore present: a large share of these flows is potentially easily reversible and the flows themselves are geographically concentrated. Some countries are apparently experiencing capital inflow surges, while others are still experiencing low and insufficient levels of flows. A large group of poorer developing countries continue to receive little or no private flows.

Moreover, as the *World Economic and Social Survey* (DESA, 2005) showed, these positive figures on the recovery of private capital flows to developing countries hide a less positive story. The year 2004 was actually the 7th consecutive year that net transfers of financial resources to developing countries deteriorated – with the net figure now estimated at some $350 billion. Previously, negative net transfers from developing countries was largely a result of capital outflows, but more recently the large and growing figure is down to the massive foreign exchange accumulation that is taking place in many developing countries, particularly in Asia. Initially, this was seen as a sensible way for countries to protect themselves against potential market shocks and crises, but the reserve hoarding has now become a concern.

1.2 Capital account liberalisation, market failures, and the sea change at the IMF

Capital account liberalisation describes the removal of restrictions, or capital controls, on capital flowing into and out of an economy. The liberalisation of the capital account in developing countries has usually been accompanied by financial liberalisation, i.e. the removal of restrictions in the domestic financial market.

Debate on the benefits and costs of fully free international capital mobility has raged for many years. During the 1980s and 1990s, the period that saw the rise of neo-liberalism, markets for international capital were significantly opened up. Nearly all the world's countries, with very few exceptions[3], made moves towards capital account liberalisation during this period. This was partly due to the adoption of the 'Washington Consensus'[4] by many policy makers in developing countries and also because of the conditionalities imposed on many countries by the international financial institutions (IFIs).

[3] Two well-known exceptions were China and India.
[4] A term originally conceived by the economist John Williamson to describe a set of policy recommendations put forward by Washington-based institutions such as the IMF, which has been widely used to signify the adoption of neoliberal or market-oriented reforms.

During this period the International Monetary Fund (IMF), in particular, advised many low- and middle-income countries to do away with capital controls and open up their financial markets. The Fund did recognise that it was important that developing countries opened their capital accounts in an 'orderly manner', allowing room for a debate about the sequencing of liberalisation measures, but there was no question that capital account liberalisation was the ultimate goal. Indeed, at the annual meetings in 1997, the IMF was pushing for member states to agree to change the Fund's charter to make the realisation of full capital account liberalisation one of the institution's explicit aims.[5]

Arguments in favour of fully free international capital mobility are rooted in neo-classical economic theory. According to this view, capital mobility should bring advantages to both developed and developing countries while any restrictions on capital movements would lead to inefficiencies and hold back economic growth. Following this argument, capital mobility allows savings to be directed to their most productive uses. In concrete terms, capital should flow from developed to developing countries bringing significant benefits, i.e. complementing savings in those countries that will lead to more investment, faster economic growth and rising standards of living. A further argument is that capital inflows impose a market discipline on governments that can have a positive impact on growth, that is, by encouraging governments to keep a check on inflation and fiscal deficits in order to attract foreign capital.

However, while the Washington Consensus view had taken hold in many official circles, a growing number of studies were raising serious questions about the validity of the neo-classical arguments in favour of capital account liberalisation in developing countries.[6] Two papers written just as Asia was succumbing to financial crises, Eatwell (1997) and Rodrick (1998), used empirical studies to question the benefits of international capital mobility and showed that the expected benefits for developing countries had not been realised.

This is mainly because the costs of capital mobility are the other side of the same coin as the benefits. Increased access to foreign capital often makes macroeconomic management difficult, in good times as well as in bad. A sudden inflow of capital can result in an over-valued exchange rate that, in turn, fuels inflation. The authorities may then raise interest rates to combat inflation, but this may serve to attract further foreign capital inflows. Inflows of liquid assets, such as portfolio flows, can increase a country's vulnerability to crisis. Accumulating high levels of foreign borrowing, in the form of either bank loans or bonds, is also a very risky strategy.

A 2001 paper (Cobham) commissioned by Oxfam which set out to examine the linkages between capital account liberalisation and poverty reduction found that while the growth benefits of capital account liberalisation in poorer countries were far from proven, there were clearly significant costs. Similarly, Lee and Jayadev (2005) found little evidence that capital account liberalisation has positive effects on growth. In fact, the evidence they present points to the opposite: where capital controls have been used as an active part of a well-managed industrial and macroeconomic policy framework, they have had a significant positive effect on growth. The authors also found that there was a negative correlation between capital account liberalisation and the share of national income going to labour. This would appear to support the notion that labour's bargaining power is reduced when capital is more mobile.

There is a considerable literature examining the reasons why financial markets usually fail to produce the optimal allocation of resources that neo-classical economics predict.[7] This literature focuses on the market failures in financial markets such as information asymmetries, moral hazard, and the theory on panics and self-fulfilling crises.[8] While some of the key theories on financial market, failures go

[5] IMF, 1997

[6] See Cobham, 2001 for a full literature review on capital account liberalisation and capital controls, and their respective costs and benefits.

[7] See, for example: Keynes, 1936; Kindleberger, 1978; Eatwell, 1997; Wyplosz, 1998; Krugman, 1998.

[8] For more on market failures in international financial markets, see Part III of this paper.

back to Keynes and earlier, there was a renewed interest in these ideas at the end of the 1990s when the interaction between global financial markets and developing country economies produced such disastrous outcomes.

Since the crises of the late 1990s, there has been a significant change in attitude and language amongst some of the previous supporters of fully free international capital movements. A sea change in the position of the IMF on capital account liberalisation began in 1999 when the chief economist, Michael Mussa, acknowledged the risks involved for developing countries. Over the next few years, the Fund re-examined the case for capital controls – publishing a comprehensive study (IMF, 2000) on their use in various countries – and acknowledged that controls can have a useful role.

The IMF has also toned down considerably its policy stance on capital account convertibility. Anecdotal evidence suggests that this shift goes beyond rhetoric, with a significant change in the nature of country-level advice on capital account issues. In recent years, African countries, for example, have reportedly been advised to liberalise with caution.

Despite this loss of enthusiasm within the international community for full capital account convertibility, the trend among developing countries has remained very much in the direction of liberalisation (Williamson et al, 2003). This study of 28 developing countries examining the extent to which each had liberalised its capital account as of 1990 and 2001 showed that 16 of the countries had a more liberalised capital account in 2001 than they had in 1990, while no country had moved in the opposite direction.[9] Breaking it down by region, and according to the classifications used in the paper, Latin American went the furthest towards full capital account convertibility, with Sub-Saharan Africa and North Africa and the Middle East also taking significant steps towards liberalisation. East Asia, which was already quite liberalised by 1990, did carry out some further liberalisation measures, while the smallest change observed was in South Asia, where countries still had a partly repressed capital account by 2001.

One important reason for the paper's finding that the trend towards capital account convertibility in developing countries continues unabated, despite widespread acknowledgement of the considerable dangers, is that capital controls are now targeted for elimination through trade agreements. For example, in bilateral free trade agreements negotiated with Chile and Singapore, the United States stipulated the elimination of sensible and market-friendly controls in both cases (Williamson et al, 2003). Furthermore financial market liberalisation has become a key target of the WTO's General Agreement on Trade in Services (GATS); eliminating – or at least limiting – barriers to the foreign supply of financial services and investment by foreign financial firms has been a priority in GATS negotiations.[10]

1.3 Types and characteristics of capital flows

Foreign direct investment (FDI) is clearly less easily reversible than other financial flows and can bring benefits associated with technology transfer and provision of market access. During the financial crises in Asia and other developing regions, for example, FDI proved the most resilient type of capital flow. However, FDI to developing countries is also highly concentrated. In 2002, 84 per cent of FDI to developing countries went to 12 mostly middle-income countries including China and India, while only 5.3 per cent went to sub-Sahara Africa. It is worth noting, however, that taking the relative size of host countries into account, as a share of gross domestic product (GDP) the ratios for sub-Saharan Africa are similar to those for Latin America and Asia.[11] An interesting trend observed in FDI is the increase in south–south flows; by the end of the 1990s, over one third of FDI inflows to developing countries were from other developing countries.[12]

[9] Williamson, Griffith-Jones and Gottschalk, 2003.
[10] See the General Agreement on Trade in Services, Understanding on Commitments in Financial Services:, http://www.wto.org/english/tratop_e/serv_e/21-fin_e.htm
[11] See Cobham, 2001.
[12] DESA, 2005: chapter 3

Bank lending, particularly short-term bank lending, tends to be more volatile and pro-cyclical than FDI. Bank lending to developing countries increased rapidly in the lead up to the financial crises of 1997/1998, before turning negative once the crises had hit (see Table 1). Since 2003, bank lending to developing countries has picked up again. The proportion of short-term loans in total bank lending to developing countries has dropped since the Asian and Russian crises, which means that the recovery in bank lending should also be more stable.

A recent trend for international banks is to increasingly lend in foreign markets via subsidiaries, rather than as cross-border bank lending as before. This trend has both advantages and disadvantages. On the positive side, banks increasingly lend from their local branches in local currencies and usually fund themselves through domestic deposits. This means that the shift to operating via subsidiaries will help improve financial stability by making countries less vulnerable to crises. On the other hand, it also means that foreign banks are now contributing less to foreign savings in developing countries. Another factor that is likely to result in lower levels of foreign bank lending to developing countries is the recent change to the Basle Capital Accord. There is widespread concern that the revised Basle Accord will lead not only to enhanced pro-cyclicality of bank lending, but will also reduce the level and increase the cost of bank lending to developing countries (see below).

Portfolio flows, which consist of both debt (bonds) and equity (shares) flows, are also more volatile and pro-cyclical than FDI. Bond financing and the purchase by foreign investors of developing country stocks both boomed during the 1990s. Following the crises of 1997/1998, portfolio flows to developing countries turned negative, before returning to positive figures in 2004 (see Table 1). However, the volatility in developing country bond markets seen more recently has served as a reminder that, even during generally more stable periods, the sustainability of bond financing cannot be relied upon.

Portfolio debt flows – or bonds – can be issued by both governments and the corporate sector in developing countries and can be a useful source of funds. However, access to these flows has tended to be confined to middle-income (emerging market) countries partly because capital markets in poor countries are less developed.

During the 1990s, derivatives became an integral and increasingly important part of the story of international capital flows – including capital flows to developing countries. Many banks and other financial market actors used derivative instruments in the years immediately preceding the Asian crisis when lending to and investing in developing countries. Due to the increasing role played by derivative products over the last decade, it is useful to understand what they are and the ways in which they impact on global financial stability.[13]

A derivative is a financial contract whose value is linked to the price of an underlying item (a commodity, currency, interest rate, bond, share, etc). Examples of derivative contracts include 'futures', 'options', 'forwards' and 'swaps'. One example would be a foreign exchange forward contract, under which one party agrees to buy (and another party agrees to sell) a set amount of a particular currency, say the Thai baht, at a pre-agreed price on an agreed future date. Credit derivatives, which have received a lot of media attention recently, are effectively a form of insurance taken out by those whose asset(s) are exposed to some kind of credit risk (such as a bankruptcy). The much talked about CDOs (or Collateralised Debt Obligations) are a form of credit derivative.

Derivatives have a useful role for hedging the risks associated with business operations, trade and finance and as such are an important element of the risk management techniques employed by financial and non-financial firms. For businesses operating internationally, the ability to hedge against the risk of changes in exchange rates is especially useful.

[13] For more on derivatives, see the website of the Derivatives Study Center, Financial Policy Forum (www.financialpolicy.org). This section on derivatives is largely drawn from the various primers and other documents available on the DSC website.

While derivatives can play a very useful role, they also make speculation and market manipulation easier and lead to increased macroeconomic volatility. Their widespread use has increased systemic risk – and the impact of abuses in derivatives trading can be particularly damaging for developing countries. Foreign exchange forward contracts, for example, have increasingly been used for currency speculation (that is, speculators bet on whether a given currency will appreciate or depreciate) rather than for their legitimate purpose of hedging against foreign exchange risk. Both the Mexican peso crisis of 1994/5 and the East Asian financial crisis were exacerbated by the use of derivatives to take large speculative positions on exchange rates.

Derivatives are traded in two main types of markets: in exchanges and in over-the-counter (OTC) markets. In terms of the relative share of total derivatives business, trading volumes are higher in the exchange trading element while the amounts outstanding are higher in the OTC markets. According to BIS figures, the overall amount outstanding in the global OTC markets stood at just over $240 trillion at the end of December 2004.[14] The amount outstanding in the exchange-traded part of the market is around $60 trillion.[15]

The exchange trading element of the derivatives market is fairly well regulated and supervised. The OTC market, however, is unregulated and opaque and therefore very hard to monitor. This makes the OTC market a very effective instrument for many kinds of market abuses including tax avoidance, flouting regulations and reporting requirements, and manipulating markets. Moreover, some derivative products are so complicated that regulators, and in some cases even the investors who are buying them, fail to understand the risks involved.

Despite the associated risks and public concerns, the derivatives market is growing and is set to continue to grow. The impact of derivatives trading on developing countries is also likely to increase as more countries become ever more integrated into global financial markets. For these reasons, and given the dangers that derivates can pose for global financial stability, it is very important that regulation and supervision of the global derivatives market is enhanced.

2 Global economic governance and recent developments in financial market regulation

This section briefly describes the main public sector bodies that play a role in international private financial flows as well as the regulatory authorities that oversee financial markets. It will review recent developments and current issues in financial market regulation. The question of governance will also be addressed.

2.1 The International Monetary Fund

The IMF is the key institution overseeing capital account and financial market issues in developing countries. It provides advice to countries on the sequencing of capital account opening and on the functioning of the domestic financial sector. When countries are hit by crises, the Fund leads the international response, acting as lead lender on rescue packages and advising on the types of policies that should be implemented to prevent the crisis from deepening. The IMF also carries out extensive research into financial market issues, producing the biannual Financial Stability Report (previously published once a year as the Capital Markets Report).

Despite its key role in the global financial system, the IMF has come under a lot of criticism in recent years; the nature of the advice the institution hands out, its response to crises, and the way in which it is governed, have all come under attack.

[14] BIS, 2005
[15] Conversation with Randall Dodd of the Derivatives Study Center (November 2005)

When the crises hit Asia, the international community was still relying largely on inadequate contingency financing arrangements. IMF facilities such as the Standby, and the newly created Supplemental Reserve Facility (SRF) and Contingent Credit Line (CCL), were designed to provide short-term lending to countries experiencing economic shocks. Not only were these arrangements short-term, but they also carried high interest rates thus imposing a further debt servicing burden on countries facing difficulties. The financing arrangements that made up the rescue packages were also accompanied by policy conditionality on tighter fiscal and monetary policy. In many cases, these conditions, designed to restore market confidence in crisis-hit countries, actually served to damage the economy and deepen the crises. Moreover, the high levels of public debt servicing together with fiscal tightening led to damaging cutbacks in public spending, with devastating consequences for human development.[16]

Concern over the inadequacy of existing arrangements for handling financial crises in developing countries led to widespread acknowledgement of the need to revise the existing facilities, as well as the need for new approaches to involving the private sector during crises (see the following section for more on this).

One of the major obstacles to the formulation of more appropriate policies at the IMF is the institution's governance structure that gives insufficient voice to developing countries. The IMF enjoys near universal membership, but not all members are equally represented. Under the current system, voting power at the Fund is distributed according to the level of quota each country has which means that those countries with stronger economies have more votes. The governance of the IMF is therefore dominated by the G7 and European Union countries, despite these countries representing less than one-fifth of the world's population.

This power balance is reflected in the representation of countries on the Executive Board, which is itself then represented in the membership of the International Monetary and Financial Committee (IMFC). The IMFC plays a key role in the governance of the IMF and in global policymaking on many macroeconomic and financial issues. The current governance structure ensures that developing countries are under-represented. This democratic deficit not only creates legitimacy problems, but it also adversely affects the quality of policy formulation.

2.2 The World Bank Group

The World Bank Group also has a significant role in global governance arrangements concerning the flow of private capital to developing countries and the functioning of financial markets. Since the crises of the late 1990s, the World Bank – together with the IMF – has been overseeing the development of, and progress with, the implementation of standards and codes n developing countries, carrying out national assessments of observance of standards and codes. As is the case with the IMF, the World Bank has near universal membership but is effectively run by the developed countries, resulting in failures of legitimacy as well as effectiveness.

The International Finance Corporation (IFC), the private sector lending arm of the World Bank Group, promotes private sector development in developing countries. The IFC is the largest multilateral source of loan and equity financing for private sector projects in the developing countries. Although the IFC operates on a commercial basis, charging market rates, it only invests in projects that cannot get financing elsewhere. The IFC also helps developing countries gain better access to international capital markets, for example by arranging syndicated loans from banks or mobilising investment through investment funds.[17]

[16] See paper 2 of this series for more on the human development impact of financial crises.
[17] The IFC both sets-up and invests in various funds (debt and equity) to promote foreign portfolio investment in developing countries. For more on this, see Part III in this series and the IFC website, http://www.ifc.org/ifcext/treasury.nsf/Content/SyndicationandResourceMobilization

2.3 The Financial Stability Forum

The Asian crisis was followed by a period of intense discussion among the international community on how to reform the international financial architecture and improve global governance. It was in this context that the Financial Stability Forum (FSF) was established in 1999. The principle objective of the FSF would be to ensure co-ordination among national and international authorities and supervisory bodies to promote international financial stability. More specifically the FSF was assigned three key areas of work: the identification of vulnerabilities in national and international financial systems and sources of system risk; to ensure that international rules and standards of best practise were developed, and gaps identified and filled; and to ensure that consistency in rules across all types of financial institutions were improved.

However, the FSF has little representation from developing country governments. Only Hong Kong (China) and Singapore are members. The FSF membership is made up of senior representatives from central banks, supervisory authorities and treasury departments of nine OECD countries (Australia, Canada, France, Germany, Italy, Japan, the Netherlands, United Kingdom and the United States), International Financial Institutions (the IMF, the World Bank, the Bank for International Settlements (BIS) and the OECD), international regulatory and supervisory groupings (such as the International Organisation of Securities Commissions, IOSCO, and the International Association of Insurance Supervisors, IAIS), committees of central bank experts and the European Central Bank.

Since 2001, the FSF has made efforts to increase its outreach by holding regional meetings with non-member financial authorities in Latin America, Asia-Pacific and Central and Eastern Europe. In May 2005, the FSF held a first African regional meeting in Pretoria, South Africa.

The FSF and Standards and Codes

Since the late 1990s, a number of standards and codes of international best practice in the financial sector have been formulated and implemented, designed to 'help promote sound domestic financial systems and international financial stability'. Various public and private bodies have had a hand in developing these standards and codes, including the FSF, which identified twelve key international standards in 2000 as the most important for strengthening financial systems.

These standards have become the basis for the Financial Sector Assessment Programs (FSAP) and Reports on the Observance of Standards and Codes (ROSC) carried out by the IMF and the World Bank. The Bank and the Fund have significant leverage in developing (borrower) countries to enforce implementation of the standards. However, as most were designed by exclusively developed country standard-setting bodies, they are often not well suited to developing countries' less well developed financial and economic sectors. Moreover, research has shown that the adoption of standards and codes may undermine the developmental role of the financial system in some countries (Gottschalk 2005).

2.4 The Bank for International Settlements

The Bank for International Settlements (BIS) was created with a specific mandate of promoting central bank co-operation for the purpose of maintaining global financial stability and providing additional facilities for international financial operations. The BIS works to improve coherence of monetary polices in particular, and macroeconomic policies in general. It also acts as a bank, offering banking services to nearly all the world's central banks. With the increasing integration of global financial markets during the 1990s, international central bank co-operation became even more important.

The key decision-making bodies at the BIS are the Board of Directors and the General Meeting of member central banks (of which there are 55). The Board, which is responsible for determining the strategic direction of the BIS and supervising the management, meets regularly throughout the year. The Board has 17 members currently comprising: the Governors of the central banks of Belgium, France, Germany, Italy and the UK and the Chairman of the Board of Governors of the US Federal Reserve – who each appoint another Board member of the same nationality – and the Governors of the central banks of Canada, Japan, the Netherlands, Sweden and Switzerland.

A number of influential committees (the Basle Committees) with relevance to the functioning of the international financial system have been set-up by the Governors of the G10 central banks and have their secretariats at the BIS.[18] One of these is the Basle Committee on Banking Supervision.

2.5 The Basle Committee on Banking Supervision

The Basle Committee on Banking Supervision was set up in 1974 to improve banking supervision at the international level. The work of the committee covers three main areas: it provides a forum for discussion on supervisory issues; it co-ordinates the supervision of international banking groups and their cross-border activities; and it aims to improve financial stability by improving standards of supervision. The Basle Committee has considerable power as it develops international standards that are implemented through national legislation.

The Basle Committee, which meets four times a year, is made up of senior representatives of bank supervisory authorities and central banks from 13 countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the UK, and the US.

With the increasing integration of global financial markets, the Basle Committee has made efforts to extend its reach; it encourages interaction between members and non G-10 banking supervisory authorities through the distribution of research and a biannual conference.[19] In 1997, the Basle Committee published the 'Core Principles for Effective Banking Supervision' – in part a response to the Mexican peso crisis – which aimed to provide a blueprint for an effective supervisory system. In developing the 'Core Principles', the Committee worked closely with the supervisory authorities in fifteen emerging market countries; representing a major step towards increasing the participation of developing countries in their discussions and decision-making processes.

However, the lack of formal participation by developing and transition economies in the Basle Committee continues to impact negatively on some key areas of its work. A pertinent example has been the preparatory work undertaken by the Committee for the recent updating of the Basle Capital Accord. Since 1999, when the Committee first presented the proposed changes to the Accord, there has been widespread concern about the potential impact on international bank flows to developing countries. One reason for the Committee's failure to give these concerns their due weight is the lack of formal developing country participation in the preparation of the new Accord. In developing Basle II, the Institute of International Finance (IIF) – which represents the interests of the major international banks – was heavily influential.

Basle Capital Accord

In 1988, the Basle Committee introduced a capital measurement system that is known as the Basle Capital Accord. The Accord's risk management framework stipulated a minimum capital requirement of eight per cent for banks and, since 1988, this framework has been adopted in most countries in the world with internationally active banks. In 1999, the Basle Committee put forward a series of proposals for a New Capital Adequacy Framework that would replace the original Basle Accord. After years of heated discussions over the shortcomings of the proposals, the revised Framework was issued in 2004 and is intended to serve as a basis for national-level legislation.

Basle II, as the new framework is referred to, is made up of three pillars: minimum capital requirements (to improve on the original requirements in the Basle Accord); supervisory review of an institution's internal assessment process and capital adequacy; and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts. While Basle II does contain many useful improvements on the original Basle Accord, it is likely to have the unintended consequences of discouraging international bank lending to developing countries and making it more expensive, and

[18] The main BIS committees are: the Basle Committee on Banking Supervision; the Committee on Payment and Settlement Systems; and the Committee on the Global Financial System.
[19] The International Conference of Banking Supervisors.

making such lending more pro-cyclical. These outcomes will not help to achieve stable flows of private capital to developing countries.

The Basle II aims to increase the risk sensitivity of capital requirements and thereby align them more closely with actual risks. To achieve this, there is a move towards the increased use of banks' own internal risk management systems (in what is called the Internal Ratings Based or IRB approach) to determine capital requirements.[20] This 'internalises' into regulation the inherent pro-cyclicality of banks as lending institutions (Bhattacharya and Griffith-Jones) as banks will have to increase their capital requirements in bad times. This is likely to increase the pro-cyclicality of lending that can, in turn, lead to increased volatility.

The new Accord may also overstate the risk of bank lending to developing countries, partly because the Accord does not recognise the benefits of diversifying portfolios across countries. This implies a likely increase in regulatory capital requirements for lending to developing countries, which will result in less lending to these countries and an increase for them in the cost of the remaining lending. The benefits of the diversification of bank lending to developing countries should have been explicitly incorporated into the Accord.

2.6 The International Accounting Standards Board

The International Accounting Standards Board (IASB) sets international accounting standards that stipulate how various activities should be reflected in the financial statements of organisations in the UK and some other countries. Standards issued by the IASB are known as International Financial Reporting Standards (IFRSs) and they play an important role in safeguarding financial stability. The IASB is currently working with other national accounting standard setting bodies, such as the US Financial Accounting Standards Board, towards internationally convergent accounting standards to ensure the comparability of corporate financial statements.

The governance of the International Accounting Standards Committee (IASC), the oversight body of IASB, rests with 19 trustees, chaired by former US Federal Reserve chairman Paul Volcker. The majority of trustees are from the US and Europe, with one each from Brazil, Hong Kong (China) and South Africa. The IASC receives its funding from a range of sources including the major accounting firms, private financial institutions and non-financial companies, central banks, as well as other professional organisations. The IASC Board, which has 14 members, has no representation from developing countries.

Given the increasingly global nature of financial activity, and the importance of financial accounting and reporting standards, current moves driven by the IASB towards internationally convergent standards are clearly to be welcomed. However, the current governance structure of the IASC and the IASB is heavily skewed towards the interests of the private sector and the major developed economies. International standards need to be developed with the participation of as wider group of countries as possible and global standard-setting should be the preserve of a more genuinely legitimate institution.

2.7 Multilateral Development Banks, export credit agencies and the provision of trade finance21

Trade finance, which supports international trade operations, plays an important role in the supply of finance to developing countries. This is particularly the case for the smaller and poorer developing countries many of which have low levels of creditworthiness. Many low-income countries that cannot access private bank credit through other means are able to borrow for trade finance, as traded goods can act as collateral.

[20] For more on the 'Internal Ratings Based Approach' and its drawbacks in terms of increasing pro-cyclicality and reducing levels of bank lending to developing countries, see Griffith-Jones, Segoviano, and Spratt, 2002 and 2004.
[21] Section 2.7 is drawn from DESA, 2005.

The Multilateral Development Banks (MDBs) and national export credit agencies (ECAs) are among the key providers of trade finance, supported by guarantees, insurance and collateralised lending. Trade finance can be especially important during and immediately following economic crises, helping countries to export their way out of the crisis and introducing a valuable counter-cyclical element into the provision of finance. However, recent crisis episodes have shown that trade finance diminishes during crises indicating the need for MDBs and ECAs to play a more proactive role in supporting developing countries during and after crises.[22]

Export credit agencies provide government backed export credits in the form of loans as well as guarantees or insurance for loans and investments. Export credit agencies have traditionally played an important role in providing guarantees for long-term credit and investment to developing countries. However, with the recent move to a purely commercial basis by many ECAs their positive role in granting guarantees for lending and investing in developing countries may be declining.

3 Policy proposals for more stable financial markets

3.1 Prudential regulation and supervision

Developing countries, which are introducing liberalising measures, in both the domestic financial system and the capital account, can benefit from the introduction of extra prudential measures in the banking system. Banking regulations can place limits on banks' foreign borrowing and foreign exchange transactions. Restrictions can also be placed on foreign currency loans to domestic companies – limited to those that have the capacity to generate foreign currency – as well as limit bank lending to domestic companies that have high exposure to short-term foreign denominated liabilities. These measures can help to prevent the kinds of currency and maturity mismatches that were seen during the crises of the late 1990s and the beginning of this century.

3.2 Capital controls

There is growing evidence that in a fully liberalised environment, the risk of periods of financial instability leading to large-scale macro shocks is higher than under more controlled conditions.[23] Surges of capital inflows can cause difficulties for developing countries in good times and bad. Not only does the volatility in international financial markets mean that inflows can suddenly cease or reverse, thereby increasing the risk of crisis, but large-scale inflows also create problems for macroeconomic management. At the same time, government investment in public services often becomes limited because public spending decisions are made with the reaction of financial markets firmly in mind. Developing country governments may, therefore, find it useful to use some form of controls on capital inflows.

There are three main types of capital controls: prudential controls in the banking system, market-based measures, and direct controls. The first involves banking regulations (as detailed above), which limit the borrowing of domestic banks. The second type, market-based measures, include taxes on some types of inflows or requiring companies to place non-interest-bearing reserve deposits against foreign currency borrowing. One example of this is the now discontinued Chilean 'encaje', a reserve requirement that firms had to deposit with the Central Bank for a year on foreign currency borrowing.

More direct capital controls involve blanket or quantitative restrictions. For example, many countries restrict the access of foreign investors to the domestic bond or equity markets or require non-residents to hold securities for a minimum period before resale is permitted. Another example is the restriction on foreign borrowing by domestic companies. Some countries – including China and India – impose limits on foreign exchange transactions.

[22] DESA, 2005 (Chapter 3).
[23] See, for example, Borio and White, 2004.

Market-based measures, like the Chilean example, have gained the most support. Most importantly, controls should be designed to meet the particular need of the country using them and they should also be flexible enough to adapt to changing circumstances. Regulatory regimes that are constantly in place, and either loosened or tightened depending on need, are better than *ad hoc* responses.

Given that financial markets are now acknowledged to behave pro-cyclically, there is a clear need for counter-cyclical measures to be introduced into regulation. Capital controls and prudential regulations can provide a counter-cyclical element. For example, capital requirements should be pro-cyclical – as asset prices rise, the proportion of capital that has to be put by also increases. Other instruments, such as forward-looking loan loss provisions for banks, or at least cyclically neutral provisions, can also be useful.

Williamson (2005) has argued that emerging markets should limit, and perhaps even eliminate, the foreign currency borrowing of their governments. Instead he proposes that governments issue counter-cyclical 'growth-linked' bonds on the international market that would pay a higher interest rate to investors when the country was growing and a lower rate when the country was experiencing difficulties. Given the role of currency mismatches in recent crises, Williamson also suggests that governments should discourage their private sector borrowers and lenders from issuing and holding assets denominated in foreign currencies. This could be done by, for example, imposing higher taxes on interest earned on foreign currency assets than on interest from domestic currency denominated assets.

3.3 Local bond and equity markets

Following the financial crises of the last decade, much emphasis was placed on the banking system as the main form of financial intermediation in developing countries. It has been argued, however, that many countries would benefit from establishing deeper equity and bond markets.

Since the late 1990s, many developing countries have been developing their domestic corporate bond markets. This has a number of advantages: it increases the options available to local firms, helps to reduce the dependency of developing countries on external borrowing, and can help to reduce the maturity and currency mismatches on the balance sheets of firms and banks in developing countries (IMF, 2005). A well functioning local corporate bond market, which attracts both domestic and foreign investors, can also serve to minimise the vulnerability to international capital markets and to cutbacks in lending by local banks. However, domestic bond markets are themselves subject to volatility and in situations where local bond markets are developing very quickly, they need close supervision by regulators to reduce the risk of accumulating bad credits.

3.4 Currency transactions taxes

Currency transaction taxes (CTT) are small taxes levied on transactions in foreign currency markets – an idea which could possibly be extended to markets for securities, derivatives and other financial instruments. Currencies are traded in high volumes in liquid markets across the world and therefore have the potential to be a very attractive tax base.

Often referred to as the 'Tobin tax', the idea for a tax on foreign exchange transactions was put forward by James Tobin in 1972 as a way to enhance macroeconomic stability by reducing the volume of speculative short-term currency dealing. Renewed interest in the CTT or Tobin tax over the last decade in part reflects heightened concerns about speculative currency trading and financial market volatility, and the role they have played in precipitating financial crises.[24] A further reason is the potential of a CTT to generate substantial revenues that could be used to fund international

[24] For an excellent overview of issues around the Tobin Tax, see Ul Haq *et al.*, 1996. The international ATTAC movement, which is active in many countries around the world working to get the Tobin Tax implemented, was set up in 1998 (see www.attac.org).

development assistance.[25] In the context of the UN Financing for Development initiative and the UN Millennium Development Goals, many have suggested that a CTT could help to fill the current funding gap.

The high level of foreign exchange and other financial market transactions mean that even a modest tax would have the potential to be a substantial revenue earner. Global foreign exchange turnover is now approaching $2,000 billion per day, with the bulk of transactions unconnected to the real economy. The rates usually proposed for a CTT range from as little as 0.005 per cent (or half of one basis point) – in order not to distort market activity – to as much as 0.25 per cent.

Despite considerable support for the concept of a CTT, there has always been widespread recognition that the proposal is also problematic; not least, because it has been assumed that in order to be effective a CTT would have to be universally adopted and enforced. Even supporters of the CTT have acknowledged the enormous political challenge that raising such a tax on global basis represents. However, a new study has shown that due to technological advances in global foreign exchange markets it would now be possible for a CTT to be implemented unilaterally by any country that wished to do so (Spratt, 2005).

In the context of the UK, this study shows that a levy of 0.005 per cent on sterling trades (what is referred to as a stamp duty on currency transactions) in both the traditional foreign exchange market and the foreign exchange derivatives market would raise approximately $3.22 billion (or £1.86 billion) per year in revenues.[26] The paper also shows that incentives for financial institutions to avoid the tax in the UK would be low or non-existent. The levy itself is small, and the only way in which institutions could avoid the tax would be to effectively remove themselves from the highly efficient international foreign exchange transaction and settlement systems from which they derive real financial benefits. The costs of avoidance for financial institutions would therefore far outweigh the impact of the tax itself.

This proposed stamp duty on sterling currency trades is explicitly designed as a revenue earner, rather than as a means to impede excessive currency trading. In fact, the supporters of this proposal point to the negligible and non-distorting effect it would have on currency markets as a key point in its favour. This kind of proposal, as put forward in the Landau report and advocated by the Stamp Out Poverty coalition, would appear to be the most sensible. A small levy could raise substantial revenues to help the international community meet the UN's Millennium Development Goals, while other policy tools – such as prudential regulations – would be better suited to discourage speculative trading in financial markets.

3.5 Supervision at the international level

Progress on making the international financial system more stable has so far been asymmetrical, with the focus on strengthening macroeconomic policies and financial regulation in developing countries. Progress at the global level, and particularly in capital source countries, has been far less encouraging.

First, there appears to be inadequate understanding of the complex interrelationship between different actors in the global financial system, the sometimes damaging impact of this interaction on the macro-economy and resulting regulatory needs (Bhattacharya and Griffith-Jones). For example, the pro-cyclicality among ratings agencies can impact negatively on lending and investment decisions while herding among certain categories of investors, such as hedge funds, can impact on the investment

[25] The concept of a tax on foreign exchange transactions purely as a means for raising funds for development was examined in the 2004 Landau Report. In the UK, the Stamp Out Poverty campaign is advocating a small stamp duty on sterling currency transactions (see www.stampoutpoverty.org).

[26] Stamp Out Poverty states that the £1.86 billion per year that the levy would raise in the UK could add a further 50 per cent to current UK aid expenditure of £3.8 billion per year. Clearly, if the stamp duty were implemented in the UK, close scrutiny would be needed to ensure that the revenue is used for additional aid expenditure (rather than to replace existing or planned spending).

choices of other investment managers, which can then lead to asset price bubbles in booms and result in contagion effects during crises. These interactions need to be better understood by national and international regulators and standard-setters. Increased levels of co-ordination, and in some cases integration, are therefore needed between regulators in different financial sectors (Bhattacharya and Griffith-Jones).

Second, there is also widespread concern at the global level about certain actors; institutions and instruments that require increased levels of supervision. Major areas of concern include large, complex institutions (that is, hedge funds) and increased exposures to complex products (for example, derivatives).

Hedge Funds and Derivatives

Hedge funds, most of which operate from the US, are estimated to control over $300 billion in capital globally.[27] While this is a relatively small proportion of the total capital in global financial markets, hedge funds use leverage to take often very large positions. These funds pool money from wealthy individuals and institutional investors and typically pursue highly leveraged and therefore risky investment strategies on behalf of their clients.

Global hedge funds invest in emerging market countries, using investment strategies that comprise taking directional bets on market prices of bonds, stocks, commodities and derivatives. They seek to profit from changes in prices brought about by a country's shifting macroeconomic fortunes. As was seen during the Asian crisis, hedge funds can manipulate markets to destabilise the currencies of developing countries. Herding initiated by hedge funds has also caused other large-scale asset price movements and contributed towards contagion in financial markets.

Yet, hedge funds are notoriously and purposefully non-transparent. Until recently, hedge funds have largely escaped regulation by gaining exemption from registering with the relevant supervisory authorities (the Securities and Exchange Commission in the US and the Financial Services Authority in the UK).[28] This means that the authorities often have no idea who the owners and operators of these funds are – and therefore no way of knowing if they have previous convictions for securities fraud – and are unable to monitor their operations. Hedge funds also participate in the over-the-counter (OTC) derivatives market, which is also non-transparent.

A number of arguments have been put forward as to why regulating hedge funds may be unnecessary or just too difficult. First, some argue that rich, sophisticated investors do not need the protection of regulatory authorities. However, as hedge funds manipulate markets and pose a threat to global financial stability, the economy and the wider public do need protecting. Second, some have argued that for institutions with very active trading strategies, normal reporting requirements and supervision that reviews a 'snapshot' of current positions is not very useful in assessing the overall risk exposure (see for example Rajan, 2005). However, in many cases it takes a significant amount of time for hedge funds to build up their positions, indicating that reporting requirements would indeed be useful.[29]

Given the threat that hedge funds can pose to financial stability and their track record in contributing to crises in developing countries, it is important that they are brought under the regulatory control of the relevant supervisory authorities.

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[27] See www.financialpolicy.org.

[28] Certain characteristics of hedge funds: for example, a small number of investors or minimum investment levels (e.g., $1 million) which indicate that investors are High Net Worth Individuals (HNWI), have allowed them to gain exemption from registration.

[29] In the case of collapsed hedge fund Long-Term Capital Management, for example, the $1.4 trillion in derivatives on its books when it folded would have taken some time to accumulate.

Better regulation is also necessary in derivatives markets to prevent the build up of large, speculative positions, which can contribute to financial crises. The three basic pillars of regulation in financial markets – registration and reporting requirements, capital and collateral requirements, and orderly market rules – should apply to derivatives markets.

Greater transparency with regard to elements such as market prices, trading volumes and large trader positions will be necessary in order for the regulatory and supervisory authorities to ensure financial stability. Given the complexity of some derivative instruments, this will probably imply that regulators will have to 'upgrade their skill set' in order to perform their supervisory functions effectively (IMF, 2005).

This need for greater transparency and better regulation particularly applies in the case of the unregulated and opaque over-the-counter (OTC) derivatives markets. There are strong incentives for traders in these markets to oppose regulation; if prudential regulations were introduced in the OTC market, it would effectively become like the exchange traded markets where competition is greater and profits are lower. This would mean more people would enter the market and the profits of OTC derivatives traders would be significantly squeezed. However, regulating the OTC market would be advantageous for all those, such as internationally active companies, who use derivatives to hedge risk (i.e. the legitimate end of the market) as costs would go down and fears of fraud and other problems would be reduced.[30] The benefits to the global economy, in terms of increased financial stability and security, would also be considerable.

3.6 Basle II

As discussed in the previous section, Basle II is likely to discourage international bank lending to developing countries and increase the cost of remaining lending, as well as making it more pro-cyclical. This is mainly because the benefits of diversifying portfolios across countries are not recognised in the new Accord. In order to prevent Basle II having the unintended consequence of damaging the access of developing countries to sufficient and stable international capital flows, a number of changes would be advisable.

First, the benefits of the diversification of bank lending to developing countries should be explicitly incorporated into the Accord so that risks can be accurately measured. Second, counter-cyclical measures should be incorporated into Basle II in order to compensate for the increased pro-cyclicality resulting from the adoption of the Internal Ratings Based (IRB) approach. Third, it is also very important that representatives from developing countries be included in the Basle Committee so that developing country concerns and knowledge can be properly considered when designing new regulatory measures.

3.7 Encouraging more and better flows to developing countries31

Special initiatives are needed to help attract private capital to developing countries, which has the potential to have a positive developmental impact – particularly to the low-income countries that receive a much lower level of private flows. These initiatives could include publicly funded incentives for encouraging socially responsible investment.[32] Another approach would be improvements to the types of public guarantee mechanisms available to developing countries, including the creation of counter-cyclical guarantees.

Public guarantee mechanisms, such as those promoted by the multilateral development banks and export credit agencies, can play a positive role in mitigating the risks associated with long-term investment and loans to fund activities such as infrastructure investment in developing countries.

[30] Conversation with Randall Dodd, Derivatives Study Center (November 2005)
[31] Section 3.7 is taken from Bhattacharya and Griffith-Jones, 2004.
[32] The potential for SRI in developing countries is explored in more detail in paper 3 of this series.

Guarantee mechanisms can increase flows, extend the maturities of debt instruments, and reduce spreads in developing countries.

However, existing loan guarantee mechanisms address overall risk rather than specifically dealing with the problem of cyclicality in financial markets. Given that financial markets tend to overestimate risk in bad times and underestimate risk in good times, there is a strong case for public institutions to take on an explicitly counter-cyclical role to compensate for the market failure. This could be done by the Multilateral Development Banks[33]: not only by providing counter-cyclical lending, but also by incorporating a counter-cyclical element in the risk evaluations they make for issuing guarantees for lending to developing countries. This would involve MDBs assessing risk with a more long-term perspective than is typical in the private sector.

Responding to crises[34]

The financial crises of the last decade, and their considerable development costs, have highlighted the need for the international community to have adequate financing facilities at its disposal. The funds available under such facilities need to be sufficiently large, and should be able to be dispersed very quickly, if they are to be effective in helping to stop the outflow of private capital when a currency comes under attack or a financial crisis threatens.

Given the current scale of international private capital flows, however, there will be situations when public funds will be insufficient to offset the outflow of private capital. For this reason, the international community needs to find faster ways for countries experiencing funding difficulties to reach agreements with their private creditors. More formal debt workout procedures, which would involve the private sector at a much earlier stage in crisis resolution, should be developed. Although the IMF's proposal for a Sovereign Debt Restructuring Mechanism was rejected, work should continue on finding a feasible alternative proposal, which could gain more widespread acceptance.

Reforming global governance arrangements

Developing and transition countries remain inadequately represented in the key institutions and groupings that govern the global economy including the IMF Executive Board, the IMFC, the Bank for International Settlements, the Basle Committee on Banking Supervision, and the Financial Stability Forum. In recent years, this issue has been receiving increasing attention. At the Monterrey conference (see below), all governments committed to increasing the voice of developing and transition economies in global governance and there is now a serious debate on reforming the voting structure at the IMF.

Increasing the representation and influence of developing countries in international decision-making on financial affairs is important both to give these countries a stronger voice and to enhance the legitimacy of the institutions concerned. Insufficient representation arrangements result in a decline in the efficiency of the institutions and a heightened sense of 'democratic deficit' (Bhattacharya and Griffith-Jones, 2004).

First, the position of developing countries needs to be enhanced in those institutions (such as the IMF, the World Bank Group and the BIS) where they already have some, but not sufficient, participation.

At the IMF, it is now widely recognised that an increase in the share of basic votes is necessary to allow smaller economies to be adequately represented. When the Bretton Woods institutions were set up, the equality of all member states was recognised in the allocation of 250 basic votes to each member country. The basic votes originally made up 11.3 per cent of total votes; they now represent just 2.3 per cent. An amendment to the Fund's Articles to increase the share of basic votes is therefore

[33] There may also be some potential for some Export Credit Agencies to provide counter-cyclical guarantees on credit and investment in developing countries.
[34] For more on policies to enhance crisis prevention and crisis management, see Part II of this paper.

necessary. As the current quota structure at the IMF fails to reflect the actual scale of countries' economies, the quota formula should also be amended to properly reflect the growth of many developing countries.[35] At both the IMF and the World Bank, there is a strong case for increased representation of African economies on their Boards.[36]

Second, it is essential that developing countries be represented in those fora where they currently have no voice, including in the standard-setting bodies such as the FSF and the Basle Committees. New global standards, such as those policed by the ROSC (Reports on the Observance of Standards and Codes), international accounting standards, and the Core Principles for Banking Supervision are often not well suited to developing countries' less well developed financial and economic sectors. Meeting the new standards governing the financial sector has also been a costly development for many poorer developing countries. In order to increase the legitimacy and effectiveness of global financial standards and codes, developing countries need to have a role in their formulation.

The Monterrey Consensus

The UN International Conference on Financing for Development was held in March 2002 in Monterrey, Mexico. The outcome of that conference, referred to as 'the Monterrey Consensus', contained a commitment to implement a range of actions designed to improve financing for development, particularly in developing countries. These commitments are categorised under six main headings:

- mobilising domestic financial resources for development
- mobilising international resources for development: foreign direct investment and other private flows
- international trade as an engine for development
- increasing international financial and technical cooperation for development
- external debt
- addressing systemic issues: enhancing the coherence and consistency of the international monetary, financial and trading systems in support of development

Many of the proposals outlined in this paper form part of the commitments of the Monterrey consensus; for example, those on contingency financing facilities during crises, the need for an international debt workout mechanism, and the importance of increasing the representation of developing countries in international decision-making and standard setting. The Monterrey follow-up process, which is overseeing implementation of the various commitments, is still under way (see www.un.org/esa/ffd).

Part II: What is the evidence on the impact of financial market instability and inadequate regulation on poverty reduction?[37]

1. Financial market crises and poverty[38]

Excessive volatility of financial flows, and resulting macro-economic volatility, and financial crises have been among the major causes of poverty and inequality in developing countries over recent decades. Pronounced cycles of market confidence in developing countries, with corresponding high levels of capital inflows, followed by abrupt increases in the perception of risk among market actors, resulting in sudden capital outflows, are extremely destabilising and very costly for developing countries.

[35] For more on reform of the IMF quota formulas see New Rules, 2005; Griffith-Jones, 2004; and papers by Ariel Buira and Yilmaz Akyuz on the G24 website (www.g24.org/papers.htm).
[36] Under current arrangements, the two African constituencies jointly represent 45 countries.
[37] Private Finance to Developing Countries: Background Paper Part II for the International Finance Chapter of *From Poverty to Power*, by Jenny Kimmis.
[38] This section draws on Gottschalk, 2004 and Griffith-Jones and Kimmis, 2003.

As the crises of the last decade have shown, poor people are affected disproportionately by financial crises; with women and children often among the hardest hit. Crises affect not only the current living standards of poor people, but also cause irreversible damage to human capital that can seriously undermine their capacity to grow out of poverty. Even when economic recovery after crises is accompanied by fairly rapid improvements in poverty rates, the damage to the human capital has more long-term negative effects. Crises also damage developing countries' capacity to attract more sustainable inflows of foreign capital, which can have further negative impacts on future growth.

1.1 Transmission channels: how macro economic shocks impact on the lives of poor people

Financial crises clearly have a profound negative impact on the lives of poor people. To gain a better understanding of how macro shocks impact on poverty and inequality it is useful to look at the various transmission channels between the macroeconomic events during a crisis episode and the country's poverty profile. The most relevant channels include changes to the exchange rate, fiscal tightening including increased interest rates, and slowed growth.

In all the major crisis episodes of the 1990s and the beginning of this century – Mexico, East Asia, Russia, Brazil, and Argentina – the financial crises were caused by a sudden reversal of capital flows. The first, immediate effect was a sharp devaluation of the exchange rate. This can have both direct and indirect impacts on poor people. The direct negative impact is on poor people's purchasing power, caused by the sharp increase in the price of imported goods such as food and medicine.

The indirect impacts occur through two main channels. First, the devaluation will increase the country's external debt profile and this is likely to result in the government cutting back public spending – including social expenditure – in order to meet the increased debt service obligations. A reduction in expenditure on social services during crises has been shown to have both immediate and long-term negative impacts on poor people. For example, cutbacks in spending on health and education will result in a reduction in human capital; thus limiting the capacity of poor people to produce and generate income in the future (Lustig, 2000). Poor people are often forced to liquidate physical and financial assets during a crisis in order to smooth consumption, but this often serves to limit their capacity to continue with their livelihood (Fallon and Lucas, 2002). Moreover, renewed employment opportunities during the initial recovery period are often less well remunerated (Fallon and Lucas, 2002).

Second, the impact of the devaluation on the wider economy will result in a reduced demand for labour, with falls in real wages and increases in unemployment as well as in less secure forms of employment. Devaluation harms the private sector, as banks and large companies, which have borrowed on international markets, will see the value of their dollar liabilities rise. As a result, many financial crisis episodes have resulted in widespread insolvencies which in turn puts pressure on domestic banks and may even lead to a collapse of the domestic banking system.

The rise in bankruptcies in the private sector results in a decline in real wages and job losses. If the banking system collapses, the impacts will be felt across the whole economy. Empirical evidence shows that governments, and so ultimately tax payers, have largely met the costs of banking crises. These costs also tend to be higher in developing countries.[39] For example, the cost of resolving the banking crises in the worst-hit Asian crisis countries represented up to 30 per cent of GDP (Honohan and Klingebiel, 2000). These costs can combine with other factors to severely constrain government resources for social spending during a crisis.

Another channel through which financial crises impact on poor people is increased interest rates. In response to exchange rate devaluation and the rapid exit of foreign capital, many governments have raised interest rates in an attempt to convince foreign capital to stay. Such a strategy has traditionally

[39] Honohan and Klingebiel (2000) showed that developing countries as a group had suffered cumulative fiscal costs of over $1 trillion in resolving banking crises over the previous 25 years.

been a central component of IMF advice on fiscal and monetary tightening for countries experiencing capital account-led crises. However, a sharp increase in interest rates during a crisis has been shown to have disastrous consequences for the domestic economy. Many have argued that when the East Asian economies were first hit by financial difficulties, the adoption of more expansionary policies – rather than the fiscal tightening imposed by the IMF – may have prevented the financial crises from becoming full-blown economic and social crises (see for example Wade, 1998). High interest rates imposed during a crisis can lead to a credit crunch, just as access to capital is vital (Cobham, 2001). This often becomes a vicious circle, with the reduction in the availability of credit further constraining output and resulting in even higher levels of unemployment.

A further channel through which a capital-account led crisis will impact on poor people is reduced growth. Before the crisis hit, the East Asian economies had been growing steadily for over three decades. As a result of the crisis, GDP fell by over seven per cent in Malaysia, by ten per cent in Thailand and by thirteen per cent in Indonesia. Such dramatic falls will affect poor people in a number of ways including through further job losses and lower real earnings; there is also likely to be indirect effects through reduced public provision of basic services. The following section looks at the social impacts of financial crises, looking at evidence from a number of recent crisis episodes.

1.2 Evidence on the social impacts of crises

Sharp reductions in GDP growth as a result of the crises in Mexico, Korea, Malaysia, Thailand, Indonesia and Russia resulted in lower real earnings and higher unemployment. This, in turn, led to a reduction in household income and consumption. Due to consumption smoothing, consumption fell less sharply than income in most crisis countries – but the falls were nonetheless often dramatic. In Mexico, for example, household consumption fell by 25 per cent between 1994 and 1996 (Baldacci et al, 2002).

As a result of falling income and increased unemployment, poverty in the crisis-hit countries rose and in some cases increased substantially. In Indonesia, for example, the poverty headcount ratio nearly doubled between 1996 and 1999 (see Table 1). As can be seen in Table 1, there were also significant increases in the number of people living in poverty in Russia, where the poverty headcount ratio increased by 50 per cent between 1996 and 1998, as well as in Argentina where over 50 per cent of the total population were living in poverty by 2002.

Table 1 : Poverty headcount ratio for selected crisis countries

Country	Crisis start date	Year	Poverty headcount ratio (%)
Mexico	December 1994	1994	36
		1996	43
Indonesia	July 1997	1996	15.7
		1999	27.1
Malaysia	September 1997	1997	6.1
		1998	7.0
Korea	October 1997	1996	9.6
		1998	19.2
Russia	August 1998	1996	21.9
		1998	32.7
Argentina	December 2001	2001	35.8
		2002	53

Source: Gottschalk, 2004

People in the crisis-hit countries were also affected by reduced access to social services. In Mexico, for example, social expenditure fell from 9 per cent of GDP in 1994 to 6.8 per cent of GDP in 1995 (Lustig, 2000). Public spending was also cut in Indonesia as a result of the crisis, with some of the largest cut-backs in areas that impact most on people living in or close to poverty such as education, health and housing. Government expenditure on education was reduced from the already low level of 1.4 per cent of GDP in 1996 to 0.7 per cent in1997 and 1998 (Gottschalk, 2003).

Reduced access to social services is one of the reasons why the impacts of crises tend to be distributed unequally. Singh and Zammit (2000) explain that women are more affected by crises partly because reductions in social services place a heavier burden on those who undertake unpaid household duties and care work. Lee and Rhee (1999), writing on the social impact of the Asian crisis, state:

> *It is the marginal groups such as the poor, the less experienced, the less educated, women, and young workers who are most severely affected by the crisis. As a consequence, even though the crisis does not bear a long-term effect on overall income distribution, it definitely aggravates poverty for the victimised core group over a significant period.*

World Bank (2001) research has shown that most social indicators either deteriorate or improve more slowly during economic crises. Health indicators that are sensitive to reduced food consumption or lower incomes tend to worsen. For example, following the Mexican crisis in 1994/95, infant and pre-school mortality caused by nutritional deficiency rose. Increased costs for imported drugs and reduced expenditure on health care are the other major reasons for declining health indicators following crises. In an article examining the consequences of reduced public expenditure on primary health care in Indonesia following the crisis there, the authors show that reduced access to effective health care among poor communities led to a dramatic reversal of previous improvements in infant mortality rates (Simms and Rowson, 2003).

Education indicators, such as school attendance and literacy rates, also suffer during crises. In Indonesia, for example, the proportion of poor children not enrolled in school increased from 4.9 per cent to 10.7 per cent in the 7-12 age group, and from 42.5 per cent to 58.4 per cent in the 13-19 age group (World Bank, 2001). School dropout rates for poor children in both age groups also increased as a result of the crisis.

1.3 The crisis in Argentina[40]

The background

The crisis in Argentina was caused by both domestic and international factors. On the domestic side, the convertibility regime – despite its success in bringing down inflation and restoring credibility in the country's financial system – had made Argentina vulnerable to the cycles in international capital flows which have tended to exacerbate boom-bust in developing countries (Ocampo, 2002). In the early 1990s, investor perceptions of Argentina were very positive and the country attracted high levels of capital inflows. Following the Asian crisis, however, investors' perceptions of risk in emerging markets changed dramatically and capital flows dried up. When the Argentinean economy hit difficulties in 2001, the markets lost confidence in the sustainability of the country's debt servicing capacity and withdrew further. In January 2002, the peso was devalued and the currency effectively collapsed.

The response of the international community

While Argentina was trying to address the crisis during 2001, the international community failed to come to the country's assistance. As the crisis deepened, the IMF not only failed to provide additional financial resources to help Argentina, but also actually suspended lending under the stand-by arrangement that was already in place. This increased concern in the international financial markets, triggering a further deepening of the crisis and contributing to the collapse of the currency.

[40] This section is adapted from Griffith-Jones and Kimmis, 2005.

The actions of the IMF in Argentina are in stark contrast to the way in which the international community should help countries during crises. First, as the sustainability of the convertibility regime became increasingly doubtful, the IMF should have discussed more alternatives with the authorities. Second, as the Fund supported Argentina's economic policy in the years immediately preceding the crisis, it was irresponsible to cut the country loose at the very time when it most needed assistance.

The economic and social impacts of the crisis
The recession in Argentina worsened dramatically as a result of the financial and economic crisis. The country's GDP suffered an accumulated reduction of more than 20 per cent between 1999 and 2002, falling by 11 per cent in 2002 alone (Carvalho, 2003). Economic contraction forced thousands of companies out of business. As a result, demand for labour dwindled, leading to heavy job losses and a steep fall in real wages. Unemployment increased to 22 per cent during the crisis, bringing the number of workers either unemployed or in part-time jobs to approximately 5.6 million. Real monthly wages declined by 18 per cent over the course of a year (CEPR, 2002).

Higher unemployment, less secure employment, the fall in wages and steep increases in the price of basic goods resulted in a sharp rise in poverty in Argentina. In the year to May 2002, the number of poor people in Argentina had risen by 6.15 million to a staggering 19 million – or 53 per cent of the total population. Of the 19 million people in poverty, 9 million were living in extreme poverty – representing an increase of 4.5 million in one year. Children were particularly hard hit by the crisis, with reports of malnutrition and hunger in various provinces and in the suburbs of Buenos Aries (CEPR, 2002). Poverty levels in Argentina had never before risen so much in such a short space of time. Inequality, measured by the GINI coefficient, increased from 0.49 to 0.53 between May 1999 and May 2002 (Perry and Serven, 2003).

1.4 Policy lessons from recent episodes of macro-volatility and financial crises
The crisis in Argentina and the other financial crises of the last decade have raised a number of important issues concerning the behaviour of international financial markets in developing countries, the response of the international community to financial and economic crises, and the preparedness of developing countries to cope with economic shocks when they do occur. This section will review four key areas for policy development: the provision of liquidity during crises; debt workout procedures; making economic policy sensitive to poverty concerns; and social safety nets.

Contingency financing
As the principal provider of emergency liquidity assistance during episodes of financial disturbance, the IMF plays a crucial role in both preventing and containing crises. Yet, as the experience of Argentina showed, the unwillingness of the international community to provide financial assistance to countries in crisis can contribute to both triggering and deepening a crisis. It will be vital to achieving poverty reduction and improved equity that the international community, in general, and the IMF in particular, has adequate financing facilities to prevent crises occurring, deepening, and spreading through contagion.

During the 1990s, the very high levels of private capital flows to developing countries, and the ease with which they can be reversed, greatly increased the need for official liquidity to deal with sudden and large reversals of flows. The failure of the international community to effectively fulfil this role is one of the main reasons why many developing countries, particularly in Asia, have been accumulating such high levels of foreign reserves as a form of self-insurance against possible future crises. This policy, although understandable, is not only costly for the countries concerned but it is also creating huge global imbalances that pose a significant threat to international economic stability.

Among the key lessons learnt from the crises has been that the provision of emergency financing needs to be large-scale, should be able to be disbursed rapidly, and should be available to countries that may suffer contagion effects. The international community should review existing IMF contingency financing facilities – including Stand-By Arrangements and the Supplemental Reserve

Facility – and create a new facility to replace the now defunct (and deeply flawed) Contingent Credit Line.

Debt workout mechanism
The huge increases in private flows to developing countries seen during the 1990s, together with the devastating financial crises of the last decade, brought the issue of debt workout procedures involving the private sector to the fore.

During the 1990s, it became painfully apparent that public funds could no longer be relied upon to offset the outflow of private money during a crisis. There was also concern at the time that the scale of IMF-led rescue packages would encourage lenders and investors to behave irresponsibly believing that they would be bailed out should trouble strike. The crises also highlighted the need to find faster ways for countries experiencing difficulties to reach agreements with their private creditors. During the Asian crisis, for example, in the time taken to set up private sector debt restructuring programmes countries slipped from facing difficulties into experiencing a full-blown crisis.

Over the last decade recognition of the need to involve – or 'bail in' – the private sector at a much earlier stage in crisis resolution has increased considerably. Disagreements have revolved around whether such arrangements should remain fairly informal or take a more formal shape.

The proposal for a Sovereign Debt Restructuring Mechanism (SDRM), put forward by the IMF, was not adopted and debt workout mechanisms have so far remained informal in nature. The SDRM proposal, based on private sector bankruptcy legislation, would have provided a legal framework within which debt could be restructured in an orderly manner. The IMF Board rejected the SDRM proposal, which was opposed by private sector and Paris club creditors as well as by some developing country governments. It seems likely that one of the main reasons for the proposal being rejected was the objection of the private sector to such rules. However, the huge development costs associated with financial crises, and the threat that crises and contagion pose to the international financial system, imply that more work should be done to find a feasible debt workout mechanism that could improve both crisis prevention and crisis management.

Policy sensitivity
It is also essential that the international community in general, and the IMF in particular, adopts a more flexible approach to the policy mix that can be applied to achieve stabilisation in different crisis situations. Pursuing fiscal adjustment through further expenditure cuts during crises serves only to deepen recession that not only worsens the economic outlook, but also results in further increases in poverty and inequality.

Crises clearly have a negative impact on growth and the living standards of poor people, and an inadequate crisis response can exacerbate these problems. Concerns over the social impacts of the policy conditions of the IMF required during some recent crises, most notably the crises in East Asia, highlighted the need for changes in the conditionality that traditionally accompanies rescue packages.

As was widely argued following the Asian crisis, the IMF should allow governments the fiscal policy space to pursue expansionary policies to counteract economic contraction during crises. This, in turn, would provide space to continue with existing, and implement new, social protection measures. Social concerns need to be mainstreamed into the design of crisis response policies. For example, in assessing the most appropriate policy mix to achieve stabilisation, the probable impact on poor people and poor communities of various alternative strategies such as raising taxes, cutting expenditure, and so on, should be taken into account.

Social safety nets
Recent crisis episodes have also demonstrated the importance of strong social safety nets. These consist of a wide range of policies and programmes – such as unemployment insurance, price

subsidies, nutrition programmes and social service fee waivers – that provide emergency income support and access to basic social services to poor and vulnerable members of society during a crisis. They are important for mitigating both the immediate and the long-term negative impact: preventing more people from slipping into poverty, and helping individuals and households cope with the consequences of crises without undermining human capital.

Work on social safety nets undertaken since the Asian crisis has identified that they should be: (i) part of permanent social protection schemes, so they can respond quickly to the needs of vulnerable people during crises; (ii) varied, with different programmes targeting different groups; and (iii) country-owned and designed. However, as it is very difficult for governments to fund sufficiently large social safety nets in times of crisis, the international community should also be willing to provide assistance to developing countries with financing social safety nets during economic shocks.

2. The offshore industry, banking secrecy and poverty

The offshore industry is part of a much deeper problem facing the global economy. As a result of capital becoming increasingly mobile as well as rapid technological change, wealthy individuals and transnational corporations (TNCs) are able to move their money freely around the world. Many have chosen to locate their wealth and their profits in offshore jurisdictions that offer minimal or zero tax rates. The problem is exacerbated because while capital has become increasingly global, tax regimes have remained largely national – and attempts to improve international cooperation in tax matters have been undermined by intense lobbying.

This situation is undermining the capacity of governments to tax their citizens and the businesses operating within their countries. Many states are under increasing pressure to offer competitive tax rates in order to attract and retain foreign capital. And while these developments are putting pressure on governments all over the world, the negative effects are felt most strongly in developing countries. This is because governments in developing countries are being deprived of the revenues they need to sustain investment in infrastructure and fund basic services. One recent study estimates that, if the problems of global tax evasion and avoidance could be adequately addressed, the potential gain for developing countries would be in excess of $200 billion a year (Cobham, 2005).[41]

This section of the paper will begin by examining some of the main problems associated with the offshore world: tax evasion and capital flight; bank secrecy, crime and corruption; transnational corporations, tax planning and tax competition; and offshore and financial instability. This section will then review the current regulatory environment, before presenting a range of proposals designed to help fill regulatory gaps and address the problems associated with offshore.

2.1 Tax evasion and capital flight

Secret bank accounts and offshore trusts facilitate capital flight. One of the key motivations for capital flight[42], which describes the moving of financial assets out of a country by wealthy individuals, is to escape paying taxes.

Studies of offshore wealth holdings have shown that rich individuals in developing countries tend to hold a far larger proportion of their wealth in offshore tax havens than their North American and European counterparts. For example, over 50 per cent of the total holdings of cash and listed securities of rich individuals in Latin America are estimated to be held offshore.[43]

The scale of capital flight to the offshore economy is immense. In March 2005 the international pressure group Tax Justice Network (TJN) published research findings showing rich individuals held

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[41] This estimate is based on addressing three areas of 'tax leakage': the income earned on assets held offshore by wealthy individuals; corporate sector profits that are transferred to low tax jurisdictions; and, income from shadow economic activity.
[42] Capital flight can be either legal or illegal.
[43] Tax Justice Network, 2005.

that $11.5 trillion of personal wealth offshore. A large proportion of this wealth is managed from approximately 70 tax havens in order to either reduce tax or avoid paying tax altogether. If the income from this wealth was taxed in the countries where those rich individuals were resident or derived their wealth, the additional tax revenue available to governments worldwide would be in the region of $255 billion annually.

Clearly, capital flight can have significant social costs, particularly for developing countries. The loss of needed government revenues and foreign exchange often results in lower levels of investment in infrastructure and human capital. Capital flight is also likely to have negative impacts on equality, as wealthy citizens escape taxation while poorer citizens face higher taxes or cuts in social expenditure to make up for shortfalls in government revenues (Epstein et al, 2005).

Capital flight, which was an important issue during the 1980s debt crisis, became a cause for concern again during the financial crises of the1990s. In Mexico, Russia and East Asia, the financial crises were accompanied by large amounts of capital flight. Yet addressing the problem is very difficult because capital flight is difficult to quantify due to the use of offshore and deliberate moves to obscure what are often illegal or underground money and asset flows (Epstein et al, 2005).

Even when legal, capital flight is making it increasingly difficult for governments around the world to introduce progressive economic policies if they in any way threaten the interests of the more wealthy citizens. As Epstein (2005) states: 'capital flight can be a powerful political weapon against government policies that threaten the wealth or the prerogatives of the rich.'

2.2 Bank secrecy, crime and corruption

Banking secrecy and offshore trusts also provide a secure cover for laundering the proceeds of political corruption, fraud, embezzlement, illicit arms trading, and the global drug trade. Again, this impacts particularly negatively on developing countries. One money laundering expert estimates the volume of 'dirty money' outflow from poorer countries in recent decades at $5 trillion.[44]

Corruption clearly threatens development; and it is the offshore system that facilitates the laundering of the proceeds of corruption. Many of the world's most notorious corrupt leaders – Mobutu in the former Zaire, Sani Abacha in Nigeria, and Pinochet in Chile – have been valued clients of the private banking industry.

Multinational companies operating in some of the world's poorest countries also make use of the offshore system to facilitate the plunder of natural resources by business and political elites and to bribe government officials. A recent study on Nigeria shows how corruption has prevented the country from benefiting from its considerable oil wealth.[45] In Nigeria's case, the interests of developed country governments have coincided with those of the large multinational oil companies, which have used the offshore system to siphon profits out of the country.

While the international community exerts pressure on many developing countries to address the problem of public corruption, there has been less attention paid to the destination of much of the illicitly obtained money. It is the private bank facilities and trust services provided by global financial institutions headquartered in the developed countries and operating offshore that allows corruption to take place on such a devastating scale.

2.3 TNCs, tax planning and tax competition

Transnational corporations (TNCs) make use of the offshore system to gain significant tax advantages. One way they do this is by setting up affiliates in offshore jurisdictions, which they use to hold assets

[44] Baker, 2005
[45] Rowell et al, 2005

or route income in a way that reduces their tax liability in both the countries where they operate and where they are headquartered.

Transnational corporations are also able to manipulate inter-company transactions to decrease their tax liability. These inter-company transactions now dominate world trade. Inter-group sales – sales from one company within a group to another company within the same group – are estimated to account for more than 60 per cent of world trade. Much of this trade passes through tax havens (it is estimated that approximately 50 per cent of world trade passes through havens).

TNCs are therefore able to structure their trade and investment flows through subsidiaries in tax havens in order to gain significant tax advantages. This limits the capacity of governments in poor countries to raise revenue through taxation on foreign-owned businesses. It also gives those TNCs that make use of international tax avoidance opportunities unfair competitive advantage over nationally-based competitors. The current set-up contains an inbuilt bias for multinational businesses over domestic firms in poorer countries as the latter tend to be smaller and more domestically focused.

Tax competition

With capital having become increasingly mobile, the threat that companies will relocate unless given concessions on lower regulation and lower taxes has forced many governments to respond by engaging in tax competition to attract and retain investment capital. Tax competition involves states offering incentives such as lower tax rates on profits, tax holidays, accelerated tax allowances for spending on capital assets, subsidies and other forms of inducement.

Competing to offer an attractive tax environment for global capital is becoming a headache for all the world's governments. By creating downward pressure on tax rates, tax competition reduces the capacity of states to finance public services effectively. The problem is even more acute for developing countries, however, as social and economic development is held back by under-investment in infrastructure, education and health services. However, the IMF, World Bank and EU have all, in varying ways, encouraged developing countries to compete in this way for investment.

Tax competition, if allowed to continue unchecked, would result in a 'race to the bottom' in which governments would be forced to cut tax rates on corporate profits to zero and subsidise those companies choosing to invest in their countries. To a certain extent this is already beginning to happen; some states with limited economic options have made tax competition a central part of their development strategy. This inevitably undermines the growth prospects of other countries, as they attract investments away from them, thus stimulating the race to the bottom.

2.4 Offshore and financial instability

The offshore system is now an integral part of the global market for capital. Offshore financial centres (OFCs) are used as conduits for rapid transfers of portfolio capital into and out of national economies that can have a highly destabilising effect on financial market operations. OFCs are also closely associated with derivatives trading and the investment activities of hedge funds, both of which pose a serious threat to global financial stability.[46]

The offshore system has contributed to the rising incidence of financial market instability, and is set to continue to do so as national financial systems grow ever more interdependent. Evidence on the behaviour of international investors during the financial crises of the late 1990s (in East Asia, Russia and Brazil) shows that funds based in offshore centres behaved more speculatively and were more likely to pull out heavily of the crisis hit countries (Gottschalk and Griffith-Jones, 2003).

Financial and currency crises such as these can have a devastating impact in developing countries where their smaller, more fragile capital markets make them particularly vulnerable to economic

[46] For more on derivatives and hedge funds see Part I.

shocks. As the experiences of East Asia, Russia and Argentina have shown, financial crises can cause damaging economic downturns in developing countries, destroying livelihoods and increasing poverty levels.

Some developing countries have responded to this threat by accumulating large hard currency reserves to protect their economies from financial instability. These reserve holdings are not only costly for the countries concerned, but they are also beginning to cause global imbalances, which are also a threat to global economic stability. However, in the absence of better regulation and more effective measures to reduce financial market volatility, many countries feel they have no choice.

The offshore world – by providing a screen behind which investors are using increasingly complex products – serves to hide the national identity of the capital invested and sometimes even the institution making the investment. This makes regulation at the national level extremely difficult, so it is important that offshore jurisdictions should be subject to international regulation.

2.5 Regulatory gaps and policy failures

The offshore world and the existence of tax havens allow structures to be set up to carry out real functions in the real world but without any requirement for a transparent legal presence that confirms their existence or the nature of their activities. This creates the opportunity for tax evasion, facilitates capital flight and allows the money laundering of proceeds from drug trafficking, people trafficking and other crimes to take place largely undetected. The negative impact from these abuses is felt most strongly in developing countries.

Yet until recently international initiatives to tackle the problems posed by offshore finance and tax havens, the majority of which are directly or indirectly connected to financial centres in OECD countries, have paid insufficient attention to the position of developing countries. This problem was highlighted in an Oxfam report, published in 2000, which drew attention to the harmful impact of tax havens and offshore on developing countries (Oxfam, 2000).

Since then, the report of the Monterrey Financing for Development initiative included a call for a strengthening of international cooperation on taxation and greater coordination of the work of the various multilateral bodies involved in tax matters (UN, 2002). The report also called for special attention on taxation issues to be paid to the needs of developing countries and countries with economies in transition.

Following this the International Monetary Fund, the OECD, and the World Bank published their joint proposal on *Developing the International Dialogue on Taxation*.[47] This was designed to facilitate technical discussions between different tax administrations and the sharing of good practices with the aim of improving the functioning of national tax systems in developing countries. What the joint proposal failed to address, however, was how developing countries could tackle the problem of capital flight to tax havens. Nor are there currently any global initiatives under way to abolish banking secrecy in tax matters, or to implement a global framework for automatic information exchange of relevant tax information.

2.6 Proposals

If the benefits of globalisation are to be extended to poor people, governments must regain the capacity to tax their citizens and businesses operating within their countries, and to use the revenues to finance infrastructure, essential public services and necessary wealth redistribution. A fair and just taxation system is a prerequisite for poor countries to fund sustainable development and eliminate poverty through domestic resources – rather than relying on aid and external debt. The following proposals would address some of the current policy failures and go some way towards helping governments regain control over taxation.

[47] See the IMF website: http://www.imf.org/external/np/fad/itd/2002/031302.htm

Corporate social responsibility
Nothing better reflects the corporate responsibility of any company than its payment of taxes. Tax payments are a major component of a company's economic footprint in the country or countries in which it operates. Yet, records of tax payments are not being made available at present although there are small moves towards increased disclosure in the US, the UK and some other developed countries.

Under current international accounting standards, transnational corporations are required to present consolidated accounts. This means that the profit and loss accounts of large groups are presented as if they were single company; all inter-group transactions are effectively eliminated. Clearly, this makes it almost impossible to tell which companies are structuring their trade and investment flows through subsidiaries in tax havens, and manipulating inter-company transactions, to gain tax advantages.

The *Publish What You Pay* campaign has had some success in calling on companies in the oil, gas and mining sectors to publish what taxes and other revenues they pay to the governments of developing countries.[48] *Publish What You Pay* have proposed that a new International Financial Reporting Standard (IFRS) be introduced that would require companies in the extractive industries to disclose revenue payments on a country-by-country basis. However, as corporate tax abuse is universal, further action is also needed to address the problem in other sectors.

Tax Research[49] and the Tax Justice Network are proposing the creation of an International Financial Reporting Standard (IFRS) to be adopted by the International Accounting Standards Board, the accounting standard-setting body for all quoted companies in Europe and some other areas of the world, and its US equivalent the Financial Accounting Standards Board (IASB).[50] The proposed IFRS would greatly enhance transparency, by requiring all transnational corporations to report on how they behave in all the countries in which they operate.

The proposed new IFRS would effectively de-consolidate the consolidated accounts of internationally active companies. Information that a TNC would be required to disclose would include: the countries in which it operates; the names of the subsidiaries through which it operates in those countries; what sales they make in those countries, both to third parties and inter-group; what profit they make in each country; and how much tax they pay there. As every transnational corporation already has this information available for internal accounting and management purposes, this proposal is technically simple and would impose very little cost on companies.

Importantly, this information would allow all stakeholders – shareholders, employees, suppliers, NGOs, governments and tax authorities – who have relationships with TNCs to assess the risks involved in dealing with them and understand where and how profits are being declared. For example, if the profits of a company were being declared in tax havens, but most of the sales and purchases that took place there were inter-group and few people were employed, it would be very likely that the company was shifting profits for tax advantage.[51]

The increased transparency offered by the proposed IFRS represents an important step towards forcing global companies to behave like global citizens. More generally, the last few years have seen an important shift as taxation is increasingly being viewed as a corporate responsibility issue. Part of the reason lies with the financial scandals of recent years, such as those involving Enron and Parmalat,

[48] Publish What You Pay, 2005
[49] Tax Research Limited is a research consultancy working on taxation and corporate responsibility issues, see www.taxresearch.org.uk
[50] For more on representation and legitimacy issues concerning standard-setting bodies such as the IASB, see Part I of this paper.
[51] See the example of the coffee trading company Volcafe in Tax Justice Network, 2005 (pp46-47) and on the Berne Declaration website http://www.evb.ch/en/p25010009.html

but the work of pressure groups such as TJN is also helping to raise the public profile of tax.[52] The large accountancy firms and some major companies are beginning to recognise that public expectations of corporate behaviour on tax are changing; management issues associated with tax can impact on reputation, and therefore on risk.[53]

Strengthening international cooperation on tax

Strengthening international tax cooperation is a crucial part of remedying the current imbalance between global businesses and nationally based tax regimes. The European Union has made some progress with the European Savings Tax Directive, but this is restricted in scope. Tax Justice Network and others have proposed an international regime of automatic information exchange agreements, which would significantly reduce the opportunities for tax evasion and tax avoidance.

An automatic information exchange regime would include the following elements: (i) all banks and other financial institutions should be required to disclose all interest, dividends, royalties, licence fees and other income (including that from employment) that they pay to citizens of another country each year; (ii) this information should be automatically exchanged between countries so that each country can ensure that income paid to its citizens is properly taxed; and, (iii) any country refusing to cooperate should be denied economic advantages – such as access to markets without tariffs – until compliance is achieved. The principle of automatic information exchange should also be extended to corporate bodies and trusts (as well as to individuals) as a lot of tax planning involves these vehicles.

An automatic information exchange regime should initially be set up between OECD countries as immediate attempts to enforce it across all countries could prove costly for developing countries where tax systems have less capacity to deal with additional requirements (Cobham, 2005). It could then be rolled out, as capacity in developing countries increases. The international community should also put more pressure on tax haven jurisdictions to cooperate on tax matters, accompanied by assistance for small, poor and vulnerable tax haven economies to convert to less damaging alternatives (Oxfam 2000 and Cobham 2005).

Strengthening international cooperation on tax matters would also facilitate the identification and recovery of illegal flight capital, such as the proceeds of political corruption and other crimes. Heightened concern in recent years over the rise of global crime – particularly global terrorism – means that the political will to act on money laundering should now be stronger than ever.

General anti-avoidance principle

The introduction of what is known in taxation law as a 'general anti-avoidance principle' would help to counter aggressive tax avoidance. Some countries do already have such principles in place, with varying degrees of success, and it would be helpful if they became part of the law in all countries. A general anti-avoidance principle stipulates that if any transaction – or any step within a transaction – is undertaken primarily to secure a tax advantage, then the benefit that transaction gives for taxation purposes can be ignored and tax can be charged as if it had not taken place. An anti-avoidance principle therefore helps to clarify legal grey areas surrounding the mis-pricing of imports and exports within companies.

A just tax system for multinationals

A new basis for taxing transnational corporations is required, as a national base for corporate tax makes little sense when companies can operate in 150 or more states simultaneously. To prevent multinationals avoiding taxation, a special set of rules could be introduced for taxing their profits

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[52] Tax Research and the Tax Justice Network are currently constructing a 'Tax Gap Index' that will show which UK companies are – and which are not – taking their commitments to social responsibility seriously in terms of making a contribution to the societies in which they operate.

[53] For an excellent analysis of attitudes to tax and CSR among some of the UK's largest companies, see Henderson Global Investors, 2005a and 2005b. For an interesting view on reputation risk and tax from one of the big 4 accountancy firms, see KPMG, 2005.

internationally and at an agreed rate, and distributing this across the countries in which the company operates. A global minimum rate of corporate taxation should also be considered.

An institutional home for international tax matters

The creation of a World Tax Authority could assist with monitoring the international impact of national tax policies and 'make tax systems consistent with the public interest of the whole world rather than the public interest of specific countries'.[54] The responsibilities of such an authority would include: (i) to assist with international exchange of taxation information; (ii) to help protect national tax regimes from predatory practices such as tax competition; (iii) to collate relevant statistics and act as a forum for discussion and sharing of best practice; (iv) to work with international accounting bodies to define common standards for the tax treatment of transnational corporations. The establishment of a World Tax Authority would therefore represent a major step towards tackling harmful tax competition, profit laundering by TNCs and other abuses of the offshore system.

Part III: What incentives drive the behaviour of individuals and institutions in financial markets and what measures will effect change to enable financial markets to benefit poor people and communities?[55]

1. Introduction

The level of investment in developing country assets by developed country investors is low.[56] Moreover, these investment flows have been shown to be subject to short-term considerations and have therefore contributed to the boom-bust cycles that have impacted so negatively on many developing countries over the last decade. Most of the financial crises that have hit poor countries in recent years have been a result of sudden changes in asset allocation by investors, resulting in sharp reversals of capital flows.

Clearly, there are a number of factors within developing countries that discourage higher investment levels – these include problems of liquidity, corporate governance, and adequate disclosure and regulation. However, empirical studies have shown that investment in developing countries is largely explained by source country factors (Fitzgerald and Krolzig, 2003). Efforts to increase the level of investment in developing countries, as well as to make it more stable, therefore need to begin with an analysis of how investment happens. It is useful to look at the motivations and incentives for investment and examine how regulatory changes and other incentives might be used to make investment in developing countries produce better outcomes for pro-poor development.

This paper will focus on institutional investors, a category which includes pension funds, insurance companies, investment banks and many other providers of investment products. Globally, institutional investors control over $45 trillion in assets. In the UK, pension funds alone were estimated to manage assets of nearly £700 billion by the end of 2001. Yet the proportion of assets under management by institutional investors that are invested in developing countries is usually somewhere between one and seven per cent. Given the large sums involved, even a very small increase in this figure could have a substantial impact on the external funding of developing countries.

There is a strong business case for international investors to invest part of their portfolio in emerging markets. As developed countries and developing countries follow different economic cycles, there is a low correlation between emerging market securities and developed market securities. Including emerging market assets in a portfolio can therefore bring diversification benefits, improving the

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[54] This was the prime objective of a World Tax Organisation as proposed by former IMF Director of Fiscal Affairs, Vito Tanzi, in 1999. His idea was supported by Oxfam in the 2000 report on tax havens and has also been taken up by the Tax Justice Network.

[55] Private Finance to Developing Countries: Background Paper Part III for the International Finance Chapter of *From Poverty to Power*, by Jenny Kimmis.

[56] This sections focuses on investment in (rather than lending to) developing countries. Issues around bank lending are explored in Part I of this paper.

overall risk-reward mix – meaning that returns are higher for a given level of risk (Persaud, 2003). Gottschalk (2003b) has also shown that, historically, capital invested in developing countries has obtained higher returns than that invested in developed countries. This is because developing countries are some of the worlds fastest growing economies; the Asian drivers are the obvious current examples.

Despite the strong business case, however, investment levels remain low and investment flows subject to high levels of volatility. This is because of the market failures and skewed incentives that prevent investors being guided by long-term considerations and economic fundamentals. This paper begins by examining some of the barriers to investing in developing countries, and then looks at a number of proposals designed to help increase the volume and stability of investment flows.

2. Barriers to investment in developing countries[57]

Over the last thirty years, technological change and financial market liberalisation have led to a massive shift in the way the global finance industry is organised. Traditional distinctions between which types of institutions offers that services have broken down. New types of institutions, such as hedge funds, have appeared requiring new regulatory arrangements and, in the developed countries, investment managers have replaced banks as the principal managers of the savings of individuals.

Institutional investors, which together manage assets of more than $45 trillion[58], include: pension funds (public and private, occupational and personal), insurance companies (life and nonlife and reinsurance), foundations and endowments, banks and investment banks, and providers of investment vehicles including mutual funds and hedge funds. These investors do not form a homogenous group and they follow quite different investment strategies reflecting varying time horizons, liability structures and cultural backgrounds (IMF, 2005).

2.1 Perceptions of risk

Despite the widely recognised benefits of international portfolio diversification, most funds in developed countries, such as in the UK, US and Germany, are highly concentrated in domestic equities. This 'home bias' happens because investors feel more comfortable investing in assets that they feel they know and understand.

There are a number of obstacles to investors holding higher levels of foreign assets. These obstacles include currency risk, information problems (lack of information or the higher cost of information), and the characteristics of foreign stock markets[59], which investors perceive as more risky (Gottschalk, 2003a). These obstacles are magnified in the case of emerging market countries, resulting in what Fitzgerald and Babilis (2004) have labelled a 'double home bias' for these markets.

The financial crises of the last decade have had a significant negative impact on market performance in many emerging market countries – at least in the short-term. As a result of the crises, the perception of these markets among investors shifted considerably and a much more cautious attitude towards investment was adopted. In 2002, emerging market assets represented only around one to three per cent of international investors' total assets. Investors – who often lack the adequate knowledge and experience of developing country markets and were therefore unable to assess risk properly or distinguish adequately between different countries – became overly wary of investing in markets that they perceived as highly risky.[60]

[57] This section on barriers to investment draws on work carried out at the Institute of Development Studies between 2001 and 2002 and led by Stephany Griffith-Jones and Ricardo Gottschalk. This work included carrying out a targeted programme of interviews, some of which I was involved in, with a range of market participants (investors, lenders, consultants, etc) in both the UK and the US. The key findings from these interviews (as well as a full list of the institutions involved) are reported in Gottschalk 2003a, and more information on the project is available on the IDS website.
[58] The figure for assets under management by institutional investors has almost tripled since the early 1990s.
[59] For example, more shallow markets with lower levels of liquidity.
[60] Imperfect information is one of the key market failures that undermine the functioning of financial markets. Another approach, in the behavioural finance literature, applies some of the insights of psychology to financial markets, looking at how human

2.2 How investment decisions are made

The investment cycle, the decision-making process undertaken by fund managers, consists of three key phases: asset allocation, security selection and market timing. Asset allocation involves choosing the category of assets (that is, bonds, property, emerging market equities) while security selection refers to specific choice of assets within each broader category (for example, the choice to hold equity in a Mexican oil company). Market timing refers to the decisions taken on the best time to buy and sell assets.

Factors which impact on asset allocation decisions include the liability structure of the fund, the various standards and norms under which it is operating, the availability of investment opportunities, incentives for managers (including the frequency with which asset allocations are reviewed) and whether or not external consultants are used.

2.3 Models and risk management techniques

One possible barrier to investment in developing countries is the type of modelling used by actors in the investment community. UK pension funds, for example, typically use asset-liability modelling which relies on historical data on asset performance. As an investigation into the UK pension fund industry highlighted (Myners, 2001), this discourages investment in asset classes that are under-researched and where there is limited availability of historical data. Emerging markets are clearly much more difficult to model that mature markets due to the lack of research and data available.

Another barrier to investment in developing countries may be the sophisticated tools used to monitor risk for internationally diversified portfolios (Gottschalk, 2003a). Risk management tools guide investors in their decisions about when is the best time to buy and sell particular assets. One of the most common methods used for risk management is value-at-risk (VAR) analysis, which can show how the market value of an asset (or assets) is likely to change over time. Tools such as VAR analysis may be encouraging herding. As investors increasingly rely on the same methods to assess risk, they are more likely to behave similarly at times of heightened risk such as during crises (Gottschalk, 2003a).

The use of indices (including those for measuring the performance of investment managers, see below) represents a further barrier to investment in developing countries. First, there is the issue of which stocks get included in the index. Emerging market stocks feature in both global indices and specialist emerging market indices. However, even in the latter – such as the S&P/IFC and the MSCI – only stocks from around half the developing countries that have stock markets are included and, within those countries, only certain types of firms will feature (Kimmis et al, 2002). Second, in what is termed 'tracking error', limits are set on the degree of divergence permitted from the benchmark encouraging 'index-hugging' which tends to result in less innovative stock selection and less opportunity for fund managers to add value.

2.4 The incentives driving investment managers

With the shift from bank managers to investment managers the incentives that influence the behaviour of many financial market actors has changed considerably. Bank managers were traditionally paid a fixed salary, whereas for investment managers financial rewards are linked to investment returns. This means investment managers face a compensation structure that increases strongly with good performance and falls with bad performance (Rajan, 2005).

The performance of fund managers is also typically measured with reference to a peer group benchmark or an index (BIS, 2003). This provides incentives for managers to focus on outperforming other fund managers which often results in perverse behaviour such as 'herding,' when fund

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judgment is affected by tendencies such as overconfidence and inconsistency in preferences. For example, Robert Shiller's book *Irrational Exuberance* examines the types of behaviour among market actors that can result in stock market bubbles. For a good overview of behavioural finance issues in relation to emerging market investment, see Hoguet, 2005.

managers simply copy what other are doing (Myners, 2001). As the Myners report showed, this can have negative effects on the diversity of investment decision-making. Fund managers who are evaluated against a common benchmark, say the S&P 500 index, will have an incentive to buy the stocks included in that index even if they are aware that the stocks are overvalued; they know that their poor performance will be excused if the benchmark index also performs badly. In a recent paper on institutional fund managers and contagion in financial markets, Chakravorti and Lall (2004) state: 'managerial compensation systems are a key source of distortions in financial markets'.

These compensation systems represent a further barrier to investment in emerging markets. Irrespective of how attractive an investment opportunity might be, these performance criteria make it difficult for managers to invest in any asset class that others are not also investing in. And as investment managers are evaluated frequently, generating high returns in the short-term offers job security and even the admiration of peers. As Rajan (2005) notes: 'It takes a very brave investment manager with infinitely patient investors to fight the trend, even if the trend is a deviation from fundamental value.'

This herd behaviour creates higher levels of correlation in markets than is desirable and contributes towards moving prices away from fundamentals (Chakravorti and Lall, 2004; Rajan, 2005). If prices move too far from fundamentals – as in asset price bubbles – a large correction becomes more likely. Therefore herd behaviour contributes to financial market volatility and increases the likelihood of sudden shocks.

With many institutional investors, particularly pension funds, investment consultants play a significant role in the asset allocation process, advising on the selection of portfolio managers and the specific types of asset classes. Consultants are often rewarded through transaction-based fees that may encourage greater portfolio turnover. The use of consultants can therefore compound the problems outlined above, as neither the consultants nor the investment managers are operating under incentives that are in line with the objectives of investors.

3. How to effect change in financial markets

3.1 Current trends

The IMF's most recent *Financial Stability Report* notes the current demographic changes and pension reforms that have increased the size and importance of institutional investors. The current figure of global assets held by these investors of $45 trillion is certainly set to grow further over the coming years (BIS, 2003). The IMF report states that as these long-term institutional investors need to match their assets to long-term liabilities, there is now greater attention being paid to the relative merits of different asset classes and a new focus on the longer-term (IMF, 2005). This, the Fund argues, should result in a decline in home bias – and increased interest in emerging market assets – as well less frequent and less sudden changes in asset allocation.

If this were the case, it would clearly have a positive impact on global financial stability and the financing options available to developing countries; even a small change in asset allocation towards emerging markets would have a big impact. Since 2002, institutional investors have been returning to emerging markets – however, this is probably explained more by improved conditions in many of the countries concerned as well as cyclical factors in developed markets such as low interest rates.

Studies of financial market actors have shown that while institutional investors such as pension funds should, instinctively, be allocating assets with a longer-term view, this is often not the case due to a range of other influences and incentives as discussed in this paper (Gottschalk, 2003a). Moreover, the IMF report has been prepared during a period of relative stability in emerging markets. A study analysing the behaviour of international investors during the crises of the late 1990s and the beginning of this century (in East Asia, Russia and Brazil) showed that investors did pull out quite heavily once the crises hit (Gottschalk and Griffith-Jones, 2003). So while there may be more divergence in investor

behaviour and less frequent changes in asset allocation during normal times, the findings of this study imply that behaviour converges once markets are experiencing difficulties.

3.2 Asset allocation and performance criteria

The systems used for asset allocation and the incentives provided to fund managers are clearly distorting investment outcomes and may well be discouraging investment in emerging market assets. Issues such as the use of benchmarks and indices and the timeframes under which investment managers are evaluated require further examination. Some of these issues were addressed in the Myners report, which made a number of recommendations in the context of private equity investment in the UK. Policymakers could consider using regulatory measures to shift the managerial compensation system to better align the behaviour of investment managers with the public interest (Rajan, 2005).

It has also been proposed that the requirement of some funds that managers have some of their own wealth invested in the funds that they manage could be rolled-out to encourage better investment practices (Rajan, 2005). These so-called 'personal capital requirements' would provide incentives for managers to take a longer-term view and would also ensure that they internalise the risks that they take.

The use of increasingly uniform, sophisticated risk management techniques may also be limiting the level of investment in developing countries. It would be useful therefore to promote more diversity in the risk assessment techniques adopted by different financial institutions. If all funds and other investors could construct unique risk assessment methods that are specifically tailored to their needs they would be much less prone to herding and more likely to hold developing country assets for longer (Gottschalk and Griffith-Jones, 2003).

3.3 Tax incentives

Given that there are substantial and proven benefits to diversifying an investment portfolio towards emerging markets, governments in developed countries could play a role in helping investors break through the barriers to such investment. In the UK, for example, pension funds are already the recipients of heavy tax breaks in order to encourage higher rates of saving. The UK government, and governments in other developed countries, could provide support through the tax system to encourage institutional investors to invest a higher proportion of their assets in developing countries.

As the benefits of investing in developing countries are more likely to be manifest over the longer-term, it might also be useful for governments to provide incentives – such as tax breaks – to encourage longer-term investment. One option would be the introduction of a taper tax, similar to the one introduced for capital gains tax in the UK, under which the tax charged on selling an investment is lower the longer an investment is held (Kimmis et al, 2002).

3.4 Investor education

Lack of knowledge on developing countries and inexperience in analysing information from emerging markets is clearly acting as a barrier to increased investment. This suggests that there could be some public policy role in providing analysis on developing country stock markets – at least until the market is big enough to support such a function in the private sector. For example, the IFC is examining the possibility of funding free-standing research services on emerging markets that would reduce the costs of research for individual institutions (see the section below on SRI in emerging markets).

In the specific case of pension funds, the increasing shift from 'defined benefit' to 'defined contribution' schemes will result in an increased role in investment decision-making for individual

investors (or 'ultimate investors').[61] Evidence from the United States suggests that individual investors may be more risk-averse than professional investors. It is important, therefore, that investors are presented with the option of investing in emerging markets and that they are properly advised of the risks and rewards of doing so. Again, there may be a public policy role on investment advice pertaining to defined contribution pension schemes at least until the market has the capacity to fulfil that function.

3.5 Specialist emerging market funds

A further proposal to increase the level and stability of investment in emerging markets is that the number of specialist emerging market funds should be increased. A study on the behaviour of international investors during financial crises has shown that specialist emerging market funds are much less likely to abandon countries during shocks and crises than funds that invest across both developing and developed countries (Gottschalk and Griffith-Jones, 2003). As these specialist funds are mandated to invest only in emerging markets, they lack clear investment alternatives. Moreover, specialist managers are more likely to have better information on, and knowledge of, the countries they invest in and are therefore well placed to exploit market opportunities (such as assets being under-priced due to contagion effects). In this way, they can act as contrarian investors – providing a useful role by investing in markets that other investors are ignoring.

3.6 Socially responsible investment in emerging markets

In recent years, Socially Responsible Investment (SRI)[62] has had considerable success in making private capital a force to influence sustainable business practices. However, until now SRI has remained a mainly developed country phenomenon. Of the $2.7 trillion assets held by SRI investors globally, most are held in the US and some other developed countries.[63] The level of SRI in emerging market assets currently stands at an estimated $2.7 billion – or 0.1 per cent of global SRI assets – with the majority held by institutional investors.

In 2003, the IFC commissioned a study looking into the potential role for SRI as a tool for facilitating sustainable development in emerging markets. The study concluded that there was indeed an untapped potential for SRI in emerging markets. There is an increasingly strong awareness of developing country issues among the public in many investing countries; the study points to social investors engaging in issues such as apartheid in South Africa or, more recently, sweat shop labour and climate change issues.

However, there are also a number of barriers, which have inhibited the growth of SRI in emerging markets. First, while it is now widely recognised that investing in companies with good CSR credentials is good for business (and therefore share prices), investing in companies that are globally responsible in their location, choice of suppliers and relationship with their community is not seen as a supporting factor for share prices (Persaud, 2003 and Just Pensions, 2004).

Second, in developed countries, social investors often lack knowledge and experience of emerging market investments and tend to assume that these markets are very risky and volatile. Developing country markets and companies are small, and carrying out research on a large number of small companies in markets where political and economic risks are high and variable is expensive (Persaud, 2003). Investors often doubt the profitability of emerging market investments and have concerns about the availability of good stocks as well as poor liquidity. As the IFC report states:

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[61] Defined contribution schemes currently account for around 20 per cent of occupational pension schemes in the UK, but this figure is set to rise in the future. See BIS, 2003 on the importance to financial stability of providing ultimate investors with as large a choice of investment strategies and products as possible.

[62] SRI is defined as an investment process that considers the social and environmental consequences of investments within the context of a rigorous financial analysis using three main strategies: portfolio screening, shareholder action (or engagement) and community investment.

[63] SRI assets held by UK investors (mainly pension funds and insurance companies) reached around $326 billion by 2001 (Persaud, 2003).

For relatively uninformed investors, including many social investors, emerging-market investment is associated with perceived problems of corruption, absence of reporting transparency, lack of access to relevant corporate management information, ineffective legal regimes, inadequate investor protections, illiquid stock markets, market volatility and general political risk. These perceptions of risk are influenced by memories of the emerging-market financial crisis of the late 1990s as well as current scandals including Russia's oil imbroglio.

The lack of credible data on the social and environmental performance of companies in developing countries is also a problem. There is also a lack of clear understanding over which objectives SRI should have in the developing country context. There is even a concern that some elements of the SRI agenda may inadvertently be harming developing countries. Negative screening, which results in excluding companies that do not meet minimum standards on environmental, social and other issues from an investment portfolio, can punish developing country firms which face greater difficulties meeting these standards than their developed country counterparts (Gottschalk, 2003b).

Despite these barriers and concerns, SRI has the potential to have a positive impact on sustainable development. Given the size of developing country markets, even fairly modest investment levels could achieve significant results. There is also a strong business case for investors to hold some of their SRI portfolio in emerging markets. In addition to the benefits of international diversification (discussed in the previous section), the IFC study shows that the so-called 'SRI premium' is also relevant in developing countries.[64] As the IFC study states, SRI works in developing countries for the same reasons as it does in developed ones: 'Responsible companies are better managed, have access to new markets, face fewer risks, have better branding and reputations and have more loyal and better-trained workforces.'

The IFC believes that over the medium to long-term, the growth prospects for SRI in emerging markets are strong – particularly among institutional investors. In order to encourage this growth, the report puts forward a number of recommendations to facilitate the creation of a strong, emerging market SRI infrastructure. These recommendations centre on how the IFC's Sustainable Financial Markets Facility could help stimulate emerging market SRI and they include:

- the development of a stronger knowledge and networking infrastructure (for example, in developed countries there are a range of groups and activities which include fund companies, trade associations and organisations working on SRI issues)
- the creation and development of research services and CSR performance data services for emerging markets
- the motivation of more institutional and retail SRI in emerging markets, including the support of a high-profile emerging market fund.

The following case-study on Intelligence Capital is an example of one such fund.

[64] One of the most comprehensive studies on the subject so far has been *Developing Value* published by SustainAbility. Assessing over 240 businesses in over 60 countries, the study found that good corporate governance and environmental and social responsibility resulted in financial benefits to businesses in emerging markets.

Intelligence Capital: lowering the barriers to emerging market investment

Intelligence Capital (IC) is a London-based financial advisory firm which, together with the Commonwealth Business Council and leading financial institutions experienced in emerging market investment, has developed a global index and a global fund designed to help lower the obstacles to investing in emerging markets by demonstrating the benefits of an internationally diversified portfolio.

CBC Global Index

Intelligence Capital and the Commonwealth Business Council have created the CBC Global Index, which combines three elements: the benefits of diversification; gross domestic product weightings; and global engagement. Research has shown that, because developed and developing countries follow different economic cycles, a portfolio which includes equities from both sets of countries in equal measure is likely to be less volatile and risky than one which has only developed country assets. The index seeks to reduce risk through international diversification.

Most global indices give emerging markets a weight of around 4 per cent because they are based on market capitalisation. The CBC Global Index, however, weights investment according to purchasing power parity (PPP) adjusted gross domestic product (GDP). As a result, the Index gives emerging markets a weight of around 45 per cent, allowing it to reflect the importance of the fastest growing yet under-represented countries in the world. The Index also includes a socially responsible dimension, involving an engagement process, which aims to encourage companies to commit to promoting better corporate governance and citizenship.

CBC Global Engagement Fund

The CBC Global Engagement Fund has been developed by Intelligence Capital and the Commonwealth Business Council and is sponsored by Elara Capital Advisors Ltd, a London-based investment bank regulated by the Financial Services Authority. The Fund's portfolio is managed by State Street Global Advisors (SSGA) and F&C Management Limited.

The CBC Global Engagement Fund, like the CBC Global Index, is GDP weighted across the world's largest economic regions; current asset allocations are 53 per cent in developed economies and 47 per cent in emerging markets (with 27 per cent in emerging Asia). Once the regional allocations have been set according to GDP, country weightings within each region are then determined by market capitalisation.

The developed country part of the portfolio is managed passively by SSGA and the emerging market part of the portfolio is managed actively by F&C, with an engagement process in both elements of the Fund. In the case of the developing country element, F&C apply their Responsible Investment Overlay (RIO). The objective of the RIO is to encourage companies in the portfolio to enhance business performance (and reduce long-term risks) by addressing their corporate governance standards as well as their social, ethical and environmental impacts. Engagement takes the form of exercising voting rights on all shares held in the portfolio and engaging in dialogue with management on particular issues. Each year, the RIO prioritises key issues – such as human rights and climate change – and key sectors – such as pharmaceuticals and banking. In developing countries, F&C adopt a gradual approach to engagement, with sensitivity to appropriate standards in the local context.

The Fund's sponsors aim to demonstrate the benefits of a globally balanced fund, encouraging other investors to hold a greater proportion of their assets in emerging markets once they see the potential rewards. If all institutional investors in developed countries increased the share of their portfolio in emerging markets from around five to around ten per cent, the impact on developing countries would be significant. And while initially no low-income countries have been included, there is the possibility of creating regionally-focused emerging market funds in the future.

Sources: Interview with Dr Stephen Spratt, Head of Research at Intelligence Capital Limited, the Intelligence Capital website (www.intelligence-capital.com), the Commonwealth Business Council website (www.cbcglobalindex.com) and the F&C website (www.fandc.com).

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