

International Standards for Strengthening Financial Systems: Can Regional Development Banks Address Developing Countries Concerns?

Liliana Rojas-Suarez¹

Prepared for the Conference on: *Financing for Development: Regional Challenges and the Regional Development Banks* at the Institute for International Economics

February 19, 2002

I. Introduction and Background

Following the eruption of the Asian crisis in mid-1997, the international community at large has increasingly focused on developing new mechanisms for financial-crisis prevention. These efforts respond to the realization that while globalization can bring significant benefits to countries undertaking transparent and sustainable policies, it also lead to severe disruptions in countries that liberalize their financial systems without having fully dealt with domestic economic and financial weaknesses and fragilities.

It is, therefore, no coincidence that the high frequency of financial crises observed in recent years throughout the world has happened in the context of the dramatic growth of international capital markets that followed the liberalization of financial systems and the development of new financial technology without adequate regulatory and supervisory frameworks.

But weak domestic financial systems have not been the only source of severe financial problems. In the absence of complete information about a country's capabilities to deal with external shocks, market concerns about the financial stability of a country can result in deteriorated perceptions about the financial soundness of other countries broadly categorized as "similar" according to a number of factors, including geographical location (the so-called "neighborhood effect") or analogous economic and/or financial ratios.² "Contagion" is the term commonly used to describe this phenomenon.³

The lesson learned from these episodes is that the intricate workings of global markets need new and better coordinated global regulatory and supervisory frameworks. While effective domestic regulatory frameworks are essential, they are not sufficient to ensure financial stability as they do not take into account the new interrelationships across countries created by the process of globalization in a world of imperfect information. Efforts to promote financial stabilization, therefore, must simultaneously

¹ This paper has benefited from the comments of Helmut Reisen and the excellent research support and valuable suggestions of Trond Augdal. Any remaining errors are, of course, my own.

² Common ratios assessed by the market include debt to GDP and the current account deficit to GDP.

³ There are a large number of recent papers attempting to explain this phenomenon. See for example, Calvo (2000), Claessens, Dornbusch and Park (2000), Pericolli and Sbracia (2002), Perry and Lederman (1999), Reinhart and Kaminsky (2000).

focus on strengthening both domestic financial markets as well as improving the international regulatory framework.

It was precisely the discontent with the capacity of the existing international architecture to prevent the eruption of financial sector crises that led to the creation of the Financial Stability Forum (FSF) in April 1999. The FSF was established for the specific purpose of promoting international financial stability by engaging the cooperation of governments, markets and international organizations in improving the process of financial supervision and surveillance. A major component of the activities of the FSF has been the coordination of a comprehensive set of “international standards and codes to strengthen financial systems.” In a nutshell, common standards attempt to tackle two main objectives. First, by being common, the standards aim at facilitating international comparisons and hence avoiding the negative externalities created by confusing and incomplete information on a country’s economic policies. Second, by setting them at high levels, the standards aim at enhancing the role of market discipline: countries that want to improve their access to international capital markets will have the incentive to enforce the standards; the standards can act as benchmarks to guide policymakers’ reform efforts.⁴

Identifying codes and standards, however, is not an easy task. To the question: what guarantees the stability of financial systems, there are a multitude of answers that go from the well-known prescription for macroeconomic consistency and sound domestic regulatory financial frameworks, to reforms in a number of economic and institutional sectors, to the full dissemination of a wide variety of information.

Prioritization becomes, therefore, a key issue when establishing and implementing standards and codes. In this regard, while the FSF has identified over 60 standards, the institution has highlighted a set of 12 standards, grouped in three areas, deemed to be essential for sound financial systems. These standards have been set by a number of international institutions and are understood as being “minimum requirements for good practice.”⁵ (Table 1) Each standard, in turn, contains a number of guidelines. While some are very specific, like the standards on data dissemination, others are quite general, like certain aspects of the transparency of monetary policy, and allow for variation from country to country.

Given the importance attached by multilateral organizations to the observance of standards and codes, the IMF initiated in 1999 the preparation of Reports on the Observance of Standards and Codes (ROSCs). Assessments on the status and progress of one or more standards are conducted on a voluntary basis. Sometimes, these assessments take place in the context of the IMF surveillance process (Article IV consultations). It is the intention of the IMF to keep a standardized format for all ROSCs and to publish them on the institution’s web site.⁶

⁴ Improved access refers, of course to both, the availability and the cost of financing.

⁵ Financial Stability Forum, April 2001.

⁶ A reading of the ROSCs published by January 01, 2002 indicates that important efforts are still needed to achieve the desired standardization of these documents.

Table 1: Key Standards for Sound Financial Systems

Subject Area	Key Standard	Issuing Body
<i>Macroeconomic Policy and Data Transparency</i>		
Monetary and Financial Policy Transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal Policy Transparency	Code of Good Practices on Fiscal Transparency	IMF
Data Dissemination	Special Data Dissemination Standard (SDDS) General Data Dissemination System (GDDS)	IMF
<i>Institutional Market Infrastructure</i>		
Insolvency	Principles and Guidelines on Effective Insolvency and Creditor Rights Systems	World Bank
Corporate Governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)	IASB
Auditing	International Standards on Auditing (ISA)	IFAC
Payment and Settlement	Core Principles for Systemically Important Payment Systems	CPSS
Market Integrity	The Forty Recommendations of the Financial Action Task Force on Money Laundering	FATF
<i>Financial Regulation and Supervision</i>		
Banking Supervision	Core Principles for Effective Banking Supervision	BCBS
Securities Regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance Supervision	Insurance Core Principle	IAIS

OECD= Organization for Economic Co-Operation and Development; IASB= International Accounting Standard Board; IFAC = International Federation of Accountants; CPSS = Committee on Payment and Settlement Systems; FATF = Financial Action Task Force; BCBS = Basel Committee on Banking Supervision; IOSCO = International Organization of Securities Commissions; IAIS = International Association of Insurance Supervisors.

Source: Financial Stability Forum

Table 2 shows ROSCs published by January 01, 2002.⁷ For each individual international standard, the table indicates the countries that have either conducted a self-assessment on that standard or have been assessed by an IMF/World Bank group of experts. There are a number of features arising from the table. First, by far, the majority of countries that have participated in this process are developing countries. Second, the standards that have been assessed most frequently are those related to transparency and banking supervision; not at all surprising given the emphasis on strengthening domestic

⁷ Not all completed ROSCs are published.

Table 2. ROSC Modules published on the IMF/ WB web sites as of Jan 1, 2002

	(i) Monetary and Financial Policy Transparency	(ii) Fiscal Transparency	(iii) Data Dissemination	(iv) Insolvency and Creditor Rights Systems	(v) Corporate Governance	(vi) International Accounting Standards	(vii) International Auditing Standards	(viii) Systemically Important Payment Systems	(ix) Banking Supervision ¹	(x) Securities Regulation	(xi) Insurance Core Principles
Argentina	Argentina	Albania	Bulgaria	Croatia	Argentina ²	Argentina ²	Cameroon	Algeria	Argentina ²	Argentina ²	
Australia	Australia	Argentina		Czech Republic	Hong Kong ²	Hong Kong ²	Canada	Argentina	Bulgaria	Bulgaria	
Bulgaria	Azerbaijan	Australia		Egypt	Kenya	Kenya	Czech Republic	Australia	Canada	Cameroon	
Cameroon	Brazil	Bulgaria		Georgia	Slovakia	Slovakia	Estonia	Bulgaria	Czech Republic	Canada	
Canada	Bulgaria	Cameroon		India	United Kingdom ²	United Kingdom ²	Euroland	Cameroon	Estonia	Czech Republic	
Czech Republic	Cameroon	Chile		Malaysia			Georgia	Canada	Hong Kong ⁴	Estonia	
Estonia	Czech Republic	Czech Republic		Philippines			Hungary	Czech Republic	Hungary	Georgia	
Euroland	Estonia	Estonia		Poland			Iceland	Estonia	Iceland	Hong Kong ²	
France	France	Hong Kong		Turkey			Ireland	Georgia	Ireland	Hungary	
Hong Kong	Greece	Hungary		Zimbabwe			Israel	Hong Kong	Israel	Iceland	
Hungary	Hong Kong	Mongolia					Mexico	Hungary	Mexico	Ireland	
Iceland	Hungary	Romania					Poland	Iceland	Poland	Israel	
Ireland	India	South Africa					Slovenia	Ireland	Senegal ³	Mexico	
Israel	Japan	Sweden						Israel	Slovenia	Poland	
Mexico	Korea	Tunisia						Mexico	Tunisia	Senegal ³	
Poland	Latvia	Uganda						Poland	Uganda ²	Slovenia	
Senegal	Mongolia	United Kingdom						Senegal	United Kingdom ²	Uganda ²	
Tunisia	Mozambique	Uruguay						Slovenia		United Kingdom ²	
Uganda	Pakistan							Tunisia			
United Kingdom	Papua New Guinea							Uganda			
	Poland							United Kingdom			
	Sweden										
	Tunisia										
	Turkey										
	Uganda										
	Ukraine										
	United Kingdom										
	Uruguay										
Total published	20	28	18	1	10	5	5	13	21	16	17
Of which developing countries	65%	79%	83%	100%	100%	80%	80%	69%	76%	81%	82%

Notes: 1) Not all countries are considered against all principles; 2) Self assessment; 3) Partly published
Source: IMF, WB websites: <http://www.imf.org/external/np/rosc/rosc.asp>; <http://www.worldbank.org/ifa/rosc.html>

banking systems. Third, there is a large disparity in the degree of countries' participation in standard-assessment: while some countries in the sample have participated in the assessment of only one standard; others have been involved in the assessment of the majority of the standards. For example, while only one ROSC has been prepared for Chile, Argentina has been involved in eight⁸. Policymakers' response to the establishment, implementation and assessment of international standards and codes has been mixed. While there is general recognition of the potential benefits of common standards, a number of policymakers and analysts have raised important concerns about the process. Criticisms cover a wide range of issues, including those who claim that the standards do not adequately incorporate key features of developing countries and others that argue that an inappropriate sequencing in implementing the standards can create more problems than solutions.

This paper deals with the issue of the appropriateness and effectiveness of international standards for the purpose of financial-crisis prevention in developing countries. Section II reviews a variety of concerns raised by analysts and policymakers. To fully exemplify the nature of concerns, this section also discusses in greater detail recent criticisms to one of the key guidelines for effective banking supervision: the banking capital adequacy standard as recommended by the Basel Committee. Focusing on this standard should prove useful given the importance attached by the international community to ensuring a sound regulatory and supervisory framework for the banking sectors in developing countries. Section III addresses these concerns and advances policy recommendations. A central part of this section is that it identifies a key role for Regional Development Banks (RDBs). Section IV raises some issues for further discussion.

II. What are the Concerns about Common International Standards When Applied to Developing Countries?

There is general agreement about the long-term benefits of establishing international standards guiding the direction of individual country's policies for the purpose of achieving financial stability. However, while most analysts agree with the principle that, under ideal conditions, policy standards, especially those for the financial sector, should converge across countries in the long run, many argue that the pressing issue for developing countries is how to handle the transition period when the preconditions needed for effective implementation of international standards may not yet be in place.

This section has two parts. The first part briefly summarizes the concerns raised regarding the setting and implementation of international standards in general. The second part exemplifies these concerns by focusing in greater detail on a standard that has been the center of much attention and criticism: the capital adequacy requirement as recommended by the Basle Committee on Banking Supervision.

⁸ Although four of Argentina's assessments were self-assessments, and not official ROSCs

a. General Concerns

General concerns about the standards are all interrelated. However, for expositional purposes, concerns can be classified into three categories: (a) perceptions of and discontent with a “one size fits all” approach; (b) problems with the sequencing of and capacity to implement the standards; (c) the “ownership” problem: lack of sufficient participation by developing countries in setting the standards; and (d) questions about the “effectiveness” of the “standards methodology.”

(i) *“One Size Fits All”*

From my perspective, this is the most important of all concerns. The main fear is that, faced with different constraints at least in the short-run, standards designed for industrial countries may not be appropriate for developing countries. Perhaps, one of the clearest formulation of this concern has been advanced by Mr. Jin Liquan, Deputy Finance Minister of China in a recent conference organized by the IMF: “Developing countries are given to understand that they can preempt a financial crisis and achieve economic stability, provided they follow rigorously the international standards and codes. But there are two questions to answer: first, are the standards and codes suitable to the developing country at their stage of development; and second, do they have a minimum institutional capacity to apply these standards and codes at the same level as developed countries?”⁹

Notice that the concern is not with the establishment of common principles *in the long run*, but with the adequacy of common standards *now*, for countries *at any level of development*. This concern has also been raised by high-level officials from some industrial countries. Take, for example, a statement by Gordon Brown, Chancellor of the Exchequer: “...there exists a danger of pushing inappropriate measures for a given country’s state of financial and institutional development, and any order of priority for implementation of the codes and standards must be carefully established on an individual basis to ensure positive net benefits.”¹⁰

While the degree of relevance of this concern depends on the particular standard, the next sub-section will argue that it is fully relevant for the banks’ capital adequacy standard.

(ii) *Sequencing and Issues on Capacity Implementation*

These concerns are closely related to the above. A main issue is that lacking appropriate *institutions*, such as adequate legal frameworks and appropriate judicial systems, compliance with the so-called “key standards” may not produce the desired results. For example, a government may comply with the standards for disclosure, while actually disclosing very little because of lack of data resulting from ineffective control

⁹ Excerpt taken from *IMF Survey*, volume 30, No. 7, April 2, 2001, p. 103.

¹⁰ Excerpt taken from: Brown (1998).

within the public sector.¹¹ A natural, yet unresolved question is, therefore, shouldn't countries first set up the appropriate institutions that guarantee the *enforcement of the provision of* quality of (and quantity of) data to be disseminated before actually testing whether the country meets the standard for disclosure?

Policymakers' "fear" of inappropriate sequencing when applying policy recommendations to developing countries largely designed in and for industrial countries is cemented on past disastrous experiences. For example, liberalization of domestic financial markets, a prescription whose long run benefits are widely accepted, became a popular policy in Latin America in the late 1970s and early 1980s. The eruption of banking crises that followed, resulting in the worst economic episode in the region in recent history—the so-called "lost decade"—is well known. Was financial liberalization the culprit? Not really, it was a "sequencing problem." Successful financial liberalization requires the adoption of sound regulatory and supervisory frameworks, and those pre-conditions were not in place in the region. A lesson well learned... *ex-post!*¹²

Further examples of the "right sequencing of reforms" abound in the literature. One of the best-known arguments is that liberalization of the capital account should only be undertaken when a sound banking system is in place and fiscal stability has been achieved.¹³ Notwithstanding the proliferation of examples supporting the need for such sequencing, only very recently has the IMF published statements supporting the maintenance of controls to capital *inflows* in cases when the domestic financial system may not be sound enough to intermediate those inflows.¹⁴

Having faced many experiences of "wrong sequencing" in policy reform, it is only natural that this issue appears high on the list of developing-country policymakers' concerns.

But even if the timing of the implementation of the standards is right, a number of countries are concerned about their capacity to pursue the task effectively. The requirements in terms of resources and technical ability may well surpass those available to some of the countries, especially in some of the poorest regions of the world, such as the sub-Saharan region.

(iii) *The "Ownership" Problem*

Another well-voiced concern by many representatives from developing countries is their insufficient participation in the *design* and *prioritization* of standards. The argument is that under-representation of developing countries in standard-setting institutions and forums contributes to the problems of standards' adequacy, sequencing

¹¹ This is the result from the 1998 Uganda's case study on Transparency Practices as reported by Brown (1998).

¹² The seminal work by Carlos Diaz Alejandro (1985) was one of the first studies in establishing the importance of sequencing.

¹³ For a full discussion on preconditions needed for an effective *and sustained* liberalization of the capital account, see, Mathieson. and Rojas-Suarez (1993)..

¹⁴ See, for example, Fischer (2001).

and implementation discussed above. A complementary argument is that is that the limited involvement leads to a lack of “ownership” of proposed policy reform. It is claimed that this, in turn, constitutes an important deterrent for congresses to support the implementation of the standards.

Table 3 shows the participation of countries in standard-setting bodies. Involvement is certainly quite mixed. For example, standards set by the IMF and the World Bank, such as those on transparency and dissemination, have the participation of the entire membership (183 member countries). In contrast, the Basel Committee on Banking Supervision, which sets standards on banking supervision, has a membership of only 13 countries, all from the industrial world. It is true that there are intensive consultations with a large number of developing countries, especially through the *Core Principles Liaison* Group, but the strong perception in developing countries is that the last word remains within the membership.

Perhaps the most frequently voiced concern about developing country involvement is the membership of the FSF, the main institution in charge of coordinating the standards and codes. As shown in Table 3, the FSF membership consists of G-7 countries plus Australia, Hong Kong, Singapore and The Netherlands.¹⁵ The response of the FSF has not been to broaden its membership, but rather to establish a number of working groups with significant participation of developing countries.

Membership in FSF working groups is presented in Table 4. The degree of participation of developing countries varies significantly depending on the subject matter. For example, while the working group on highly leveraged institutions remains an industrial-country set, fifty percent of the members participating in the working group on deposit insurance are developing countries. However, in spite of these efforts by the FSF, the perception of “lack of ownership” of the standards remains strong among developing countries.¹⁶

(iv) Are the Standards Producing the Expected Results?

While standard-setting and standard-assessing institutions fully recognize that adoption of international standards is an additional instrument in policymakers’ toolbox for crisis-prevention and not the “magic wand” to ensure financial stability, some analysts and the press have recently questioned the effectiveness of the policy recommendations, including the international standards, by multilateral institutions. The Argentinean crisis of early 2002—a full combination of banking disruptions plus default

¹⁵ The four non-G7 countries are included as they represent significant financial centers.

¹⁶ Some representatives from industrial countries also agree with this view. See, for example, Brown, G. (1998), *op. cit.*

Table 3. Countries' participation in standard-setting bodies

	(i): Monetary Policy and Financial Policies	(ii) Fiscal Transparency	(iii) Data Dissemination	(iv) Insolvency and Creditor Rights Svstems	(v) Corporate Governance	(vi) International Accounting Standards	(vii) International Auditing Standards	(viii) Systemically Important Payment Svstems	(ix) Banking Supervision	(x) Securities Regulation	(xi) Insurance Core Principles
Organization	IMF	IMF	IMF	WB	OECD	IASB	IFAC	CPSS	BCBS	IOSCO	IAIS
Participation	International Monetary Fund 183	International Monetary Fund 183	International Monetary Fund 183	World Bank 183	Organisation for Economic Co-operation and Development 30	International Accounting Standards Board 106	International Federation of Accountants 122	Committee on Payment and Settlement Systems G-10	Basel Committee 13	International Organization of Securities Commissions 99	International Association of Insurance Supervisors 66
					Australia Austria Belgium Canada Czech Republic Denmark Finland France Germany Greece Hungary Iceland Ireland Italy Japan Korea Luxembourg Mexico Netherlands New Zealand Norway Poland Portugal Slovak Republic Spain Sweden Switzerland Turkey United Kingdom United States				Belgium Canada France Germany Italy Japan Luxembourg Netherlands Spain Sweden Switzerland United Kingdom United States		

Source: Organizational web sites - hyperlinked at: <http://www.fsforum.org/Standards/KeyStds.html>

Table 4. Membership in FSF working groups

	Task Force on Implementation of Standards ²	Incentives to Foster Implementation of Standards	Working Group on Capital Flows	Working Group on Offshore Centres	Working Group on Enhanced Disclosure	Working Group on Highly Leveraged Institutions	Working Group on Deposit Insurance
Established	Sep-1999	Apr-2000	Apr-1999	Apr-1999	Jun-1999	Apr-1999	Apr-2000
Ended	Mar-2000	Sep-2001	Apr-2000	Apr-2000	Apr-2001	Apr-2000	Sep-2001
ToR	To explore issues related to and consider a strategy for fostering the implementation of international standards for strengthening financial systems.	To monitor progress in implementing core standards and further raise market awareness of standards.	To evaluate measures in borrower and creditor countries that could reduce the volatility of capital flows and the risks to financial systems of excessive short-term external indebtedness.	To consider the significance of offshore financial centres for global financial stability.	To assess the feasibility and utility of enhanced public disclosure by financial intermediaries	To recommend actions to reduce the destabilising potential of institutions employing a high degree of leverage (HLLs) in the financial markets of developed and developing countries.	To review recent experience with deposit insurance schemes and consider the desirability and feasibility of setting out international guidance for such arrangements.
Final report	Issues of the Task force on Implementation of Standards	Final Report of the Follow-Up Group on Incentives to Foster Implementation of Standards	Report of the Working Group on Capital Flows	Report of the Working Group on Offshore Centres	Multidisciplinary Working Group on Enhanced Disclosure Final Report	Report of the Working Group on Highly Leveraged Institutions	Guidance for Developing Effective Deposit Insurance Systems
Member Countries	Australia Canada China France Germany Hong Kong (chair) India Italy Japan Mexico Netherlands South Africa Sweden UK US	Argentina Australia Canada France Germany (chair) Hong Kong India Italy Japan Sweden UK US	Brazil Canada Chile France Germany Italy (chair) Japan Malaysia South Africa UK US	Canada (chair) France Germany Italy Japan Singapore Switzerland Thailand UK US	Australia Canada France Germany Japan Mexico Sweden UK US	Australia Canada France Germany Hong Kong Italy Japan Netherlands UK (chair) US	Argentina Canada (chair) Chile France Germany Hungary Italy Jamaica Japan Mexico Philippines US

Source: Financial Stability Forum; www.fsforum.org

on domestic and international obligations—has motivated this concern. The concern can be summarized in the following two questions. First, why is it that Argentina, one of the developing countries most involved with the ROSC’s process (it has four official ROSCs and four self-assessments published on the IMF web-site) is experiencing what appears to be one of the deepest and lengthiest crisis in recent history? Second, why did a positive assessment by the IMF/World Bank about progress in the implementation of four standards not shield the country against the eruption of a financial crisis?

While explaining the Argentinean crisis is certainly beyond the scope of this paper, it is not difficult to predict that this episode will be used over and over again by those who are skeptic about the usefulness of the standards.

b. Concerns with a Key Standard: Banks’ Capital Requirements

The capital adequacy standard as recommended by the *Basel Capital Accord* (the “Accord”) is a key item in the *Core Principles for Effective Banking Supervision*, which in turn forms the basis for the FSF standards on Banking Supervision.¹⁷

While, strictly speaking, minimum capital requirements as recommended by Basel were established only for internationally active banks, in practice they have formed the basis for assessing capital adequacy in all banks, including those that operate domestically. In fact, this is fully recognized in the *Core Principles for Effective Banking Supervision*, with no other comment but the emphasis that the recommended capital is a minimum and that national supervisors may require more stringent requirements.

The international capital standard can be used to exemplify the concerns with the standards in general, as discussed above. The fundamental reason is that there is evidence showing that capital standards had very little usefulness as a supervisory tool in a number of crisis episodes in developing countries; i.e., the capital requirements were not able to prevent the eruption of severe banking crisis. The rest of this sub-section explores how each of the concerns with the standards applies to the capital adequacy ratio.¹⁸

(i) Some Evidence Justifying Concerns: The Capital Standard has not Always Produced the Expected Results in Developing Countries

Encouraged by the perceived success of capital requirements as a supervisory tool in industrial countries, developing countries have been advised to adopt similar rules for

¹⁷ As established in the *Compendium of Standards* by the FSF, the standard on Banking Financial Regulation and Supervision has been set by the Basel Committee on Banking Supervision in the document: *Core Principles for Effective Banking Supervision*, September 1997. This document contains twenty-five principles. Principle 6 states that capital requirements should be those established in the Basel Capital Accord. The “Accord” is the popular name of the Basel Committee’s document entitled: *International Convergence of Capital Measurement and capital Standards*, published in July 1988.

¹⁸ A full discussion of the issues contained in this section is in Rojas-Suarez, L., *Can International Capital Standards Strengthen Banks in Emerging Markets?*, Institute for International Economics, Working Paper Series, December 2001.

capital adequacy.¹⁹ Indeed, during the 1990s many developing countries directed their financial reform efforts towards implementing the recommendations of the Accord. However, albeit with quite diverse outcomes, the recent experience of banking problems in developing countries, especially in emerging markets, indicates that capital requirements often have not performed their expected role as an effective supervisory tool, in that the accumulation of capital in banks' balance sheets did not act as a "buffer" to deal with unexpected adverse shocks to banks.

Recent evidence can be used to substantiate the statement above. Chart 1 shows growth rates of banking systems' net equity during the year *prior* to the eruption of a major banking crisis. If equity capital is at all a good indicator of banking soundness (that is, insufficient or decreasing capital should be signaling banking weaknesses), banks in countries about to fall into major crisis should be facing difficulties in raising capital. This has indeed been the case in banking crisis in industrial countries. As shown in Chart 1, during the year before the eruption of banking crises in Sweden, Norway and Japan, net real equity growth became negative. The Chart also illustrates a non-crisis episode in the US to show that in "normal times" net real equity grows at moderate rates. In contrast, at the eve of disastrous crisis episodes in developing countries, real net equity growth was not only positive, but also reached very high levels. Cases in point are Thailand, Mexico and Ecuador, where judging from the rapid accumulation of equity capital, this indicator did not serve as a signal for major banking turbulence. *Large and growing stocks of net equity did not prevent the eruption of severe banking crises.* Notice that the behavior of net equity growth was related to the country's degree of *development*, not to its size.²⁰

Further evidence that capital ratios have been meaningless in signaling banking problems in many developing countries is contained in Rojas-Suarez (2001)²¹. The main result is that, among traditional indicators used by supervisors as early warning indicators of banking problems, the capital to asset ratio has performed the worst. For example, in Mexico, a country that claimed to have adopted the capital standards recommendations of Basel just before the eruption of the 1994 banking crisis, the behavior of the risk-weighted-capital-to-asset ratio was useful to predict problems accurately in only 7 percent of the banks that experienced severe crises. Indeed, according to the data provided by the Mexican Supervisory Authority, most banks in Mexico were in full compliance with capital requirements and held a ratio well above 8 percent!

The conclusion that can be derived from the above evidence is not that capital requirements can be of no use for supervisors in developing countries *ever*. As the

¹⁹ Undoubtedly, the summary statistic for bank risk, which includes a composite assessment of credit and market risk, is the capital-to-risk-weighted-asset ratio. The capital ratio can serve this function because, at least in theory, enforcement of each of the other supervisory ratios implies an adjustment in the value of assets and liabilities that ultimately affects the size of the bank's capital account.

²⁰ Notice, for example, that banks' real net equity growth was *negative* on the eve of the banking crises in two small industrialized countries in the sample: Norway and Sweden. Thus, net equity behaved as expected for industrial countries in these two countries, despite their small size.

²¹ See, Rojas-Suarez, L.(May 2001).

discussion below demonstrates, the conclusion is that for the capital standards to work there are some pre-conditions that many developing countries may not be meeting in the immediate term. Effective banking supervision may, therefore, need to take into account particular features of developing countries that are different from those of industrial countries.

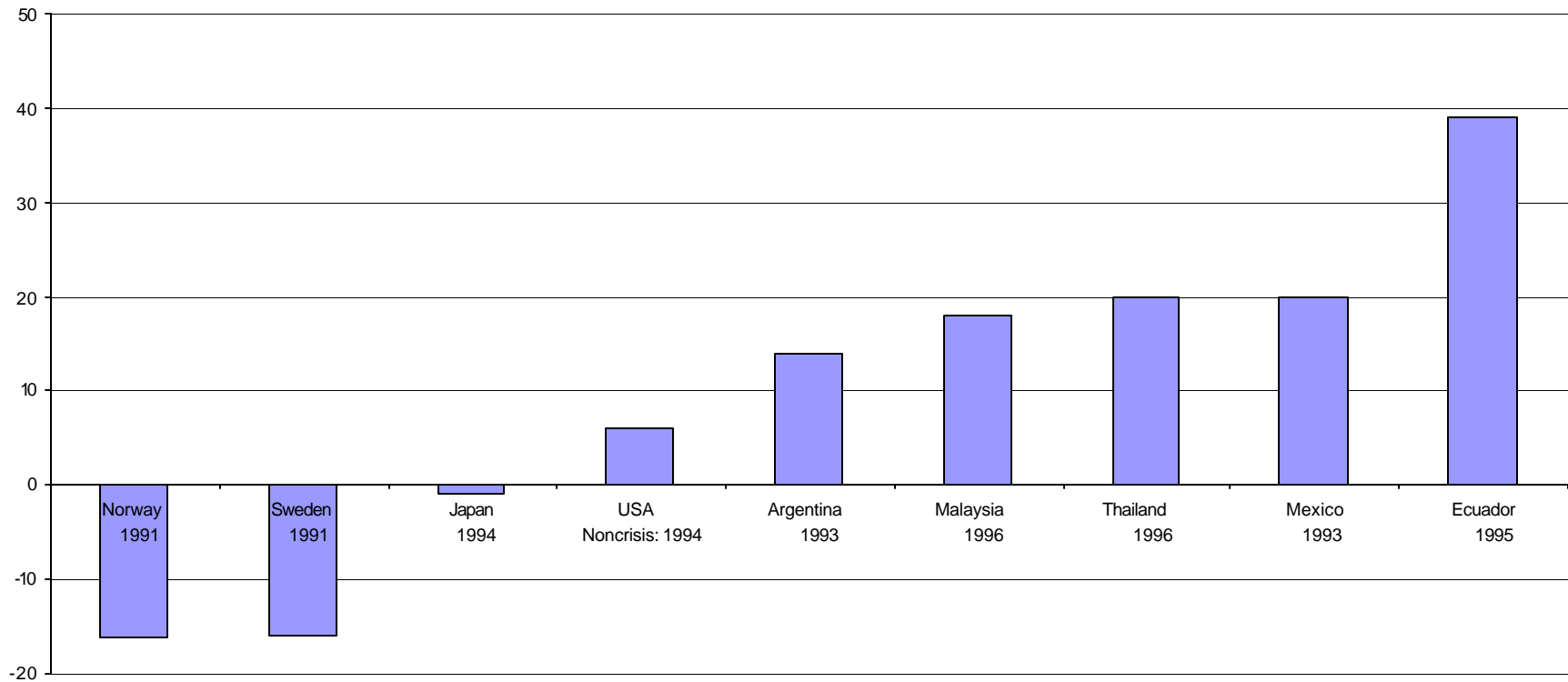
(ii) One Size does not Fit All: What does it take for the Capital Standards to Work?

There are a number of reasons for the disappointing performance of capital requirements as an effective supervisory tool in developing countries. The main argument raised in this paper is that for this standard to work, two sets of conditions need to be met. The first relates to the quality of data and the overall supervisory framework and the second to the depth and efficiency of markets. The first set of conditions is well known and is fully recognized by members of standard-setting bodies: compliance with adequate accounting and regulatory frameworks is necessary to make the capital adequacy standard work. Inappropriate accounting standards and reporting systems, improper classification of non-performing loans and under-provision of reserves against credit losses stand out as the best examples of inadequacies reducing the effectiveness of capital requirements. In addition, a deficient judicial framework, unable to enforce supervisory actions when a bank's performance is deemed faulty, seriously undermines the efficiency of bank ratios.

But if the above were the only preconditions, concerns about the appropriateness of the capital standard for developing countries would be exaggerated. All that would be needed is an adequate prioritization and ordering of the principles stated in the Basel's Committee's *Core Principles for Effective Banking Supervision*. This, indeed, is often done in practice. A more fundamental problem with the capital standards, however, goes beyond the establishment of rules and regulations into a feature *particular to developing countries*, namely the lack of deep and liquid capital markets. The second set of conditions for the appropriate performance of capital standards imply that, even when accounting, reporting and legal frameworks are adequate, capitalization ratios will be less effective if liquid *markets* for bank shares, subordinated debt, and other bank liabilities and assets are not available to validate the "real" value of bank capital as distinct from its accounting value. Therefore, changes in the market value of bank capital that provide supervisors in industrial countries information regarding the quality of reported capital will not be effective in developing countries.

In contrast to industrial countries, asset ownership, both financial and real is still highly concentrated in many developing countries, making the potential market for equity capital small and uncompetitive. In such an environment, the intent of the capital standard—to increase the proportion of uninsured funding (equity and subordinated debt) to insured funding (deposits) in order to reduce bank stockholders' incentive to take risks

Chart 1:
Real Net Equity Growth in Selected Banking Systems at the Eve of a Crisis*
(in percent)



*Except the United States data, which is presented as a benchmark.

Sources: Rojas-Suarez and Weisbrod (1997) , Rojas-Suarez (2001), various Central Bank statistics and IFS data.

at the expense of existing public safety nets--can be easily subverted.²² Shareholders' wealth may not really be at risk when they supply equity capital to a bank because shareholders can finance their stake with a loan from a related party, which may even be a non-financial corporation and hence outside the regulators' purview. Thus, concentration of wealth provides incentives for bank owners to supply low-quality bank capital and, therefore, to undertake higher risks than in industrial countries.

This suggests that it can be relatively easy for bank owners in several developing countries to raise large amounts of low-quality equity capital relative to the bank's capital base in a short time. Indeed, this feature may explain the results shown in Chart 1: the rapid growth of net "accounting" equity displayed at the eve of banking crises in several developing countries reflects the "low quality" of capital in these economies. *Lacking a market that assesses the quality of bank capital, capitalization ratios can not reveal the "true" riskiness of bank activities and, therefore, can not serve as an effective supervisory tool.*

Clearly, the severity of this problem varies widely across developing countries. For many countries, the constraints limiting the usefulness of capital requirements are extremely binding, begging the question: Is there an alternative to the use of capital standards for assessing the strengths of banks *now, in the immediate future, when preconditions for the effectiveness of the capital standard are not in place?* I will deal with these questions in Section III.

In some other countries, however, a continuous increase in the participation of foreign banks from industrial countries is de facto reducing the degree of connected-lending activities among financial institutions and between financial institutions and the real sector. Furthermore, in this (still small) group of countries, the accounting, regulatory and supervisory frameworks have improved drastically. Although there are very few developing countries with sufficiently deep and liquid capital markets,²³ the participation of foreign banks can provide an outside source of capital for the pursuit of new wealth. The competition induced by the entry of new providers of wealth can indeed contribute to improve the usefulness of capitalization ratios. For this group of countries, the relevant question is whether adopting the internationally accepted capital standards recommended by the Basel Committee is appropriate (both, the current and the newly proposed Accords). The next section discusses this issue.

(iii) Sequencing and the Degree of Development Matters

The discussion above clearly demonstrates the importance of the degree of financial development for the effectiveness of the capital standards. For industrial countries, where deep and liquid capital markets *validates* the value of accounting capital, the standard has proven useful. In contrast, for the least developed countries in the world, wealth concentration and the resulting absence of competitive capital markets severely hinders

²² This point has been advanced by Rojas-Suarez and Weisbrod (1997); and Rojas-Suarez, L. (2001)

²³ Chile, Hong Kong and Singapore may be the countries, among emerging markets, with the deepest financial sectors.

the usefulness of *any* bank capital standard, not only that recommended by the Basel Committee. In between these two extremes, there is a group of developing countries, where the participation of foreign banks has improved the functioning of the markets. In this group of countries, mostly classified as *emerging markets*, capital adequacy requirements can act as an effective supervisory tool. The question here is: are the capital standards as suggested by Basel the right standards for strengthening banking systems of developing countries with, say, an intermediate degree of financial deepening?

My assessment is that, paradoxically, the usefulness of the Basel capital standard is limited when the standard *is applied in a similar manner as in industrial countries*. The claim in this paper is that a straightforward application of the standard can actually *weaken* banking systems in emerging markets.

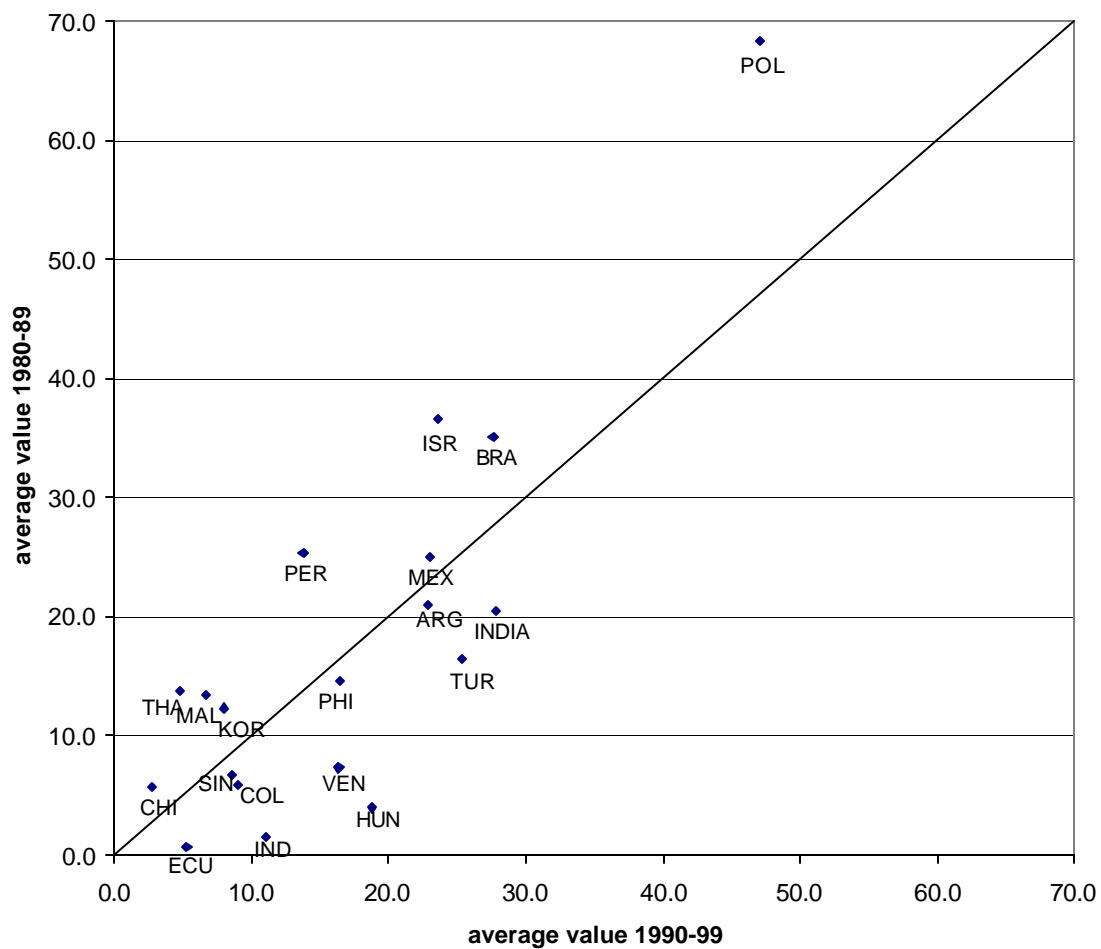
An example that serves to clarify this point is the treatment of bank credit to the government.²⁴ Under the current Accord, loans to the public sector carry a 0% risk weight if the country belongs to the OECD and 100% if the loan is to a non-OECD government. The idea, of course, is that government claims from OECD countries can be considered “safe assets”. However, when applying the Basel recommendations to their domestic economies, most non-OECD countries attach a 0% risk weight to their own government paper. That is, banks in emerging markets treat paper issued by their governments as a “safe asset”, an assumption far from reality if one takes into account the default history of governments in emerging markets, highlighted by the recent ones in Argentina, Russia and Ecuador²⁵. The problem with this practice is that by economizing on capital requirements, banks have a strong incentive to concentrate a significant portion of their asset holdings in government paper. This incentive not only gives a false impression of “bank safety,” but even more importantly, also contributes to weaken the “franchise value of banks,” which is rooted in their capacity to assess credit risk.

Chart 2 illustrates this. The chart shows that the share of government paper in banks’ balance sheets has increased during the 1990s relative to the 1980s for many emerging countries (many countries are located to the right of the 45 degree line). This result is a sad irony: a significant component of the efforts of financial sector reform undertaken in the early 1990s aimed at *decreasing* the share of banks’ claims on government! It is important to note, of course, that the results in Chart 2 should not be entirely attributed to an inappropriate implementation of regulatory reform. In a number of countries, banking crises were resolved by replacing bad loans with government paper (Mexico and the post 1997- East Asian-crisis countries are notorious for this). Given the lack of access of emerging markets to international capital markets during crisis periods,

²⁴ See, Rojas-Suarez (2001) for additional examples of how strict application of the Basel capital standards can have unintended consequences in emerging markets.

²⁵ Argentina does not attach zero risk weight to government paper, but the risk weights still favor this kind of instrument.

Chart 2. Claims on central and noncentral government as a percentage of total assets of deposit money banks 1980s against 1990s



it is very difficult to conceive alternative procedures for banking crisis resolution. To take this into account, I eliminated banking crisis periods from the sample, including *five years* after the crisis. The basic result did not change: many banking systems in emerging markets held as much or more government paper in the 1990s than in the 1980s.²⁶

As Chart 2 shows, the ratio of claims on government as a percentage of deposits not only has increased for many countries, but is also very high. Large countries such as Argentina, Brazil, India, Mexico and Poland display ratios close to 30 percent. Indeed, among the sample of countries, Chile can be singled out as the only country that succeeded in reducing this ratio to low levels (1.7 percent by the year 2000).

While a thorough understanding of banks' decisions to hold public vs. private assets would require the specification of a complete model, it is fair to argue that the regulatory treatment of government paper has played an important role in banks' decisions. This regulatory incentive has important consequences during recessions as banks tend to magnify the downward trend in economic activity by shifting their portfolio further away from credit to the private sector and towards government paper.

The evidence above suggests that the regulatory treatment of banks' claims on government tends to reduce the soundness of banking systems in emerging markets.²⁷ This concern, as obvious as it may look, is, however, not taken into account when assessing *country progress in strengthening financial systems*. Indeed, emerging markets attaching zero risk weight to domestic government liabilities would not receive a "warning signal" from multilateral organizations even if the government is highly indebted as such a practice is not perceived as conflicting with the international standards!

What does this all say about sequencing? The answer again lies in the degree of country development. For industrial countries, no sequencing is necessary; they can comply with the Basel Accord and even improve upon it (as has actually happened through the current proposal for a modified *Basel II*).

For the least developed countries, the poorest of the world, where the workings of markets are highly limited, sequencing is a central issue. It is essential to first establish the appropriate legal, judicial and accounting framework before setting high hopes in the effectiveness of capital standards. This, however, does not mean that these countries can

²⁶ The case of Argentina is particularly telling. During the early 1990s, following the implementation of the currency board, banks decreased their relative holding of government paper. After the banking crisis of 1995, there was an increase in holdings of government paper that one can associate with the restructuring efforts of the financial sector, including improving the liquidity of the banks. However, way after the crisis was completely resolved, banks continued to increase their claims on government. By the end of 2000 the share of banks claims on central and noncentral government as a percentage of total assets reached 25 percent, a ratio close to the 27 percent observed in 1991 at the beginning of the currency board.

²⁷ A counter case may be made by arguing that domestic government debt is safer than public external debt. However, given the long history of government-induced domestic defaults, either in the form of straight confiscation of deposits or sharp devaluations and inflations that drastically reduced the real value of government paper held by residents, I find this argument simply unconvincing.

not design appropriate supervisory tools that *work*. Section III presents some suggestions on this subject.

For the more advanced developing countries, sequencing is also important, but of a different nature. Having fulfilled the requirements for the adequate functioning of capital standards, their challenge is to *adapt* the Basel requirements to the country's circumstances. As the example above demonstrates, it is inappropriate to attach zero risk weight to government paper if market indicators signal concerns about the default probability of such instruments. A straightforward sequencing follows: it is essential to achieve a sustainable path for public debt before treating government paper as "risk-free" assets in banks' balance sheets.

(iv) Can "Better Representation" in Standard-Setting Help Improve the Effectiveness of the Capital Standard in Developing Countries?

Facing the difficulties discussed above, it should be no surprise that representatives from developing country feel an urgent need to participate in the design of standards for the supervision of their banking systems. The need for increased participation has become even more pressing when considering the recent issues that will arise for the stability of financial markets in developing countries if the newly proposed Basel II were to be implemented.

In the proposed Basel II, internationally active and/or large banks can choose between either using ratings provided by external agencies or their internal rating system as a basis for classifying the credit risk of loans and for calculating regulatory capital requirements. Concerns with the adverse effects on developing countries of implementing this proposal have been widely analyzed.²⁸ Here I will only summarize two.²⁹

The first concern is that the adoption of either of these two approaches in industrial countries may exacerbate the volatility of capital flows to developing countries. There are two reasons. First, banks in industrial countries basing their credit assessments on their own internal risk procedures will be given larger discretion in assessing the risks involved in lending to developing countries, in contrast to current practices in which all loans to non-OECD corporations and governments carry a 100% risk weight. If an underestimated risk from a credit to a developing country materializes, international banks will quickly reverse the inflows to economize on capital requirements, exacerbating the sharp turns in capital flows to developing countries. Second, if international banks adopt the ratings provided by external agencies, the volatility of capital flows to developing countries would be exacerbated even further. This is so because rating agencies have a track record of lowering ratings to developing countries *after* the occurrence of problems in these countries. Indeed, credit rating agencies are

²⁸ See, for example, Griffith-Jones and Spratt (2001), Reisen (2001), Latin-American Shadow Financial Regulatory Committee, Statement No.2, April 2001.

²⁹ These concerns have been raised by the Latin American Shadow Financial Regulatory Committee, chaired by the author.

better at “risk confirmation” than “risk diagnosis.” This will make international bank credit to developing countries even more pro-cyclical than it currently is.

The second concern relates to the more favorable treatment of capital requirements for short-term inter-bank lending. While the current Accord already requires lower capital charges for short-term inter-bank lending, the proposed new Accord lowers even further the maturity on inter-bank loans subject to preferential treatment. This implies that international banks will have an incentive to reduce the maturity of loans extended to developing countries. This will, in turn, increase the fragility of developing countries’ financial markets to adverse unanticipated shocks. This strongly conflicts with the efforts of many developing countries to improve the resilience of their financial systems by extending loan-maturity. Most importantly, this recommended policy *strongly* conflicts with the intent of the FSF to avoid the eruption of systemic crises!

The above is a clear example of how particular features of developing countries warrant strong representation from these countries in international forums and standards-setting bodies to voice concerns on international policy recommendations that could, unintentionally, produce undesirable results. That is, a policy recommendation could weaken rather than strengthen financial systems in developing countries.

III. Addressing Concerns and Proposing Solutions: A Role for Regional Development Banks

The main conclusion from the previous discussion is that policymakers in developing countries and standard-setting bodies face a difficult dilemma: How to ensure the convergence towards sound international standards in the *long-run* while recognizing that lack of preconditions for the effective functioning of some standards could render the implementation of those standards counterproductive in the *short-run*.

This paper argues that the answer lies in the design of country and/or regional-specific policies aiming at dealing with the *transition*. This approach implies identifying the necessary preconditions for the standards to work, designing *transitional* policies to deal with short-term constraints, recognizing the adequate sequencing and timing for implementing the standards and building the necessary institutional framework for the sustainability of the standards.

This section advances recommendations for dealing with these multiple tasks. The first part of the section builds upon the example of the bank capital standards and provides suggestions for how the issue of “lack of preconditions” can be handled. Recommendations advanced here shows that complementary policies, specific to the country’s level of development can go a long way in ensuring the success of the capital standards in the long-run, even if the standard could prove to be ineffective, or even have unintended adverse consequences in the immediate term. The second part of the section generalizes the lessons learned from the capital adequacy example and suggests that

regional development banks can play a fundamental role in supporting countries' efforts towards financial stability during the transition period.

a. Dealing with the Problems of the Basel Accord Applied to Developing Countries: Supplementing International Standards with Country/Regional-Specific Recommendations

As discussed in section II, the level of financial development is central for the appropriateness and effectiveness of the Basel's capital requirements. Consequently, policy recommendations to deal with problems associated with capital requirements also need to differ across countries and regions.

Earlier in the paper, two groups of developing countries were identified according to their degree of financial deepening. For the first group, the least financially developed group, where capital standards have no meaningful use, it is obvious that the sustainable policy consists in removing the constraints to the effectiveness of the standards, namely: (a) the implementation of an appropriate accounting, regulatory and judicial frameworks, and (b) the development of markets that validate the *accounting* capital ratios. Those policy reforms, however, often take a significant amount of time to implement. In the transition to a more comprehensive reform, it is essential to identify and develop indicators of banking problems (other than capital ratios) that reveal the true riskiness of banks. For example, deposit markets have often been identified as markets that work in most developing countries in the sense that they have been able to provide effective early-warning signals about the relative strength of banks. Recommendations for policymakers in this set of countries, therefore, should focus on strengthening the role of market discipline to substitute for the inadequacies of the regulatory capital requirements. Specific recommendations include: (a) encourage the public offering of uninsured certificates of deposits; (b) publish interbank bid and offer rates to improve the flow of information on bank quality; (c) concentrate regulatory efforts on the improvement of deposit insurance schemes to further enhance the role of market discipline; (d) avoid excessive bank access to central bank liquidity to contain moral hazard problems associated with the existence of a lender of last resort; (e) improve the credibility of safety nets by establishing "prompt corrective actions" to deal with banking problems; and, most importantly, (f) encourage the process of financial internationalization-- through promotion of foreign banking-- as market depth can only be achieved if a diverse group of investors and users of capital enter the market; that is, if the market becomes less concentrated.

Policy recommendation for the second group of developing countries, namely those where the degree of financial development allows for capital standards to be meaningful, but where their particular features such as their limited access to international capital markets and the potentially low quality of their government paper, imply that strict application of the Basel Accord may weaken domestic financial systems, are quite different.

The main recommendation for this group of countries is to design a *transitional* capital standard that appropriately reflects the risk of banks' assets because Basel (I or II) does not fit the bill in the short-run. This paper recommends that the standard should have two basic components. The first is the development of risk-based regulations in loan-loss provisions. While this is widely recognized by the Basel Committee to be an essential complement to any capital standard, the proposal in this paper is one based on prioritization: given the high frequency of adverse shocks in developing countries, the *expected* probability of occurrence of these adverse outcomes is very high compared to industrial countries. In this environment, *provisioning take a role, at times, more important than capitalization*. The second characteristic is the establishment of a reduced number of risk categories to classify assets, with the central qualification that the categories of risk should reflect the particular features of banks' assets in developing countries. Issues that need to be considered in the design of appropriate risk categories include an adequate risk assessment of government paper and the introduction of distinct capital charges for borrowers in the tradable and non-tradable sectors.³⁰ The distinction between tradable and non-tradable sectors responds to the well-known fragility of the latter sector to adverse unexpected shocks, such as a sudden stop of international capital inflows.

Additional recommendations to allow these countries deepen their financial systems and, hence, improve the effectiveness of accepted international capital standards include: (a) further enhancing the mechanisms of market discipline; and (b) deepening the process of financial internationalization through the increased participation of foreign institutional investors. Needless to say, that all these recommendations presume that those advanced for less financially developed countries (group 1) are met.

b. Improving the Effectiveness of International Standards: The Role of Regional Development Banks (RDBs)

The discussion of a key standard, the capital adequacy ratio has served to illustrate the validity of certain concerns raised by policymakers in developing countries and a number of analysts about the effectiveness of international standards.

The main conclusion of the paper is that the significant divergence in financial deepening between developing and industrial countries and among developing countries warrant the design of additional policies to deal with a transition period when the standards may either be non-effective (in the least developed countries) or have unwanted "side effects" (in the more advanced developing countries).

Recognition that there is no incompatibility between common international standards in the long run and country/regional-specific policies in the short-run can go a long way in securing financial stability. However, while the responsibility for setting international standards has been clearly identified and tasks have been assigned to a

³⁰ For a more comprehensive analysis of this proposal, see Rojas-Suarez (November, 2001)

number of international organizations and forums, transitional issues and the corresponding design of policies have received considerable less attention.

Who should deal with the transition? Clearly, the ultimate decision in policymaking rests with the countries themselves; but a strong case can be made for a key role for RDBs.

Because RDBs have extensive experience and expertise in dealing with the particular economic and financial features of their corresponding regions, they are well equipped to help countries in identifying constraints for the effective implementation of the standards. Furthermore, common institutional arrangements and market practices shared by countries within a region or sub-region allow RDBs to exploit important synergies in designing common solutions applicable to several countries within the region.

Indeed, RDBs are ideal institutions to coordinate the tasks that this paper has identified as essential for a successful implementation of the international standards in developing countries in the long run. First, because countries in a region or sub-region often share common goals (including regional integration in some cases), RDBs are in an optimal position to help countries' *prioritize* implementation of standards. Second, because countries within a region often share similar experiences during the eruption and resolution of financial crises (take for example, the Latin American crises of the 1980s or the East Asian crises of the 1990s), RDBs are well aware of the *constraints* both in institutional frameworks and development of markets that may impede the immediate effectiveness of the international standards. Third, because of the deep knowledge of the economic *and political* circumstances of countries in the region, RDBs can provide strong support in *designing transitional policies* to strengthen financial systems in the immediate future, when some international standards may not be appropriate. Fourth, because of the collaboration between RDBs and several standard-setting bodies, especially the IMF and the World Bank, RDBs can help *voice the concerns* of developing countries in adopting and *adapting* the standards. Fifth, because of their experience in advising countries in a large variety of developing issues, RDBs can provide the necessary technical assistance to help countries meet *preconditions* for the effective implementation of standards.

What instruments should RDBs use or develop to conduct these tasks? It is my view that the instruments needed at the regional level are similar to those employed at the global level. First, to design transitional policies aimed at making the international standards effective in the long run, RDBs could set special task forces and, possibly, even sub-regional working groups. This can also significantly help to deal with the issue of *appropriate representation*. Consideration could also be given to the participation of global standard-setting bodies in these initiatives. Second, to disseminate efforts towards financial stability in a country or group of countries, the RDBs could organize forums, conferences and seminars that would stress the participation of the private sector. Third, to ensure progress in implementing country or regional-specific policies to strengthen financial systems, RDBs have at their disposal *financial sector reform programs*. Once

agreements have been reached on appropriate *transitional* policies, there is no reason for not including them as part of programs' conditionality. Fourth, as countries *graduate* from transitional policies and are ready to move to the full implementation of international standards, RDBs can coordinate efforts with other multilateral organizations in the provision of necessary technical assistance.³¹

In summary, to the question posed in the title of this paper: Can RDBs help address developing country concerns with international standards? the answer is a definite yes. RDBs not only can help, but they *should*.³² It is the conclusion of this paper that regional efforts are not only desirable but also *indispensable* to achieve the sustainable convergence of developing countries toward international standards.

IV. Conclusions and Issues for Discussion

This paper has reached three major conclusions, each of which opens a number of issues for discussion. Some of those issues are presented below:

1. The paper has argued that while policy standards, especially those for the financial sector, *should* converge across countries in the long run, the pressing issue for developing countries is how to handle the transition period when the preconditions needed for effective implementation of international standards may not yet be in place. This conclusion raises the following issues for discussion:

- a. Is there agreement that policymakers in developing countries and standard-setting bodies face a difficult dilemma; namely, how to ensure the convergence towards sound international standards in the *long-run* while recognizing that lack of preconditions for the effective functioning of some standards could render the implementation of those standards ineffective and even counterproductive in the *short-run*?
- b. Is it appropriate to recommend *transitional* policies that focus on the specific constraints faced by developing countries as a mechanism to ensure that "*internationally-accepted standards*" work in the *long-term on a sustainable basis*?

2. A second conclusion of the paper is that the *degree of development, especially of financial markets depth*, matters significantly in: (a) deciding whether a country is ready to implement an international standard; and (b) designing *transitional* policies, different

³¹ The need of technical assistance at the regional level to complement efforts at the global level is fully recognized in the following statement by Andrew Crockett, Chairman of the Financial Stability Forum: "Widespread international support is needed to provide expertise and funding for the provision of technical assistance and training to assist countries in implementing international standards", Statement delivered at the International Monetary and Financial Committee Meeting, Washington, D.C., 29 April 2001.

³² As reported by Andrew Crockett (2001) the FSF has recently initiated regional meetings to discuss financial sector vulnerabilities at the regional level. The need for identification and resolution of regional financial weakness is, therefore, recognized at the global level.

from the international standards but effective in the short-run, to strengthen financial systems. Related issues for discussion are:

- a. Is it correct to conclude that the design of policies to strengthen financial systems critically depends on the country's degree of development? Is the degree of financial deepening an important variable explaining why international financial standards can be readily adopted by industrial countries, while the standards may not be appropriate for countries with very low degree of development and need serious adaptation in those developing countries with relatively most advanced financial systems?
- b. Should the degree of financial deepening influence the sequencing and timing of implementation of the standards? Do developing countries' disastrous experiences with *wrong sequencing of implementation of policies* (most notoriously, financial liberalization without adequate supervision), justify their concerns about sequencing issues related to the implementation of the standards?
- c. To what extent does the lack of appropriate institutions, such as adequate legal frameworks and appropriate judicial systems, all related to the degree of development, render the *standards* ineffective?

3. The third conclusion of the paper is that RDBs can play a key role in helping countries achieve a sustainable implementation of the standards in the long run by designing appropriate transitional policies. Indeed, the RDBs can fill an important vacuum: while the responsibility for setting international standards has been clearly identified and tasks have been assigned to a number of international organizations and forums, transitional issues and the corresponding design of policies have not been given the attention they deserve. This paper argues that regional efforts are not only desirable but also *indispensable* to achieve the sustainable convergence of developing countries toward international standards. Some issues for discussion include:

- a. Is there agreement regarding the conclusion that common institutional arrangements and market practices shared by countries within a region or sub-region allow RDBs to exploit important synergies in designing common *transitional* solutions applicable to several countries within the region?
- b. Are RDBs well equipped to help countries in: (a) *prioritizing* implementation of standards, (b) identifying the *constraints* both in institutional frameworks and level of development of markets that may impede the immediate effectiveness of the international standards, (c) providing strong support in *designing transitional policies* to strengthen financial systems in the immediate term, when some international standards may not be appropriate, (d) helping *voice the concerns* of developing countries in adopting and *adapting* the standards, and (e) providing the necessary technical assistance to help countries meet *preconditions* for the effective implementation of standards.
- c. Is it correct to conclude that RDBs have at their disposal a wide range of instruments to support *at the regional level* efforts undertaken at *the global*

level to strengthen financial systems? Are RDBs well positioned to set up special task forces and, possibly, even sub-regional groups to deal with issues related to (a) the most effective design of transitional policies, and (b) appropriate timing and sequencing of implementation of international standards? As countries *graduate* from transitional policies and are ready to move to a more comprehensive implementation of international standards, are RDBs adequately endowed (both technically and financially) to support the efforts of other multilateral organizations in the provision of necessary technical assistance?

See comment on this paper by Helmut Reisen <link to comments on 3>

References

- Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, September 1997.
- , *International Convergence of Capital Measurement and Capital Standards*, July 1998.
- Brown, Gordon, *The New International Financial Architecture, 'Codes & Standards' and the Developing Countries*, speech to the Annual Meetings of the IMF and the World Bank, Washington, D.C., October 6, 1998
- Calvo, G., *Capital Markets, Contagion and Recession: An Explanation of the Russian Virus*, in Wanted: World Financial Stability, John Hopkins University Press, 2000.
- Claessens, S., R. Dornbusch and Yung-Chul Park, *International Financial Contagion: How it Spreads and How it can be Stopped*. The World Bank, May 2000.
- Crockett, A., *Statement delivered at the International Monetary and Financial Committee Meeting*, Washington, D.C., April 29, 2001.
- Diaz-Alejandro, C., *Good Bye Financial Repression, Hello Financial Crash*. Journal of Development Economics, vol. 19, September/October 1985.
- Financial Stability Forum, *International Standards and Codes to Strengthen Financial Systems*, April 2001.
- , *Compendium of Standards*, www.fsforum.org/Standards.
- Fischer, S., *Asia and the IMF*, Remarks at the Institute of Policy Studies, Singapore, June 1, 2001., www.imf.org/external/np/speeches/2001.
- Griffith-Jones, S. and S. Spratt, *Will the Proposed new Basel Capital Accord have a net Negative Effect on Developing Countries"?*, mimeo, Institute of Development Studies, University of Sussex, 2001.
- IMF, *IMF Survey*, volume 30, No. 7, April 2, 2001, p.103
- Latin-American Shadow Financial Regulatory Committee, *The New Basel Capital Accord and Financial Stability in Latin America*, Statement No. 2, April 2001.
- Mathieson, D. and L.Rojas-Suarez, *Liberalization of the Capital Account: Experiences and Issues*, IMF Occasional Paper No. 103, Washington D.C., March 1993.
- Pericoli, M. and M. Sbracia, *A Primer on Financial Contagion*, bank of Italy, January 2002.

Perry, G. and D. Lederman, *Financial Vulnerability, Spillover Effects and Contagion: Lessons from the Asian Crises for Latin America*, The World bank, 1999.

Reinhart, C. and G. Kaminsky, *On Crises, Contagion and Confusion*. Journal of International Economics, 2000.

Reisen, H. *Will Basel II Contribute to Convergence in International Capital Flows”?*, mimeo, OECD Development Center, May 2001.

Rojas-Suarez, L., *Can International Capital Standards Strengthen Banks in Emerging Markets?* Institute for International Economics. Working Paper No. WP01-10, November 2001.

-----, *Rating Banks in Emerging Markets: What Credit Rating Agencies Should Learn from Financial Indicators*, Institute for International Economics, Working Paper No. WP01, May 2001.

-----, and S. Weisbrod, *Towards an Effective Financial Regulatory and Supervisory Framework in Latin America: Dealing with the Transition*, in Rojas-Suarez, L. (ed.), Safe and Sound Financial Systems—What Works for Latin America, IADB, Washington, D.C., 1997.

