

Building the Financial  
Infrastructure for Middle  
Class Emerging  
Economies

A Paper from the Project on Development,  
Trade, and International Finance

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A Council on Foreign Relations Paper

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## FOREWORD

In the wake of the 1997-98 financial crises in emerging economies, many prominent thinkers focused their energies on what went wrong, how it could have been prevented, and what reform measures are required for the future. While some concentrated specifically on financial markets within the economies in question, others examined the larger system-wide implications. The Council on Foreign Relations Project on Development, Trade, and International Finance convened a Working Group in an attempt to look at the problem from both levels, to investigate the problems in the world economy that led to the crises, and to propose policy options calculated to prevent future large-scale disturbances.

Specifically, the goal of the Working Group, which began in 1999, was to promote discussion of different perspectives about the necessity for change in the world economic system, and to look at concrete forms that change might take. These included, but were not limited to, discussions about reforming the international financial architecture to facilitate a transition from export-led growth to internally or regionally demand-driven development strategies that offer the populations of the developing world an improved standard of living.

One of the Working Group's several undertakings was to commission papers from the participants on a broad range of subjects related to the international financial architecture. The authors come from a variety of backgrounds, and their papers reflect a diversity of perspectives. However, we believe that all of them provide useful insights into international financial architecture, and that they represent collectively factors that should be considered by both U.S. and international economic policy makers.

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# Building the Financial Infrastructure for Middle Class Emerging Economies

## INTRODUCTION

The export-led growth model for emerging economies is driven by their need to service external debt and build foreign exchange reserves. It has foundered in the aftermath of financial crises characterized by collapsing currency and asset values, widespread bankruptcies in real and financial sectors, rising unemployment, and negative growth rates.<sup>1</sup> In many developing countries, a higher volume of exports is needed to earn the same income that previously sufficed to meet external obligations. As a result, profits and wages have fallen, lowering earlier gains in per capita income and threatening past improvements in income distribution, education, and life expectancy.

The sustainability of the export-led growth model is also threatened by dramatic increases in the current account deficits, external debt, and domestic debt ratios of the major global importer/consumer.<sup>2</sup> As U.S. ability to maintain its role becomes less certain, fewer countries appear to be willing or able to absorb more imports or to accept current account deficits. Continued slow growth in Japan, the second-largest national economy in the

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<sup>1</sup>Blecker, Robert A, "The Diminishing Returns to Export-Led Growth," Discussion Paper (New York: Council on Foreign Relations, October 1999).

<sup>2</sup>Blecker, Robert A, "The Ticking Debt Bomb: Why the U.S. International Financial Position is Not Sustainable," Briefing Paper (Washington, D.C.: Economic Policy Institute, June 1999).

global system, would hamper its ability to assume some of the burden carried by the United States, even if its own adherence to an export-led growth model were not in itself a major inhibiting factor. Continued restructuring, high levels of unemployment, and constrained monetary and fiscal policies within the European Community also do not suggest robust increases in demand for imports of goods and services in the near future.

Diminishing returns to the export-led growth strategies that emerging economies have followed (and have been encouraged to follow) during the last two decades will require the development of new strategies to promote growth. Both developing and developed countries will need to reintroduce domestic demand-driven growth as a policy objective. However, emerging economies will require more than a shift in the direction of macroeconomic policy to stimulate demand. Also required will be the development of domestic capital markets and financial systems like those in industrialized countries, which are capable of mobilizing and channeling domestic savings to expand internal economic activity. That, in turn, will require changes in global capital markets and financial infrastructure to support and encourage reinstatement of a role for domestic demand-driven growth in the global economy and particularly in emerging economies.

The choice of an economic paradigm necessarily has important social and political consequences. Export-led growth strategies have tended to increase income gaps across and within countries as wage levels succumbed to the pressure to maintain competitiveness. Domestic demand-driven growth strategies have greater potential to reinstate conditions for rising wages and reduced income disparities. If that potential were realized, the resulting expansion of middle classes in emerging economies like those that have characterized North American and European societies would strengthen the viability of democratic institutions and build more stable societies. Perhaps the very least that can be expected of societies in which per capita income is rising and a majority of the population holds a rising share of total income is that they provide opportunities for escape from poverty unmatched by societies with other income distribution patterns. Building such

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societies in emerging economies may be the only means to redress the immense waste of human resources caused by widespread poverty in today's global economy.

This paper explores ways in which the institutional and regulatory structures of financial markets can be shaped to contribute to the goal of expanding shared prosperity in emerging markets. It opens with descriptions of various strategies used by industrialized countries to achieve economic and social goals by using monetary tools and public financial institutions to allocate credit to preferred sectors. The following section discusses the shift in financial flows from banks to securities markets in industrialized countries and in many emerging economies. Given the increased use of pension funds as a primary channel for collecting and allocating savings flows in both developed and developing countries, the paper focuses on ways in which these pools of private savings can be structured to (1) broaden and deepen capital and financial markets, and (2) support demand-driven growth policies and promote equality in income distribution. It proposes a more balanced division between government and private institutions in (1) making decisions involving the allocation of credit; (2) using expanding ownership of financial assets as the means to promote wider participation in overseeing and assessing the performance of the financial sector; (3) exercising corporate governance; and (4) shaping macro-economic policy decisions.

The final section of the paper outlines the changes needed in the international monetary and financial architecture to permit the shift from export-led growth to growth strategies that rely on the expansion of domestic demand. It concludes that public sector support for major changes in both international and national financial structures will be required to ensure a resumption of balanced growth in the global economy.

### **BUILDING ON PAST STRUCTURES AND PROGRAMS**

Monetary and financial policies and tools were widely used to promote economic and social objectives by industrialized countries

in the post-World War II period and had been used by the United States during the 1930s. In some countries, direct government expenditures supplied loans and grants. Others used the financial system to allocate funds to preferred sectors and lower the interest rates paid by those sectors for credit. Although the various strategies chosen were also used to increase financing for exports, the primary objective in many industrialized countries was to favor borrowing sectors such as housing, agriculture, small and medium sized businesses, and underdeveloped regions. The objective was also to increase the total supply of savings and promote balanced economic growth. In all cases these strategies constituted systems that exercised "a substantial degree of public control without public ownership."<sup>3</sup>

Countries used various types of controls to achieve the different objectives. Direct controls specified the kinds of assets institutions could hold to ensure that institutions would channel credit to a preferred sector. One example would be federally chartered U.S. savings and loan institutions, created by legislation enacted in 1934. Indirect controls provided credit incentives by using strategies that altered the relative rates of return on investments in favored sectors by lowering their cost of borrowing. Techniques used to implement indirect controls included asset reserve requirements, government borrowing in capital markets for relending to favored sectors, and government savings institutions (such as postal savings banks) designed to compete with private institutions in capturing savings flows for onlending to preferred sectors.

While the various techniques used tended to have features that accommodated both the government's economic or social priority and the characteristics of the national financial system, they have common elements that permit them to be adapted to the needs of other countries. In general, the following descriptions of national experiences with particular strategies show how effective these

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<sup>3</sup>U.S. House of Representatives, *Foreign Experience with Monetary Policies to Promote Economic and Social Priority Programs*, Staff Report of the Committee on Banking and Currency (Washington, D.C.: U.S. Government Printing Office, 1972).

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strategies can be in promoting the goals of shared prosperity and domestic demand-driven economic growth.

### *The U.S. Reconstruction Finance Corporation*

The Reconstruction Finance Corporation (RFC) was organized and began operations in February 1932, one month after the enactment of the legislation authorizing its establishment. It was patterned on the War Finance Corporation, created during World War I, which provided a precedent for government assistance to private enterprise. Its initial capital was \$500 million, but it had unlimited authority to borrow from the U.S. Treasury. It was also permitted to retain earnings for expansion of its activities, and it remained outside the congressional appropriation process throughout its active life (1932–54). At the time of its liquidation in 1957, it had disbursed \$40 billion in loans and purchases of stocks and other obligations, and had made commitments for many billions more in guarantees for loans made by private financial institutions.<sup>4</sup>

The original legislative directive to the RFC was to extend aid to agriculture, industry, and commerce by making direct loans to banks, trust companies, and other financial institutions. Subsequent emergency legislation (1935) authorized the RFC to make direct loans to solvent businesses unable to obtain credit from other sources and to recapitalize the financial system by buying the stock of banks, insurance companies, agricultural credit corporations, and national mortgage associations. A further extension of its powers (1938) authorized the RFC to purchase the securities and obligations of any business enterprise and thus to provide both capital and credit when it could not be obtained from other sources.

During its first two years of operation, the majority of the RFC's loans were to banks and trust companies (\$3.3 billion out of \$3.9 billion), with preference given to small state banks. While these efforts and the creation of the deposit insurance program in 1933 helped stabilize the banking system, they were not sufficient to reignite

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<sup>4</sup>The discussion of the RFC is based on a study written by the present author and inserted in the *Congressional Record* by U.S. Rep. Wright Patman (D.-Texas), Chairman of the House Banking and Currency Committee, on August 4, 1969.

an expansion of lending. Part of the problem was that the traditional maturity of commercial bank lending was one year or less. Most small businesses needed more secure lines of credit and easier repayment schedules. Thus, in 1935 the RFC itself became the major lender to small business, and 70 percent of its loans had a maturity of five years or more. The RFC set a precedent that effected a permanent extension in the terms of business lending. As its loans to businesses declined during the war years, commercial banks began to issue term loans.

Another substantial component of RFC lending was to agricultural agencies, most of which were part of the public agricultural credit system that had been established in earlier periods of distress for this sector. Credit programs exercised by these agencies (Federal and joint-stock land banks, regional and other agricultural credit corporations) were augmented by loans from the RFC rather than by direct lending. But the particular contribution of the RFC was to make loans to finance the sale of U.S. agricultural surpluses abroad.

Mortgage lending also became a major component of RFC financing. Its original directive was to make loans to private mortgage loan companies. However, in 1935, it was also authorized to subscribe to the capital stock of those companies. In addition, it created its own mortgage lending subsidiary, the RFC Mortgage Corporation. In 1938, it capitalized a second subsidiary, the Federal National Mortgage Association, which was transferred to the Housing and Home Finance Agency in 1950 and remains in existence as a government sponsored enterprise today. The mortgage lending program focused on residential mortgages but also financed nineteen large housing projects and made loans for income-producing properties. The RFC disbursed over \$1.7 billion through its two subsidiaries during the life of the program, \$1.3 billion of which was disbursed by FNMA as financing for 414,499 mortgages during the twelve years that it was an RFC subsidiary.

Other RFC programs provided financing for public works, including the purchase of bonds from the Metropolitan Water District of Southern California, and making loans for the San Francisco–Oakland Bay Bridge, the Pennsylvania Turnpike Commission, for

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drainage and irrigation, and numerous other projects. It also capitalized and made loans to the newly established U.S. Export-Import Bank, made disaster and relief loans, refinanced the debts of public school facilities and, in 1934, paid the salaries of teachers in the Chicago school system.

In the 1940s, the RFC was the critical agency in financing conversion to the war effort. Through eight new subsidiaries, it financed plant conversion and construction; acquired, constructed and operated its own war plant facilities; made subsidy payments to stockpile strategic and critical materials; administered the war-damage insurance program; and engaged in many other activities in conjunction with other government agencies. More than 80 percent of the RFC's activities during this period were unrelated to its normal lending operations, and about half (\$20 billion) of its total loans were disbursed during the war. At the end of the war, it shifted into a new role in financing reconversion. Almost half of its total business loans were disbursed after June 1948, and lending to businesses peaked in 1949. Lending for residential mortgages reached its highest level in 1949-50, and the RFC provided additional assistance to veterans by making a market in Veterans Administration-insured loans.

Like any other financial institution, the RFC sustained losses. Overall, however, it was a profitable institution with earnings substantial enough to pay dividends to the Treasury on its capital stock. It was able to assist the Treasury in 1941, when the public debt was approaching the limit, by directly issuing its own securities and using the funds to buy the stock of the Federal home loan banks to provide the government with additional funds. Congressional support for the RFC's activities diminished after the war, however, and the degree of discretion and flexibility that had been the hallmark of its lending programs was curtailed on the grounds that it should no longer be permitted to compete with private sources of credit. It was argued that the Corporation's countercyclical role was no longer justified in the inflationary environment of the postwar period. The winding down of its activities began as early as 1947 and continued until its final closing in 1957. Still, many of its programs survived in other forms. The most notable contin-

uations are small business lending, shifted to the newly created U.S. Small Business Administration, and the FNMA.

*Credit allocation techniques in other industrialized countries*<sup>5</sup>

**Sweden's** credit allocation program from 1950–70 focused on providing steady credit flows to housing. It used asset reserve requirements to achieve the objective of constructing “a countercyclical shield against finance problems” for this sector.<sup>6</sup> One measure of the program's success was as follows: during periods when tight monetary policy lowered the flow of funds to the industrial sector, financing for housing did not dry up, but continued to increase.

When a government uses asset reserve requirements to achieve policy objectives, it decides what share of total credit flows should go to a preferred sector. Then it requires all financial institutions to hold that percentage of their total portfolio in assets that finance that sector. If an institution does not hold the total percentage of assets required, the remainder must be entered on the balance sheet as reserves. The choice is to make an interest-earning loan to the preferred sector or an interest-free loan to the government. The authors of the 1972 House Banking Committee report that describes these techniques note that asset reserve requirements are “simple and straightforward,” do not require an elaborate regulatory framework and, unlike the U.S. savings and loan structure used to promote housing in this period, do not discriminate between small and large savers.<sup>7</sup>

In a small country like Sweden, asset reserve requirements can be implemented on a voluntary basis by using moral suasion and negotiating the targeted shares with different financial sectors. There were many mortgage lenders in Sweden during this period: mortgage banks, housing credit societies, savings banks,

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<sup>5</sup>This section is based on a study prepared for the U.S. House of Representatives Banking and Currency Committee under the direction of Professor Lester C. Thurow, Assistant Professor Robert Engle, Laura D'Andrea, Raymond Hartman, and Charles Pigott of the Massachusetts Institute of Technology. Entitled *Foreign Experience with Monetary Policies to Promote Economic and Social Priority Programs*, it was published as a Committee Print in May 1972

<sup>6</sup>U.S. House of Representatives, *ibid.*, 1972.

<sup>7</sup>U.S. House of Representatives, *ibid.*, 1972.



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the Post Office Bank and commercial banks. The major lenders issued bonds to obtain funding, and their liabilities could be purchased and held by other financial institutions (insurance companies, for example) to satisfy their reserve requirements.

**Italy** is a postwar example of a country that used government borrowing and relending to achieve economic and social objectives. This is an allocative technique that, in general, shifts the costs of supporting preferred sectors onto taxpayers rather than savers. In the Italian model, the central bank did not play the major role in the program, as did the Swedish central bank. As the program implies, however, fiscal and monetary policy were closely related, and the Bank of Italy had considerable influence in formulating the credit policies that welded the two policy tools together.

The policies themselves were implemented through special credit institutions that intermediated between private sources of funds and private borrowers, using public funds to provide credit incentives. Special credit institutions collected funds from securities markets. The buyers of the securities were private investors and commercial banks. About half of the funding came from banks that used savings held in deposits to provide long-term credit by rolling over their investments. The Bank of Italy supported this maturity transformation by issuing the securities of the special credit institutions and allowing them to be pledged by banks as collateral for four-month renewable advances.

Like several U.S. programs in the post-World War II period—housing loans to veterans, loans to small and minority businesses and to students, for example—the Italian program achieved its objectives by directly subsidizing interest payments to lower the cost of borrowing to favored sectors. Most of the subsidies were for industry, but primarily to small and medium sized industries, and for the industrialization of Italy's southern region, known as the Mezzogiorno. In the 1950s, the Mezzogiorno had remained an underdeveloped country within the borders of a country that had become heavily industrialized. Per capita income was 47 percent of that in the North. Most of the essential infrastructure for industrialization and social progress was missing: adequate roads, telephone lines, electrical generating plants, irrigation systems, etc.

The first goal of the program was to modernize and increase productivity in agriculture, the region's dominant sector. Establishing new industrial facilities was emphasized in the 1960s. Overall, the program's lending priorities reflected the belief that growth in output was the best way to alleviate high levels of unemployment in this very poor region.

Because of its emphasis on the South, the primary objective of Italy's economic program was developmental. In addition to the Cassa per il Mezzogiorno, the government's "Credit Mobiliare" group included institutions that specialized in industrial credit and credit to public works projects; others that specialized in real estate and agricultural credits; and still others that operated as special departments in the commercial banks. The range of eligible types of credit included loans to artisans, to depressed and mountainous regions in north central Italy, for disasters and natural calamities, and for hotels and tourism.

From 1960 to 1970, the Italian program succeeded in raising the flow of credit to the South and other depressed regions. Since then there have been major transformations and growth in these areas. There are still disparities in the South's proportionate share in total output and income relative to the North and Central regions, but the progress that has been made attests to the success of this nation's efforts to take responsibility for development within its own borders.

**Japan's** system of credit allocation is often referred to as the unique model for Asia. It could be argued, however, that what was unique about it was the way it adapted the U.S. RFC structure to both accommodate and reform the existing Japanese financial system. Rather than having the government borrow to finance support for lending by private financial institutions, the Japanese program channeled private savings through government owned or controlled financial institutions. Then it lent them to private financial institutions for onlending to the industrial sector. A critical objective of this strategy was to distribute credit across the entire industrial sector to promote the emergence of more promising industries. That constituted an important financial reform that weakened the *zaibatsu* system in which financial institutions were committed to

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lend within a conglomerate structure. But the overall goal of the strategy was to maximize economic growth. That objective was the overriding “social” priority of the government throughout the postwar period. Thus, investment in housing, for example, was significantly lower than in other G-7 countries. However, the rate of economic growth was substantially higher.

Personal savings were the primary source of loanable funds in the Japanese economy, and a large share of savings was held in postal savings accounts. These funds were not loaned out by postal savings institutions, but rather channeled directly to the Treasury and reloaned to other financial intermediaries that specialized in specific sectors. These specialized public institutions would then reloan their funds to private financial intermediaries. In turn, the intermediaries would loan the funds as directed to private companies in the form of short-term notes that usually were rolled over automatically and were assumed to be long-term commitments.

This financing strategy had important consequences for the structure of the Japanese financial system and the relationship between private companies and the government. Because the volume of lending was so large, companies were deeply in debt to the government. Equity and bond markets were little used and high debt levels constrained companies’ ability to retain earnings for investment. While seemingly long-term, the maturity structure of loans allowed the government to shift funds from stagnant to high-growth sectors. Such a shift occurred in the 1970s when the government recognized the extent of global overcapacity in the shipbuilding industry and downsized the Japanese sector. But the short-term structure of the lending allowed it to implement that decision gradually and with minimal disruption to the private financial sector.

The strategies that made the Japanese lending system so successful resulted in the government taking a primary role in credit decisions. As Japanese companies and banks moved abroad and gained access to alternative sources of credit in external markets, the system was weakened and, in the view of many, became counterproductive. The loss of direct government control was not replaced by a system of effective indirect controls such as those that had been provided by monetary policy and financial regula-

tion in other industrialized countries. The explosion of credit that led to the stock market and real estate bubbles in the 1980s could not have happened under the earlier lending system. But it would appear that such consequences are inevitable as liberalization dismantles old paradigms without providing adequate policy and regulatory infrastructure for the new systems that are to take their place.

## BUILDING ON EXISTING STRUCTURES AND TRENDS

One of the more profound changes that has occurred in financial markets during the last two decades is the rise in securities markets as increasingly important channels for both domestic and international private investment flows. In many industrialized countries, a growing share of private savings are placed in pension plans and other institutional pools that invest those funds directly in securities rather than placing them in the hands of intermediaries such as depository institutions. In Canadian, German, Japanese, U.K. and U. S. financial markets, assets of institutional investors more than doubled as a percentage of GDP from 1980 through 1995.<sup>8</sup> In the United States, the share of total financial sector assets held by institutional investors rose from 32 percent in 1978 to 54 percent in 1998. At the same time, the share of depository institutions fell from 57 percent to 27 percent.<sup>9</sup>

Similar trends are occurring in emerging economies. The number of countries characterized as emerging markets by the World Bank's International Finance Corporation (IFC) and that have established stock markets rose from 31 in 1985 to 48 in 1994, while the number of listed domestic companies rose from 8,916 to 19,397. Mar-

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<sup>8</sup>Bank for International Settlements, *68th Annual Report* (Basel: BIS, June 1998), and International Monetary Fund, *International Capital Markets: Developments, Prospects, and Policy Issues* (Washington, D.C.: International Monetary Fund, 1995).

<sup>9</sup>U.S. Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States* (Federal Reserve Statistical Release Z.1, September 15, 1999, [www.bog.frb.fed.us/releases/](http://www.bog.frb.fed.us/releases/)).

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ket capitalization jumped from \$171 billion to \$1.929 trillion over the same period, and climbed from 3.8 to 14.6 as a percentage of developed markets' capitalization.<sup>10</sup>

Another major development in emerging economies is the establishment of mandatory pension systems, many of which have been privatized. Chile was the first Latin American country to privatize its pension system, but other countries in the region have followed suit. Peru (1993), Argentina (1994), Colombia (1994), Uruguay (1995), Bolivia (1997), Mexico (1997), and El Salvador (1998) have implemented pension reforms. In 1997, Hungary, Poland, and Kazakhstan enacted legislation mandating the creation of private pension plans.<sup>11</sup> While some countries have shifted to a wholly privatized system, others that are implementing or considering reform have adopted the "three pillar approach" promoted by the World Bank and also used by Switzerland. This approach retains a government-funded first pillar to alleviate poverty in old age, establishes a second pillar to manage workers' mandatory contributions to provide retirement income, and advocates a third pillar that encourages additional, voluntary contributions to savings for retirement.

In several Latin American countries, the second pillar is privatized as in the Chilean model. Other countries retain a government role in collecting funds from employers but privatize their management. Others, like Malaysia, require mandatory contributions to a funded system but retain centralized national control.<sup>12</sup> Most countries that have followed World Bank guidelines in inaugurating a second, privatized pillar have created individual retirement accounts. Other basic components of reform include diversifica-

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<sup>10</sup>International Finance Corporation, *Investment Funds in Emerging Markets* (Washington, D.C.: World Bank, 1996).

<sup>11</sup>P.S. Srinivas and Juan Yermo, *Do Investment Regulations Compromise Pension Fund Performance? Evidence from Latin America* (Washington, D.C.: World Bank, 1999).

<sup>12</sup>Salvador Valdés-Prieto, "Cargos por administración en los sistemas de pensiones de Chile, los Estados Unidos, Malasia y Zambia" (English summary), *Cuadernos de Economía* vol. 31, no. 93 (August 1994).

tion over multiple asset classes and prefunding to ensure that there will be adequate assets to pay benefits.<sup>13</sup>

Meanwhile, many emerging economies have also been active in developing public and private domestic mutual funds or investment trusts. The IFC has invested in domestic funds in Thailand, Sri Lanka, India, Pakistan, and Kenya. It has also advised the government of Zimbabwe in establishing a regulatory framework for a domestic mutual fund industry. But the main thrust of the IFC's program has been the establishment of international emerging market equity funds to channel foreign capital into the domestic markets of developing countries. Both the number of international funds (953 at year-end 1994, up from seventeen in 1985) and the value of assets under management (\$106 billion in 1994) dwarf the size of domestic funds. Nevertheless, the IFC data show that international equity funds and other holdings by foreign investors amounted to only \$200 billion or 10 percent of total emerging market capitalization at year-end 1994. In a 1996 report, the IFC asserted that, while stock markets in emerging economies were primarily places where local companies raised equity from local investors, foreign funds had played "a disproportionately large role in improving the functioning of emerging markets."<sup>14</sup>

The IFC also credits Chile's 1981 shift from a public to a private pension system for playing a sizable role in increasing the savings rate and developing the country's equity market. It argues that lifting restrictions on investment assets was critical to its success. Like all other public pension funds, Chile's government-managed fund had asset restrictions that limited its investments to government paper and bank deposits. Under the new private pension system, investments in equities were permitted. The growing pool of assets encouraged more companies to issue stock. Issuers were listed to increase the share of funds raised in equity markets. By 1995, the pool of savings in pension funds had reached 46 percent of GDP, prompting the IFC to remark that this "deep pool of domestic cap-

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<sup>13</sup>Srinivas and Yermo, *Do Investment Regulations Compromise Pension Fund Performance?*

<sup>14</sup>International Finance Corporation, *Investment Funds in Emerging Markets* (Washington, D.C.: World Bank, 1996).

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ital helped the country weather the fallout from the Mexican peso crisis almost unscathed....”<sup>15</sup> It fails to mention the contribution of capital controls, which others believe played an equally important role.

In the aftermath of the massive financial crises that have affected emerging economies since 1994, the number of developing economies that have established stock markets has risen to 67 at year-end 1998. However, aggregate market capitalization—which had peaked at \$2.3 trillion in 1995—fell back to the level of 1994 in dollar terms.<sup>16</sup> Nevertheless, pools of assets valued in local currencies in both public and private prefunded pension plans, mutual funds, and unit trusts have continued to grow. They provide the infrastructure for a new form of import substitution that has the potential to raise the value of domestically held financial assets as a percentage of GDP. The levels implied would add stability to national markets and reduce dependence on foreign investment flows to finance development.

### *Pension Funds in Emerging Economies: Benefits and Problems*

Despite the number of institutions and the diversity of their functions, the financial systems of many emerging economies are viewed as weak and inefficient. Whether controlled by government or private owners, regulation is inadequate and institutions are undercapitalized. Banking systems in particular are easily controlled by political interests or private oligarchs, and their loans distributed like prizes to a favored few. While one analysis of financial developments in sub-Saharan Africa concludes that stock markets have been more difficult for self-serving governments to control than banking systems, markets can be dominated by the foreign sector as well as by high income domestic residents.<sup>17</sup> In such systems, lack of access leads to indifference rather than outrage.

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<sup>15</sup>International Finance Corporation, *ibid.*

<sup>16</sup>“Schools Brief. Stocks in Trade,” *The Economist*, (November 13, 1999).

<sup>17</sup>Leonce Ndikumana, “Financial Development and Economic Growth in Sub-Saharan Africa: Lessons and Research Agenda,” paper prepared for the Gwendolen Carter Symposium on African Development in the 21<sup>st</sup> Century at Smith College, September 24–26, 1999.

Those excluded from opportunities to borrow in the formal sector accept what they can afford to borrow from the informal sector. Neither the favored few nor the excluded seem to notice the extent to which lack of access to capital and credit for the majority of its citizens stunts a country's economic growth and development.

Prefunded pension fund systems have the potential to counter these tendencies by mandating the ownership of financial assets. The creation of individual accounts in countries that have reformed unfunded pay-as-you-go systems could, over time, significantly raise the level of interest of participants in the soundness of financial institutions and the overall performance of the economy. Moreover, as the pools of assets grow, ownership of companies becomes more widely dispersed, gradually but effectively eroding the control of various oligarchical structures in many emerging economies.

In some countries these benefits are already beginning to occur. In others, they are constrained by restrictions on the allocation of pension fund assets. Investment limits are the norm for public pension funds across the globe. Privatization has opened the way for investments in equities. However, even in reformed systems, some observers consider limits on holdings of stocks as a percentage of fund assets and of outstanding shares of individual companies to be "draconian" regulations that limit returns.<sup>18</sup> While acknowledging the lack of managerial experience, the fragility of markets, and the concern for soundness needed to build confidence in newly established systems, these critics argue for adopting the "prudent person rule" prevalent in private investment systems in many (but not all) industrialized countries.

The prudent person rule emphasizes diversification as opposed to restrictions on asset allocation. Its overall objective is to achieve the highest rate of return within the boundaries of acceptable risk. Adoption of this model by emerging economies is urged to counter the herd behavior characteristic of pension funds in Latin America, for example, as well as large concentrations of assets held

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<sup>18</sup>Srinivas and Yermo, *Do Investment Regulations Compromise Pension Fund Performance?*



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in funds that constrain liquidity. It is argued that restraints on investments in foreign assets in particular should be lifted to achieve diversity and improve returns.<sup>19</sup>

But looking to this model as it is played out in industrialized countries offers little hope that it would encourage diversity or restrain herd behavior. Pension funds and other institutional investors in the major industrialized economies tend to concentrate holdings in shares and bonds. They rely heavily on rating agencies in making investment decisions, and increasingly look to foreign stock and bond markets for additional opportunities to diversify portfolios, moving in herd-like fashion from one national market to another in search of the highest returns. Moreover, they have been accused of imposing short-term horizons on the corporate sector because the goal of maximizing shareholder value has been measured on the basis of quarterly or annual returns and has led to higher levels of portfolio turnover.

On the other hand, the “three pillar” model that emerged from the World Bank’s 1994 report on old age pension programs worldwide has itself been criticized. Teresa Ghilarducci argues that it overlooks the importance of the first “pillar”: social insurance. Noting the rising share of social security payments in the total incomes of U.S. middle-class retirees in the 1990s compared to the 1980s, she argues that the failure of U.S. private plans to pay adequate retirement income indicates that a mixed system is desirable only if it is based on universal social insurance. This is important even in the “mandatory” systems that have been adopted by emerging economies because they do not cover workers who are outside firms in the formal sector. Moreover, the mandatory deductions in wages are so high (13 percent in Chile, 13.5 percent in Mexico) that they may encourage low-income workers to opt out of the formal sector, thereby losing benefits.<sup>20</sup>

Ghilarducci also questions the assumption that high rates of return will continue to justify the shift from pay-as-you-go

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<sup>19</sup>Srinivas and Yermo, *ibid.*

<sup>20</sup>Teresa Ghilarducci, “Pension Policies to Maintain Workers’ Access to Retirement,” in Ray Marshall, ed., *Back to Shared Prosperity* (Armonk, N.Y.: M. E. Sharpe, 1999)

public sector systems to privatized plans in emerging economies. In her view, “[t]he high return to privatizing only works in an elaborate system in which populations with different age distributions are buying and selling each other’s investments.” Thus, plans in emerging economies with young populations would need to be allowed to buy foreign assets to support sales of assets by aging populations in industrialized countries.

But even that strategy might have adverse consequences. In the United States, for example, buying and selling of stocks has not been motivated by intergenerational differences such as the need to support income levels of retirees. Even as middle-class workers poured retirement savings contributions into mutual funds and the foreign sector bought more shares of U.S. stocks, wealthier U.S. individuals sold more than \$2 trillion of direct holdings of corporate equities from 1994 through the second quarter of 1999.<sup>21</sup> These sales from what might be called the U.S. version of the “third pillar” contributed to a sharp decline in the personal savings rate in recent years. They also provided funding for increased consumption and helped widen disparities in income between the top wealth-holders and all other income groups.

Like many critics of the failure of private pension systems to incorporate strategies to increase employment and income, Ghilarducci notes that using pension monies for job creation would be as important to workers as current stock market gains, which primarily benefit employers.<sup>22</sup> But creating jobs and raising incomes will become even more important as markets for exports contract and increased domestic demand becomes the alternative path to growth. Most of the pension reform programs have not yet addressed these issues. For example, Chile’s 1997 reform focused on liberalizing restrictions on instruments. It enlarged the number of companies in whose stocks pension funds could invest from 30 to 200 out of a total of 300 listed companies, and it

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<sup>21</sup>U.S. Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*.

<sup>22</sup>Investing in affordable housing is another area that would seem to be particularly important to unskilled workers, because it would improve their quality of life.

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authorized investments in project financings, securitized bonds, and venture capital funds. But it did not introduce specific policy objectives to promote economic and social programs.<sup>23</sup>

Mexico's reformed pension fund law has gone further than Chile's in expanding the range of investment instruments for pension contributions. But it also incorporates a mission statement that centers investment strategy on development and macroeconomic policy, by requiring investments in securities that encourage national productive activity, create infrastructure, and generate employment, housing development and regional development.<sup>24</sup> While limited progress has been made toward achieving these goals, it is the Mexican model that has the potential to support a transition to domestic demand-driven growth, transform the financial systems of emerging economies, and support the development of broad-based prosperity.

### STRUCTURING PENSION FUNDS IN EMERGING ECONOMIES FOR GROWTH AND DEVELOPMENT

Past models for development have tended to focus primarily on the role of public international financial institutions and national governments in mobilizing funds for investment in sectors that are underdeveloped or that have underutilized potential for growth. The array of domestic development institutions in emerging economies ranging from Brazil to Zimbabwe provides evidence of how widely used this model has been. In many countries these institutions have operated in tandem with nationalized banking systems and provided structures for credit allocation to agricultural, small business, and other borrowers. In many cases, their inability to realize growth objectives in the sectors they served was due to the failure to ensure the necessary degree of impartiality in making credit decisions.

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<sup>23</sup>Srinivas and Yermo, *Do Investment Regulations Compromise Pension Fund Performance?*

<sup>24</sup>Srinivas and Yermo, *ibid.*

But another equally serious problem was providing a source of funding for those institutions. In countries with nationalized banking systems, government backing meant that banks did not need to be well capitalized. Moreover, loans were funded by deposits. But specialized institutions required longer-term funding and were usually supported directly by the government or by sales of government-guaranteed paper. As discussed above, government paper and bank deposits tended to constitute the majority of instruments available for public pension funds and for private investment. The lack of options for investment and the low retirement income associated with public pension plans tended to encourage capital flight among middle- and high-income households. Thus, lower-income workers bore the burden of financing the government and its financial institutions, and governments were induced to borrow abroad to maintain growth.

*Capitalizing the Financial Sector*

As the Mexican pension reform law's statement of objectives suggests, one of the more important goals of pension reform in emerging economies should be to provide sufficient capital to financial institutions. Like the U.S. Reconstruction Finance Corporation in the 1930s, pension funds should be authorized to purchase the capital stock of banks, insurance companies, mortgage banks, agricultural cooperatives, lenders to small business, local credit cooperatives, regional development agencies, venture capital funds, and various other institutions that comprise national financial systems. Capitalizing these institutions would help create the financial structure needed to mobilize savings and distribute investments efficiently and productively across all segments of these economies.

The growth of a larger and more varied financial sector will, in turn, increase the menu of financial assets in which pension funds can invest, thus expanding opportunities for portfolio diversification and enhancing market liquidity. Recent reforms that have privatized banking systems using the universal bank model have not been sufficient to meet this need. Institutions are undercapitalized and, so far, have failed to introduce needed innovations. Using pension funds to capitalize the financial sector will be critical in

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countries where financial crises and bank failures have wiped out the capital base of much of the domestic system, opening the gate for increased foreign entry. But using retirement savings to provide capital to financial institutions must be accompanied by appropriate safeguards in the form of adequate regulation, effective governance, and financial guarantees as discussed below.

*Bond markets* are a segment of emerging economies' financial systems that have not yet recovered from the recent crises.<sup>25</sup> These markets could particularly benefit from domestic pension fund investment. Like life insurers, pension funds can hold long-term debt obligations more comfortably than banks. Thus, they can ensure the repayment schedules necessary to fund corporations' long-term capital investments and provide ongoing funding for domestic development institutions. Bond markets are essential if domestic funding is to grow relative to international sources as a share of total financing for public works projects and for creating infrastructure. Overall, augmenting domestic sources of long-term debt will be critical to the process of shifting to domestic demand-driven growth. The process will reduce dependence on external debt and reliance on export-led growth and will increase national ownership of both real and financial sector assets.

Deeper bond markets are also essential for the development of securitization to increase the supply of mortgage credit to middle-income households, as well as to back publicly supported affordable housing for lower-income families. Increasing and improving the housing stock is essential to the process of raising living standards. Constructing and renovating housing are activities that generate and maintain employment at both skilled and entry levels. Like public works and infrastructure, housing is a non-tradable good and thus a primary sector for leading the transition to domestic demand-driven growth.

Securitization is a technique that shifts the risk of holding long-term mortgages from depository institutions to institutional investors. Widely used in the United States, it has expanded the

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<sup>25</sup>Jonathan Fuerbringer, "The Wounds Haven't Healed in Emerging-Markets Debt," *The New York Times* (November 28, 1999).

volume and lowered the cost of housing finance. The process of securitization involves the pooling of mortgages by originators and the sale of shares in the pool to outside investors. Freed from the necessity to hold mortgages in a portfolio backed by a limited amount of capital, mortgage originators can use their special skills to perform the function of originating and servicing mortgages in an expanding market. As the technique implies, securitization requires a large institutional investor sector—pension funds, mutual funds, and insurance companies—and contributes to the soundness of their portfolios by increasing the variety of investment instruments. As was the case in the United States, however, securitization is unlikely to be developed without government support. For example, in order to support the growth of securitized mortgage pools, governments will need to develop institutions that will play the role of market makers.

*Private placements* are another potential avenue for pension fund investment in emerging economies. These are a form of credit that is negotiated directly between lenders and borrowers, often with the assistance of a financial institution in locating and advising the two parties. In the United States, insurance companies have played an active role as lenders in the market for private placements. The borrowers have tended to be smaller and innovative enterprises without standing in bond markets. Unlike bond issues, private placements can be tailored to the particular needs of the borrower. A single placement may include short-, medium-, and long-term tranches that will better meet the needs for growth than credits in a single maturity range. Private placements are particularly useful for developing economies, enabling them to provide funding for established private companies. Such placements can also offer funding for public development institutions that subsidize private credits to small borrowers. Otherwise, the private financial institutions granting the credits would have to pass along the higher cost of servicing many such small loans.

Investing in domestic *venture capital funds*, as Chilean pension funds are now allowed to do, is illustrative of a unique role that pension funds can assume with less risk (in an admittedly risky field) than other investors simply because the number of partic-

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ipants is so large and the risk can be spread more widely. The IFC has encouraged the activities of foreign venture capital funds and is promoting local funds and joint ventures using foreign management. Because venture capital investments tend to be very small, they can fund businesses that are too small for direct pension fund investments, IFC officials point out. They benefit the economy by contributing to innovation and to business and job creation. They are an instrument of ownership that does not require a well-developed and liquid stock market for transactions. However, they can help develop the new companies that will augment equity markets by providing the source for initial public offerings

Like private placements, venture capital funds' commitments of patient capital require oversight. But that, in turn, provides opportunities to offer technical assistance in such areas as planning, marketing, and reporting that microlenders and other small institutions cannot provide.<sup>26</sup> True, the potential for disproportionately large gains relative to outlays, which can cushion losses in the overall portfolio, does not make venture capital funds risk free. However, it does justify the inclusion of a limited amount of investment in these funds in well-diversified pension pools.

### *Encouraging Participation in Investment Decisions and Corporate Governance*

It is widely recognized that pension funds are becoming the new owners of businesses in the United States.<sup>27</sup> Peter Drucker has described this development as "pension fund socialism" in view of the fact that ownership of a rising share of the means of production is concentrated in the hands of institutional investors.<sup>28</sup> Many legal and economic analysts agree, however, that the problem with this form of ownership is the lack of legal clarity in determining which participants control choices and exercise the responsibili-

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<sup>26</sup>International Finance Corporation, *Investment Funds in Emerging Markets*.

<sup>27</sup>U.S. House of Representatives, Hearing before the House Education and Labor Subcommittee on Labor-Management Relations, February 9, 1989 (Washington, DC: Government Printing Office, 1989).

<sup>28</sup>Peter F. Drucker, *The Pension Fund Revolution* (New Brunswick, NJ: Transaction, 1996).

ties of ownership: sponsors (employers), beneficiaries (employees and retirees), or fund managers?

In defined-benefit plans, the commitment of the employer to a contractual retirement income for the employee puts the risk of performance on the employer. Defined-benefit plans are governed by the Employee Income Retirement Security Act (ERISA), which authorizes the employer to act as a fiduciary (or to appoint fiduciaries) and to make investment decisions that will ensure sufficient income to meet future contractual obligations. In state and local government defined-benefit plans, the sponsor/employer is the political jurisdiction, and fiduciaries are appointed by elected officials.

Many public and private defined-benefit plans employ outside managers to make investment decisions. The larger plans use multiple managers with different managerial skills (or styles) and concentrations. Although fiduciaries of state and local government plans have assumed a major role in corporate governance during the last two decades, it is often the money managers in the private pension fund industry that exercise this major responsibility of ownership. Critics argue that numerous conflicts of interest arise from allowing outside pension fund managers to choose investments and exercise a dominant role in corporate governance. For example, a management firm's decisions about purchases or sales of the stock of a particular corporation may be influenced by its role in managing the corporation's pension assets. It may decide not to sell the stock and risk losing a customer.

Another criticism is that money managers tend to emphasize short-term gains in order to win or retain customers. In designing strategies for managing defined-benefit plans, for example, fund managers are aware that higher earnings in one quarter or over a year lower contributions in the next and, therefore, increase corporate profits. Meanwhile, the beneficiaries may be disadvantaged over the long-term. The emphasis on short-term gains in stock prices often leads many companies to adopt management strategies that will produce those gains. However, such strategies short-change investment programs that have longer-term payouts—e.g., expanding plant and equipment, upgrading technology, or increas-



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ing funding for research and development—but are nevertheless necessary for future growth.<sup>29</sup>

Defined-benefit plans remain a very large segment of the U.S. pension fund industry, although the number of defined-contribution plans is now greater. Under defined-contribution plans, the employer agrees to contribute a contractual amount based on wage levels. The employee also contributes an agreed-upon basic contribution that can be augmented at his/her discretion. Under some plans, the employer pools individual accounts and selects managers for the pool, which usually limits discretion as to the range of investments. Under other plans, the employee receives and makes contributions to an individual account that can be self-managed or invested in a mutual fund or annuity managed by professionals. In either case, the risk of performance and the size of future retirement income are not the responsibility of the employer.

Defined-contribution plans do offer beneficiaries more portability, i.e., the ability to move an account from one employer to another in case of a job change. They also offer beneficiaries some choice as to the amount to be contributed by the employee. However, the beneficiaries' role in making investment decisions and exercising corporate governance is still highly restricted. If their contributions are pooled either by the employer or if they have invested individual accounts in mutual funds or purchased annuities, the beneficiaries remain passive investors without active rights of choice. Corporate governance remains passive either because it is exercised by fund managers chosen by the employer or because the beneficiaries' individual holdings in mutual funds or direct investments are too small to be effective in influencing corporate management decisions.

In short, there is no channel for participation in the rights and obligations of ownership in pension plans in the United States, except in state and local government plans, union funds, and funds administered by the Teachers Insurance and Annuity Association (TIAA). Both union funds and TIAA funds are multi-employ-

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<sup>29</sup>Jane D'Arista, *The Evolution of U.S. Finance, Volume II* (Armonk, N.Y.: M. E. Sharpe, 1994).

er funds. Union funds are jointly controlled by employee and employer trustees, while TIAA funds are controlled by board members elected by beneficiaries. The governing structures of these two types of plans, as well as the type of control exercised by publicly appointed fiduciaries of state and local funds, offer the only U.S. models for the democratization of the immense private U.S. pension plan system. At issue in the debate on U.S. pension reform is one of the fundamental elements in a private market-based system. As articulated by Ghilarducci: "Workers own and bear the risk of failure if pension funds collapse. The first principle of property rights is that risk-bearers are property owners and have the right to some control."<sup>30</sup>

Many privatized pension systems in emerging economies face the same issues and concerns. Given that many emerging-economy pension systems involve mandatory contributions from wages, the importance of participation is underscored by the need to build confidence in the newer systems. Also, narrow elites in either public or private sectors must be prevented from capturing control over the allocation of assets for their own benefit. There is real danger that oligarchical control could dissipate the advantages of wider ownership of financial assets, particularly in Latin America where—except for a few countries, including Mexico—the government does not collect contributions. In those countries, private fund managers collect and invest contributions without public participation.<sup>31</sup> In Chile private management has thus far resulted in uniquely high fees and charges compared to international standards.<sup>32</sup> Yet this may be the least of the conflicts of interest that could emerge without direct oversight by those whose savings are at risk.

Reforms of existing and proposed private pension plans in emerging economies must address the issue of participation in ways

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<sup>30</sup>Ghilarducci, "Pension Policies to Maintain Workers' Access to Retirement."

<sup>31</sup>Srinivas and Yermo, *Do Investment Regulations Compromise Pension Fund Performance?*

<sup>32</sup>Valdés-Prieto, "Cargos por administración en los sistemas de pensiones de Chile, los Estados Unidos, Malasia y Zambia."

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that acknowledge the tension inherent in the mandatory nature of a privatized structure. Oversight could be provided by committees of legislative bodies; by local, regional, and/or national boards made up of representatives elected by beneficiaries; by union funds; or by all of the above. Active public debate concerning investment policies and governance issues should be encouraged in meetings of these and other groups of beneficiaries and their representatives or advocates.

In many emerging economies where private pension plans are already in place, they pose a particular challenge for the future of those economies. Analysts already foresee that shifts to fully funded systems will give rise to a large pension fund sector, as has been the case in the United States.<sup>33</sup> Thus, pension funds have the potential to become a powerful and comprehensive source of funding for economic policies that emphasize domestic demand-driven growth and shared prosperity. Alternatively, they may fall under the control of elites who will use them as they have used other financial institutions (such as banks) to cement political and economic control. As one analyst of financial development and economic growth has noted: "Concentration of financial resources is nothing but a consequence of concentration of political power. One cannot address the former issue without addressing the latter because they are intimately intertwined."<sup>34</sup> The hope in this case is that the roles will be reversed: that the concentration of financial resources in the hands of many wage earners will result in the diffusion of economic and political power across entire populations of emerging economies.

### *Protecting the Value of Contributions to Private Pension Plans*

Emerging economies that have established private pension plans funded by mandatory deductions from wages are necessarily concerned with soundness and performance. Both are critical for building confidence in the new systems and avoiding fraud. Latin

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<sup>33</sup>Valdés -Prieto, *ibid.*

<sup>34</sup>Ndikumana, "Financial Development and Economic Growth in Sub-Saharan Africa: Lessons and Research Agenda."

American countries rely on prudential regulations, such as fiduciary standards, accounting and auditing standards, insider trading rules, investor protection rules, and requirements for disclosure. Prudential regulations also require diversification and minimum risk-rating of assets. They also impose limits on self-investment and limit market power by restricting concentrations in share ownership. In addition, Colombia, Mexico, and Uruguay offer a rate-of-return or benefit guarantee of second-pillar pensions, at least in the initial years. In all Latin American countries with privatized systems, the highest priority is the safety of retirement assets.<sup>35</sup>

In the United States, by contrast, there has been little discussion of the safety of private pension fund assets even in the context of heated debates on privatizing social security. Those debates also tended to overlook the enormous amount of assets already held by private pension plans at year-end 1998 (\$4.3 trillion) or their size in relation to the assets of depository institutions backed by deposit insurance (\$5.1 trillion).<sup>36</sup> While it can be assumed that state and local government pension plans (another \$2.8 trillion at year-end 1998) are backed by the taxing authority of the political jurisdictions that sponsor them, the only private plans that have public backing are defined-benefit plans (\$2.1 billion). These plans are guaranteed by the Pension Benefit Guaranty Corporation (PBGC), which assumes responsibility for underfunded plans of companies that go bankrupt, thus ensuring that contractual benefits will be paid to retirees. Like other financial guarantees within the U.S. system, the PBGC relies for funding on premiums paid by covered participants—i.e., all companies that offer defined-benefit plans. The PBGC also has authority to borrow from the U.S. Treasury. However, private defined-contribution plans—the type of plans that were to be established in place of social security accounts—have no public or private backing to cover losses. With \$2.2 trillion in assets at year-end 1998, they are the fastest growing segment

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<sup>35</sup>Srinivas and Yermo, *Do Investment Regulations Compromise Pension Fund Performance?*

<sup>36</sup>U.S. Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*.

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of the U.S. pension fund industry and the weakest in terms of customer protection.

As pension fund systems continue to grow in both developed and developing economies, the issue of protecting the contributions and earnings of beneficiaries will become more important. A minimum annual real rate of return guarantee of 2 percent such as that offered by the government of Uruguay may be an appropriate means of providing protection for savings deducted from wages.<sup>37</sup> But unless the guarantee itself is prefunded, a serious market contraction would put considerable strain on governments coping with lost tax revenues and other calls on resources, such as unemployment insurance.

An alternative method of providing financial guarantees to pension fund beneficiaries would be to have the contributors themselves pay premiums into a prefunded insurance pool that would invest in government securities. Premiums would be deducted periodically from earnings on assets in individual accounts. The fact that such accounts already exist in many countries, and that accounting and reporting procedures are already in place, would make deducting premiums from earnings a routine matter. Given the growth in the size of the pension fund sector in countries with established prefunded systems, the pool of government securities backing the system would itself grow to substantial size over time. Even an annual deduction of 10 percent from *earnings*—not contributions—would eventually provide a sizable cushion to protect beneficiaries from losses.

In tandem with the growth in the insurance pool, the guarantee fund could adjust the level and coverage of benefits. For example, all contributions might be covered up to a certain amount in the years immediately following the introduction of the insurance scheme. Thereafter, the amount of covered contributions could be raised and coverage could be extended to include a portion of accumulated earnings with additional adjustments at five-year inter-

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<sup>37</sup>Srinivas and Yermo, *Do Investment Regulations Compromise Pension Fund Performance?*

vals. In any event, the first priority should be coverage of the value of an individual's contribution up to the limit imposed by the aggregate value of the insurance pool. Setting a limit on coverage would introduce a redistributive element to privatized plans that does not currently exist. This would seem a particularly appropriate place to introduce it, because higher income individuals and households can bear the risk of loss on mandated savings above the level needed to ensure adequate retirement income more easily than can middle- and lower-income wage earners.

REFORMING THE INTERNATIONAL MONETARY  
AND FINANCIAL ARCHITECTURE TO PROMOTE  
DOMESTIC DEMAND-DRIVEN GROWTH IN  
EMERGING ECONOMIES

During the 1970s, middle-income developing countries were the primary recipients of recycled surpluses from the Organization of Petroleum Exporting Countries. They bought oil from OPEC countries, capital goods from industrialized countries, and borrowed heavily to support the import-led growth strategy of that period. But the burden of servicing rising levels of external debt denominated in dollars and other strong currencies eventually became insupportable. Oil prices rose again at the end of the decade and existing loans had to be rolled over with higher interest rates and shorter maturities. The most burdensome element was that the foreign exchange needed to service debt had to be earned, and the only way to earn it was to export goods to industrialized countries with strong currencies.

The debt crisis in 1982 made clear that the heavily indebted middle-income countries—most of which were in Latin America—would have to export their way out of debt. Foreign lending dried up. Private and public international financial institutions focused on expanding export capacity as a sign that a country was regaining creditworthiness. The International Monetary Fund (IMF) instituted conditions for multilateral credits that suppressed demand in these countries. Thus, imports would fall and export surplus-

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es would result in external adjustment. The export-led growth strategy emerged in tandem with immense resource transfers. Over the years from 1983 through 1989, negative net outflows from Latin America amounted to -\$116 billion as heavily indebted countries used all foreign exchange earned from exports to service external debt.<sup>38</sup>

Given the debt overhang, rising exports could not spur growth in the heavily indebted countries in the 1980s. But the export-led growth strategy also failed to inhibit the growth of external debt. The total external debt of developing countries continued to grow, rising from about \$1 trillion at the beginning of the 1990s to \$2 trillion in 1999. True, the decline in debt as a share of exports of goods and services from 186.2 percent to 160.9 percent between 1991 and 1998 attests to the success of the strategy in raising the volume and value of exports. However, the ratio of debt service payments to exports rose from 22.4 percent to 24.0 percent during the same period. For developing countries in the Western Hemisphere, however, debt service as a percentage of exports rose from 39.3 percent to 45.7 percent.<sup>39</sup>

A central element in any future strategy for growth in the global economy must involve efforts both to reduce developing countries' dependence on external debt and to lower the level of external debt denominated in foreign currencies. This does not mean that these countries will not need foreign private capital and/or bilateral and multilateral flows, nor does it mean such funds should be prohibited. But inflows must be rechanneled in ways that minimize the burden of debt service. In addition, the system of using one or a few strong currencies as vehicle currencies in international trade and investment and as reserve assets must be changed. The following three proposals suggest a framework through which old and new institutional arrangements could be used to lower debt levels, provide new channels for capital inflows,

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<sup>38</sup>International Monetary Fund, *International Capital Markets: Developments, Prospects, and Policy Issues*, 1995.

<sup>39</sup>International Monetary Fund, *International Capital Markets* (Washington, D.C.: International Monetary Fund, September 1999).

and alleviate the barriers to growth in demand imposed by servicing foreign currency-denominated debt.<sup>40</sup>

*Issuing a New Allocation of SDRs*

A 1987 IMF staff report affirmed that allocations for Special Drawing Rights (SDRs) could serve as “a ‘safety net’ to cope with an international financial emergency of limited, though uncertain, duration.” In the absence of a true lender of last resort, SDRs represent the single instrument in place at the global level to address the problem. Moreover, new SDR allocations provide a uniquely benign alternative to bailout loans, which compound the underlying inequities inherent in a global system organized around foreign currency-denominated debt.

Given the unprecedented amount of IMF resources already committed to crisis-ridden member countries, new sources of funding are urgently needed. In theory, the IMF could obtain these funds by borrowing in private markets. But member country taxpayers would remain the guarantor of IMF obligations. And the IMF would simply perpetuate the worst features of its current crisis-response operations if it reloaned privately raised funds to impacted countries. Debt owed to the IMF is no different than debt owed to the private sector in terms of the pressure it puts on countries to export their way out of massive loan obligations.

By issuing a new allocation of SDRs, the IMF could accomplish three objectives. First, it could provide badly needed debt relief. Second, it would permit countries to shift from an export-led growth paradigm toward fostering deeper, stronger internal markets. Third, it could foster conditions for a resumption of growth in developing countries and in the global economy.

Ideally, new allocations should be directed only to highly indebted poor countries (HIPC)s and to those nations that have been hit hardest by the effects of financial crises. But changing the IMF’s Articles of Agreement to direct allocations to particular countries would be contentious and time consuming. On the other hand,

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<sup>40</sup>A lengthier version of these three proposals was published in November 1999 by the Financial Markets Center.



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a general allocation based on quotas—a system that would distribute almost half the newly issued SDRs to G-7 countries—could be done quickly, if agreed to by 85 percent of the IMF Board.<sup>44</sup>

In any event, allocations for debt relief should supplement the so-called “equity” allocations (adopted in April 1997 but not yet ratified) for countries that had not become members of the IMF in 1981 when the last SDR allocations were made. Allocations to HIPC countries should be sufficiently large to enable them to pay off public and private external debt. Allocations to other countries should be used to repay public debt and a needed portion of private debt. In the case of Russia, allocations should cover all debt incurred by the former Union of Soviet Socialist Republics. In repaying private debt, SDR recipients would exchange the drawing rights with central banks of strong-currency countries for foreign exchange, which would then be used to pay off private lenders.

In addition, recipient countries should retain a portion of the new drawing rights as reserves to back a resumption of domestic bank lending. Adding reserves to their central banks’ balance sheets would increase the countries’ liquidity, enable monetary expansion and thereby allow domestic banks to lend at reasonable rates of interest. The current reliance on high interest rates to attract foreign capital and raise currency values suppresses growth in crisis-battered countries. Borrowers can’t earn enough to repay their loans, undercapitalized banking systems drain public resources, and credit crunches deter—rather than spur—new infusions of capital by foreign and domestic investors.

Moreover, unless newly allocated SDRs are also employed as domestic financial reserves, the export-led growth paradigm inevitably will continue. Absent an injection of liquidity in domestic markets, hard-hit countries must struggle to earn the reserves needed to rebuild financial systems capable of funding job creation and income growth in the domestic economy. Currently, these coun-

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<sup>44</sup>David Lipton of the Carnegie Endowment for International Peace has suggested that a large general allocation be used to create a pool of funds to defend the international financial system in time of dire threat. Lipton’s proposal constitutes a sensible use of SDRs allocated to countries that do not need debt relief or access to international liquidity.

tries must either increase the volume of exports or borrow from external sources to augment domestic liquidity.

*Creating a Public International Investment Fund for Emerging Markets*

The second proposal puts forward a plan for establishing a public international investment fund for emerging markets. Structured as a closed-end mutual fund, this investment vehicle would address the problems that have emerged with the extraordinary growth in cross-border securities investment transactions in the 1990s. The proposal advocates a role for the public sector in managing those problems. Thus, private portfolio investment, which became the dominant channel for flows into emerging markets from 1990-94, can promote steady, sustainable growth rather than the boom and bust cycles that so far have been its primary contribution.

This proposed closed-end investment fund for emerging markets builds on existing activities of the World Bank's International Finance Corporation (IFC), whose mandate is to promote private-sector investment in developing countries. Private foreign portfolio investment in emerging markets has been actively promoted by the IFC since 1984, when the first country fund was structured in Korea. The IFC's objective in promoting portfolio investment was "to integrate domestic and international capital markets."<sup>42</sup> Initially, country funds were structured as closed-end funds but quickly shifted to open-ended mutual funds as the IFC concluded that exit possibilities encouraged more entry. Its Global Index Fund, formed in January 1994 to target pension funds in industrialized countries, adopted a semi-open structure that allowed issuances and redemptions on the last day of the month rather than continuously. As noted above, the number of country funds investing in emerging markets had exceeded 1,000 by 1994, with assets totaling \$100 billion.<sup>43</sup>

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<sup>42</sup>International Finance Corporation, *Investment Funds in Emerging Markets*.

<sup>43</sup>International Finance Corporation, *ibid.*

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As the IFC realized, the phenomenal growth of institutional investors' assets in G-7 countries suggests that foreign portfolio capital is an ideal channel for financing long-term economic expansion in emerging economies. To achieve this beneficial result, however, these economies need portfolio investment inflows that are sizable, stable, and supportive of the policy objectives of both their governments and domestic enterprises. Chile has been fairly successful in using capital controls to achieve some of these results by requiring foreign investors to hold securities for at least a year. Also, Chilean companies must maintain reserve requirements on direct borrowing abroad. Korea, too, imposed limits on foreign borrowing by domestic companies for many years before its recent liberalization. Such controls are very useful but cannot accomplish the dual task of injecting long-term private capital into developing countries while deterring the destructive fluctuations in asset prices and exchange rates associated with procyclical surges in foreign portfolio flows.

One innovation that might be equal to this task is to return to the closed-end fund structure for foreign investment in emerging market securities, but have the manager be a public international agency. The new fund could issue its own liabilities to private investors and buy stocks and bonds of private enterprises and public agencies in a wide spectrum of developing countries. Both the number of countries and the size of the investment pool would be large enough to ensure diversification. The fund's investment objectives would focus on the long-term economic performance of enterprises and countries rather than short-term financial returns. Selecting securities in consultation with host governments and representatives of pension fund beneficiaries would help the fund meet those objectives.

Unlike open-end mutual funds that must buy back an unlimited number of shares whenever investors demand it, closed-end investment pools issue a limited number of shares that trade on a stock exchange or in over-the-counter markets. This key structural difference makes the holdings in closed-end portfolios much less vulnerable to the waves of buying and redemptions that sometimes characterize open-end funds. Thus a closed-end fund

would provide emerging markets a measure of protection by allowing the prices of shares in the fund to fluctuate without triggering destabilizing purchases and sales of the underlying investments.

To further balance the goals of market stability and economic dynamism, the closed-end fund should possess a solid capital cushion. Between 10 and 20 percent of the value of shares sold to investors should be used to purchase and hold government securities of major industrial countries in amounts roughly proportional to the closed-end fund shares owned by residents of those countries. These holdings would provide investors a partial guaranteed return, denominated in their own currencies, while the government securities would explicitly guarantee the value of the fund's capital. This dual guarantee would moderate investors' concerns about potential risk.

Creating one or more closed-end funds on this model would reduce the need for capital controls, especially in countries that choose to accept foreign portfolio investment solely through this vehicle. The closed-end fund would have several additional benefits as well. It would help pension plans in developing and developed countries diversify their portfolios while minimizing country risk and transactions costs. And it would help institutional investors in developing countries share the cost of information and collectively combat the lack of disclosure by domestic issuers in those markets.

These arrangements need not reinvent the wheel. Just as the structural mechanisms and potential assets of an emerging-economies closed-end fund already exist in the marketplace, so the capacity for managing such a fund falls well within the reach of an existing public institution: the World Bank and its IFC subsidiary. Indeed, this management function follows in the line of the IFC's current activities and is thus consistent with the Bank's mandate to facilitate private investment in developing countries. Moreover, the Bank's experience in issuing its own liabilities in global capital markets would expedite the startup of a closed-end fund.

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### *Creating an International Clearing System*

The third proposal articulates an alternative to the privatized, dollar-based international monetary system that is a root cause of global instability and market failure. This proposal would create an international transactions and payments system managed by a public international agency in which cross-border monetary exchanges can be made in each country's own currency. This critical feature would help governments and central banks conduct effective economic policies at a national level. Equally important, it would allow all countries—not just a privileged few—to service external debt with wealth generated in their domestic markets. Thus it would help end the unsustainable paradigm of export-led growth governing the global economy.

A major objective of the proposal is to end the devastating declines in currency values that raise the value of external debt, wipe out foreign exchange reserves and bankrupt whole sectors of emerging economies virtually overnight. Despite repetitions of these events across the globe, establishment debate over monetary matters remains narrow, generally contenting itself with rehashing the relative merits of fixed versus floating exchange rate regimes. The Clinton Administration did propose that the IMF provide these countries' central banks more reserves to preclude traders' bets against their national currencies. But experience clearly shows that such injections only reassure investors if coupled with policies that constrain domestic growth. When growth falters, the resources invariably wind up as profits for speculators. Modest, well-intentioned adjustments to the prevailing international monetary arrangements are not capable of restoring financial stability or facilitating sustainable economic activity. A new system of currency relations is needed.

To succeed, this new system must possess three essential attributes. First, it must enable national governments and central banks to reclaim from financial markets their sovereign capacities to conduct appropriate national economic policies. Second, it must promote the ability of governments and central banks to employ effective countercyclical policies at a national level. And third, it must support a symmetrical relationship between the creation of

real wealth and the servicing of financial liabilities, regardless of the country of origin or currency of the creditor.

An international clearing agency (ICA) functioning as a clearinghouse and a repository for international reserves should be the keystone for this new system of monetary relations. Although its creation would demand significant collaboration among nations, such an institution would not be a supranational central bank. It would not issue a single global currency. Indeed, it would not issue currency at all. That would remain the prerogative of national central banks. But, by providing a multinational structure for clearing payments, it would enable countries to engage in international trade and financial transactions in their own currencies.

The proposed international clearing agency would hold debt securities of its member nations as assets and their international reserves as liabilities. Those assets and liabilities would allow the ICA to clear payments between countries. Exchange rates would be readjusted within a set range and over a set period of time in response to changes in levels of reserves held by the ICA. These periodic adjustments would reflect the valid role of market forces in shaping exchange rates through trade and investment flows. But speculators would no longer dominate the process.

The ICA's asset and liability structure also would allow it to conduct open market operations on an international basis, much as the Federal Reserve and other central banks do at the national level. By conducting these operations, the ICA would help smooth changes in international reserves caused by imbalances in trade or investment flows. For example, if a nation were experiencing excessive capital inflows, the ICA could help the national central bank absorb liquidity by selling its own holdings of that country's government securities to residents in the national market. In the case of a country experiencing excessive capital outflows, the ICA could assist the national central bank in supplying liquidity by buying government securities from residents in the national market and augmenting that country's supply of international reserves.

Thus, its ability to create liquidity would allow the ICA to act as a global lender of last resort—a role that neither the IMF nor any other existing institution is structured to play effectively. In

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this capacity, the ICA could also help countries counter the effects of political shocks, commodity price gyrations, and natural disasters on international payments.

Membership in the ICA would be open to national central banks of all participating countries and branches of the clearinghouse would conduct operations in every major financial center in order to implement its critical role in international payments. The institution would fund its operations with earnings from the government securities on its balance sheet. Like the U.S. Federal Reserve System, the ICA would remit to the issuers of those securities (e.g., the U.S. Treasury in the case of the United States) any annual earnings that exceeded expenses.

Like national central banks, the ICA should be equipped with a highly skilled transactional, policy, and legal staff. To guard against becoming a clubhouse for creditors or unrepresentative elites, the new ICA must level the central bank playing field upward. It must hew to tough disclosure and reporting standards, and its mandate must focus on the interests of people and their institutions of self-government. ICA eligibility standards should require member central banks to demonstrate genuine accountability to citizens in their own countries.

Population as well as economic output would determine participating nations' governing power within the ICA. For example, the executive committee in charge of the ICA's operations and policy should be appointed on a rotating basis, with the requirement that its members represent countries that, in the aggregate, constitute more than half the world's population and more than half its total output. To ensure diverse inputs into policy deliberations, the ICA's staff and advisory bodies would represent a variety of regions, occupations, and sectors, and include constituencies that are frequently overlooked in the formulation of national policy.

While the ICA's independent directors would be the coequals of national central bank officials, their obligations and perspective must be mega-economic in scope. In seeking to influence the course of national economic policy, the ICA would operate primarily through persuasion and negotiation rather than resorting

to unilateral exercise of its financial leverage in the open market. However, with a super-majority or consensus of member countries, the ICA would have the ability to redirect national policy in the long-term economic interest of all.

This aspect of the ICA's operations may seem radical, even with an unprecedented degree of transparency and accountability built in. In fact, it is far less radical and far more respectful of national sovereignty than financial markets' existing capacity to override national policy goals and undermine democratic institutions. Moreover, numerous precedents exist for international efforts to reshape economic policy in one country in the interest of global stability and widely shared prosperity. Among the most visible and recent precedents are attempts by the other six members of the G-7 to redirect the course Japan's macroeconomic policy.

Restoring the public sector to its historic role as facilitator and guardian of the international payments system would have deep and lasting benefits. A stable regime of currency relations is key to reversing incentives in the current global economic system for lower wages and the export of goods and capital on ruinous terms.

## CONCLUSION

Key elements in the financial infrastructure for emerging economies are participation and ownership. The discussion of widening ownership of both financial systems and real sectors through investments in pension funds implies that a larger and more effective private sector would take a broader than usual role in economic decision-making. Moreover, ownership that returns a share of profits to holders of financial assets is an important consideration in countries where religious beliefs prohibit interest payments. Such an ownership structure is also important in countries whose economies are built around the development of natural resources, because it answers concerns about the right to share in the national patrimony. Overall, ownership promotes interest and involve-



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ment to counter the apathy and even hopelessness that characterize attitudes toward economic life in many countries.

There is no guarantee that wider ownership of financial assets and of the enterprises and institutions that issue them will result in more active participation in economic life. Participation will need to be encouraged by both governments and civil society. But the potential for involvement may be greater in countries that have established mandatory private pension plans than in those that have not. In any event, interest and involvement are critical in providing the oversight to ensure that governments, financial institutions, and businesses act in the broader public interest.

Finally, in addition to arguing for adoption of national and global structures and policies that will encourage domestic demand-driven growth in emerging economies, this paper also argues for the reinstatement of a strong role for national governments in determining national economic policies. Few of the reforms needed to promote a new paradigm for growth or to ensure that gains will be broadly shared will be implemented without that role. Even in countries where privatized pension systems have been established, it is the mandatory contributions that make these systems effective. And the mandatory requirement can only be put in place and enforced by government.

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