

A Financial Architecture for Middle-Class- Oriented Development

A Report of the Project on Development,
Trade, and International Finance

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and
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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. Some studies focused on the financial markets of the emerging economies in question, while others examined the larger shortcomings of the international financial system. The Council on Foreign Relations Project on Development, Trade, and International Finance has sought 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 designed to make financial markets work better in developing countries.

The Project on Development, Trade, and International Finance issues this report as a culmination of an 18-month study conducted by Council Senior Fellow Walter Russell Mead and Senior Program Coordinator for the project, Sherle R. Schwenninger, with the assistance of a Working Group made up of leading economic thinkers, as well as representatives from Wall Street, international financial institutions, organized labor, and a range of public-interest organizations.

This report seeks to focus policy attention around measures to encourage the evolution of an international financial architecture that supports middle-class-oriented development in emerging economies. With this objective in mind, this report presents a series of ideas and policy recommendations that would enhance the effectiveness, security, and flexibility of the international financial system and greatly strengthen the system's ability to meet long-term credit needs in emerging countries. This discussion affords useful insights into international financial architecture, representing an important stimulus for new directions in both U.S. and international economic policy.

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The Project staff would like to acknowledge the help and assistance of the New America Foundation, which cosponsored on June 14, 2000, a Washington, D.C., policy conference to air the recommendations contained in this report and which has cooperated with the project on an examination of the environmental dimensions of international financial architecture. The staff would also like to thank the following organizations for hosting review sessions to consider an earlier version of the report: the Economic Policy Institute, Friends of the Earth, the Office of Development Studies at the United Nations Development Programme,

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EXECUTIVE SUMMARY

I. The Case For Middle-Class-Oriented Development

International financial architecture works best when it serves social goals that command widespread support and legitimacy. Without neglecting the more conventional goal of allowing the greatest possible global flow of capital with the least risk of financial crisis, the primary goal of international financial reform, for both economic and political reasons, ought to be to promote middle-class-oriented development around the world.

- 1. Middle-class-oriented development is the key to global prosperity and stability.** Extending the system of mass affluence found in the advanced industrial economies into the developing world as rapidly as possible is the key to global political stability and sustainable economic growth. It is also the key to building the kind of support that is needed in both developed and developing countries for sustaining the necessary reforms for stabilizing and strengthening the international financial system.
- 2. Much of the world is now ready for middle-class-oriented development.** Thanks to the economic growth of the last generation, a substantial number of economies are ready for the transition to middle-class-oriented development. When considered on the basis of purchasing-power parity, fifty-two countries with a total population of 1.5 billion have reached levels of per capita GDP similar to those at which the United States inaugurated middle-class-oriented development policies. Other large economies, such as India and China, have already created substantial middle classes.
- 3. Middle-class-oriented development enhances poverty alleviation.** Middle-class-oriented development does not mean taking resources from the poorest to concentrate on assisting

those who already enjoy better living conditions. Rather, middle-class-oriented development seeks to expand the middle class by facilitating the rise of the working poor, thus increasing employment opportunities for both high- and low-skill workers. The reforms envisioned by the report would increase the ability of the World Bank and other agencies to concentrate on poverty alleviation and would enhance the efficacy of their activities.

4. **Access to reasonably priced, long-term credit is the single most important element in the formation of a mass middle class.** Small business, municipal and other public investment in infrastructure, home ownership (either in single-family homes or apartments), post-secondary education, and other necessities of middle-class life depend upon access to credit. The thirty-year, self-amortizing mortgage is the “canary in the coal mine”: if these mortgages are widely available, then credit markets are working for ordinary citizens who aspire to become middle class.
5. **Middle-class-oriented development requires increased long-term capital flows to developing countries.** To facilitate middle-class-oriented development, international financial architecture should promote more long-term capital flows from the capital-rich G-3 advanced industrialized countries to capital-hungry emerging economies. In addition, it should expand democratic access to capital within developing countries for such purposes as home ownership, education, and the start-up and expansion of small and medium-sized business.

II. Obstacles to Middle-Class-Oriented Development

The current international financial architecture poorly serves the middle-class-oriented development needs of emerging economies in three ways.

1. **The lack of stable currencies not only makes developing economies more crisis prone but also distorts their development.** Currency risk is the single greatest deterrent to long-term capital flows to emerging economies, and one of the principal barriers to the development of deeper and more efficient cap-

ital markets upon which middle-class-oriented growth depends. The high cost of capital and short-term structure of the financial markets in most developing countries preclude a whole range of investments, including environment-friendly investments, that would otherwise be profitable. They also distort development by favoring big companies over smaller firms, foreign firms over domestic ones, and foreign exchange-earners over companies that produce for the domestic markets.

2. **Shallow and badly regulated capital markets in emerging economies tend to deny credit to small businesses and ordinary citizens.** As a result of poorly developed equity and secondary debt markets, most emerging economies are overly dependent upon the banking sector. In many emerging economies banks are not only crisis prone but also highly inefficient at allocating capital, especially to ordinary citizens and small businesses. Most emerging economies lack the legal infrastructure and regulatory machinery upon which deeper and more sophisticated capital markets depend.
3. **Poorly capitalized national and international financial institutions lack the resources and legitimacy needed to promote real capital market reform and to stem crises in emerging economies.** In many emerging markets, national institutions are too small, too close, and in many cases too politically influenced to exercise effective regulation and supervision of middle-class-oriented capital markets. The International Monetary Fund, however, is too big, too distant, and lacks both the mandate and resources to exercise effective oversight or to promote reform in most emerging economies.

III. Middle-Class-Oriented Reforms

Middle-class-oriented development requires institutional changes that substantially reduce risk for both domestic and international investors. Without attempting to prescribe in detail for each of the world's very different regions, we offer five recommendations as one example of a coherent strategy for promoting the con-

ditions and institutions necessary for effective market-based, middle-class-oriented development.

Recommendation 1: Create well-capitalized and well-managed regional central banks to serve as the frontline institutions for middle-class-oriented development. The creation of regional central banks (similar to the European Central Bank) would enable emerging economies to pool reserves, consolidate monetary policy, and undertake effective capital-market regulation and development. A diversified shareholder base is the key to well-capitalized and well-managed central banks. The report, therefore, calls for the private sector as well as member and nonmember central banks and governments to become shareholders in a regional central bank (RCB).

Recommendation 2: Regional central banks should create or adopt hard regional currencies. To reduce interest rates and lower the cost of capital, regional central banks should create a stable currency that commands investor confidence. There is no one sure path to a stable currency, and each region will need to chart its own course. The report examines two options: dollarization and the creation of regional super-currencies (artificial currencies based on a basket or combination of currencies).

Recommendation 3: Establish binding covenants for good governance and good policies. In order to develop the deep and efficient capital markets necessary to provide greater democratic access to reasonably priced credit, regional central banks—along with other elements of a regional financial architecture—would need to use their size and influence to facilitate the legal, fiscal, and regulatory reforms needed for the development of such markets. The report envisions an accession process to the RCB similar but less onerous than that to the European Union. The RCB accession process would include three agreements: a fiscal stability pact; an agreement covering legal infrastructure and regulatory standards; and a third agreement relating to the RCB's regulatory authority.

Recommendation 4: Reduce the debt burden. To reduce excessive debt burdens, the report outlines a two-part process of debt reduction and restructuring. First, as part of the capitalization of

the regional central bank, both official and private sector creditors would convert government debt into RCB equity. Second, for member countries adhering to the fiscal stability pact, regional central banks would help underwrite and place long- and short-term debt in international markets.

Recommendation 5. Create deep and liquid capital markets. The report calls for the RCBs to: 1) create a long-term mortgage and small-business credit market by chartering and spinning off regional Fannie Mae-like institutions; 2) expand equity and debt markets by chartering investment banks aimed at underwriting corporate debt and initial public offerings and by chartering and supervising for-profit pension management companies linked to compulsory savings programs; and 3) build a popular financial sector serving the needs of small- and medium-sized businesses by chartering and supervising popular financial institutions for mini-lending (loans up to \$25,000) for ordinary working people.

INTERNATIONAL FINANCIAL ARCHITECTURE: THE CASE FOR MIDDLE-CLASS- ORIENTED DEVELOPMENT

International financial architecture works best when it is seen in three dimensions. The first dimension relates to the economic principles that guide the construction and operation of any international financial system. In an age of global financial integration, most of these principles are not particularly controversial: transparency, openness, rule of law, uniform accounting standards, the need for prudential regulation, the importance of minimizing moral hazard, and the desirability for some form of lender of last resort to inject liquidity into the system at times of crisis. Indeed, these principles and measures are the subject of many of the reforms now being put forward by governments, public-policy think tanks, and international financial institutions. Some ideas, such as the appropriate exchange rate regime for developing countries, the desirability of bailing in the private sector, and whether short-term capital controls can be used effectively, are still subject to dispute, but even in these cases there is less difference now than before the Asian financial crisis.

The second dimension of international financial architecture concerns the social goals that the financial system must serve in order to command widespread support and legitimacy. Financial architecture is not neutral: it tends to favor some groups over others; some forms of development and not others. Previous innovations in international financial architecture were designed with some specific social goals in mind. The Bretton Woods system, for example, was adopted with the dual purpose of helping the war-devastated European economies to recover and of assisting the newly independent economies of the Third World to develop in the face of a dollar shortage. Indeed, the formal name of the World Bank—the International Bank for Reconstruction and Development—still commemorates that dual purpose.

The third dimension concerns the specific economic context in which the international financial system must operate. At any given historical period, there will be certain demographic and technological trends that cannot easily be altered by policy but nonetheless can have a dramatic effect on policy outcomes. Shifting demographic patterns, for example, can significantly alter savings and investment rates and thus trade and investment flows: as a population reaches retirement age it consumes more and saves less, and what it consumes also changes.¹ If these basic trends are not accommodated in the design of the international financial architecture, they can produce undesirable economic outcomes.

The challenge of this project has been to reconcile these three dimensions of international financial architecture to show how an international financial system based on sound economic principles can evolve over the coming decades to accommodate shifting development and trade patterns in a way that results in substantially improved living standards for most people in developing as well as developed countries.

Since the 1997–98 crisis, the economic debate has largely focused on the first dimension of international financial architecture—with only passing reference to the second and third dimensions. Understandably, the principal reform proposals have focused on crisis prevention and containment, and only secondarily has the debate concerned itself with the question of what kind of investment, trade, and development should international financial architecture promote. At the same time, a parallel debate and discussion within civil society circles has above all highlighted second-dimension social objectives, but without a disciplined examination of how these goals—less austerity and more poverty alleviation—can be achieved.

The result has been an unhappy consensus that policymakers face a choice between sound economic policies whose social ben-

¹For further discussion, see Robert Dugger, Robert McNally, and Richard Medley, “The American Stock Market as a Financial Risk,” a paper from the Project on Development, Trade, and International Finance, Council on Foreign Relations, New York, 2000.

efits will only be apparent in the middle to long term, or sound social policies that very rapidly produce poor economic outcomes. The perception that sound economic policies inevitably involve many years of pain leads many politicians in democratic societies to postpone reforms, or to carry them out in a half-hearted manner. This can and often does lead to a kind of policy swamp: politicians make enough reforms to make the public unhappy, but either cannot or will not reform aggressively enough to move the economy onto a sustainable, long-term growth path. In these conditions, economies can—and do—flounder for years or even for decades, partly reformed, always reforming, but somehow still stuck in the mud.

Our project has tried to find ways for emerging economies to avoid this policy swamp. More specifically, it has sought to see whether a three-dimensional approach to international architecture can find a road around, or build a bridge over, this unhappy morass. Our principal conclusion after a year of study and consultation with leading economic thinkers as well as representatives from Wall Street, organized labor, and a wide range of public interest groups is positive: certain changes in the international financial architecture can significantly enhance the prospects that emerging economies will be able to build an enduring consensus for reforms that will lead to solid and sustainable growth.

The key to such reform, we believe, is to give additional prominence to a goal that, while widely acknowledged as vital for both the political and economic development of the global system, has rarely been the direct and immediate object of international financial architectural reform. That goal is the creation of a mass middle class in emerging economies.

We believe that it is possible to develop an international financial architecture that would advance middle-class-oriented development without neglecting the more conventional goal of allowing the greatest possible global flows of capital with the least feasible risk of financial crises. An international financial architecture for middle-class-oriented development would facilitate rapid growth in emerging economies in ways that benefit the broad mass of the

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population and that greatly expand the middle classes of those societies.

While the specific elements of a middle-class-oriented development strategy would differ from country to country—reflecting the level of development, the existing economic structure, and specific cultural values of each country—middle-class-oriented strategies have certain key elements in common. As Nancy Birdsall, former director of policy research at the World Bank, has pointed out, the middle class in today's advanced Western economies has been built on a tripod of employment (rising wages), education (expanding access to formal education), and property (increased ownership of home, small business, and other property).²

Underpinning this tripod has been a credit system that supports both the investment and the consumption of households and families. In nearly all middle-class societies, widespread home ownership, often facilitated by various credit subsidies, has figured significantly into middle-class-oriented development. So has widely available credit (again, often subsidized) for such common goods and services as education, automobiles, and household durables. Another building block of middle-class societies has been a vibrant small business sector, which depends upon a credit system that allows individuals to start up new enterprises and that permits already existing enterprises to gain access to financing for expansion.

Beyond this, middle-class societies generally have benefited from a public-financed infrastructure that provides most if not all citizens with electric power, potable water, and transportation. They have also benefited from a nearly universal secondary education system that is free, and post-secondary education that is widely available. Finally, nearly all middle class societies have developed social safety nets and social insurance programs that help middle-class working families survive temporary periods of unemployment or such lifetime catastrophic events as long-term disability. They have also developed a combination of public and private pension

²Nancy Birdsall, "Building a Market-Friendly Middle Class," remarks Before Annual World Bank Conference on Development Economics, April 18, 2000.

programs that assure a dignified and decent retirement to a substantial majority of the working population.

Economists have no agreed-upon definition of the middle class, or any standard measurement by which to gauge the size of the global middle class in developing countries. While virtually every prosperous society is middle-class-oriented, not all middle-class-oriented societies have been affluent by contemporary standards. The United States was a middle-class-oriented society in 1947, when per capita GDP stood at \$10,373 in 1996 dollars.³

By this standard, a significant number of developing countries either have reached or are about to reach levels of productivity that would support a middle-class standard of living. On a per capita, purchasing-power-parity basis, Argentina, Chile, and South Korea are significantly more affluent than the United States was in 1947. Twenty-seven countries counted as “upper middle income” developing countries by the World Bank, with a combined population of 588 million, have a mean per capita income (on a purchasing power parity basis) equivalent to \$7,830, almost 80 percent of the U.S. levels of 1947.⁴ These countries, including such diverse places as Mexico, South Africa, and Malaysia, are productive enough to support a modest middle-class society. So are large emerging economies, like Brazil and India, which have lower per capita income but because of their size and technological sophistication have developed sizeable middle classes.

Countries, however, do not need to achieve middle-class levels of productivity before initiating middle-class-oriented development policies. The United States adopted middle-class-oriented development strategies during the Great Depression, when per capita incomes were as low as \$4,804—comparable to levels seen in many lower middle income countries today. All told, fifty-two developing countries with a total estimated population of 1.5 billion have reached a level of development roughly comparable to that reached

³U.S. Bureau of the Census, Population Estimates Program, Population Division and U.S. Department of Commerce: Bureau of Economic Analysis.

⁴The World Bank, *Entering the 21st Century: World Development Report 1999/2000* (New York: Oxford University Press, 2000), p.231.

by the United States when it moved decisively toward middle-class-oriented policies.⁵ With proper policies, most if not all of these countries—including all of the major Latin American economies as well as such East Asian countries as Thailand and the Philippines and, taken as a whole, the southern African region of South Africa, Botswana, Zimbabwe, and Lesotho—should have the economic resources to implement the basic features of middle-class-oriented development policies.

In other less-developed countries, middle-class-oriented development policies, particularly those aimed at expanding access to reasonably priced credit, can play a significant role in growth and poverty alleviation—or can help alleviate poverty in such moderately prosperous emerging economies as Mexico and Brazil. Indeed, a focus on expanding the middle class in emerging economies does not mean neglecting the poor. “Micro-lending,” one of the most promising development innovations of recent years, is essentially an adaptation of middle-class-oriented policy to conditions of great poverty. By giving ordinary people access to credit to start a business—one of the most important middle-class-oriented development policies—micro-lending allows individuals and families to escape poverty and take control of their own lives. The expansion of micro-lending and the development of “mini-lending” programs (of somewhat larger loans for larger, but still small and community-based enterprises) can play a significant role in national and regional development strategies.

Other classic middle-class policies, such as making home mortgages available, can create opportunity and reduce poverty in poor developing countries. The housing policies that built Levittowns in postwar America, or that put Singapore’s once-impoorished working people in owner-occupied apartments, can also serve poorer populations with lower expectations about housing. Given an appropriate credit system that allows affordable long-term loans to working households, working families in developing countries can take the money spent on rent and purchase a home

⁵Ibid., p. 231.

over twenty to thirty years. In this way, relatively poor working families can become vested with real capital ownership, which absent such a credit system they could never otherwise afford.

It is not only housing that depends on an effective, appropriate credit system. High interest rates and short maturities are financially crippling for entities seeking to meet the infrastructure and environmental needs of emerging economies, be they private utilities, local and regional public authorities, or international development banks. Safe drinking water, electric power, reliable transportation systems, sanitary waste disposal, schools, and other basic necessities of middle-class life are, whether administered by governments or provided by private companies, generally financed by access to long-term credit markets. Without such access, few advanced countries today could provide adequate facilities.

Employment also suffers in the absence of credit. The “missing” housing and infrastructure that cannot be built due to poorly functioning credit markets is matched by missing job opportunities: jobs designing, building, operating, and maintaining the housing and infrastructure that cannot be built. Any serious approach to the labor market problems of emerging economies must look at ways of substantially increasing formal sector opportunities for unskilled and semiskilled workers. Credit systems capable of enabling the construction of the housing and infrastructure needed by a rising middle class will also create the employment opportunities that bring new workers and families into the formal sector and into the rising new class of creditworthy households.

The key missing goal of the international financial reform, in our view, then, is the development of a financial system that allows working people and emerging middle classes access to long-term credit for such purposes of home ownership, education, and the start-up and expansion of small businesses. As the experience of the Western democracies in the latter half of the twentieth century demonstrates, the development of a middle-class-oriented financial system is the single most important social prerequisite for the development and consolidation of middle-class living standards for the majority of the population.

Thanks to the growth of international financial markets and the industrial revolution that is taking place in much of the developing world, the creation of a mass class of small business and homeowners and consumers is now, as suggested above, a viable option for many emerging economies. Yet, to date, international capital-market integration has not served the broader middle-class-oriented development needs of emerging economies very well. In fact, the aspiring middle classes in many emerging economies have suffered disproportionately from this decade's financial crises. In East Asia, the urban working and middle classes were particularly hard hit by the 1997–98 crisis, as declining employment and wages hurt middle-income salaried workers, and high interest rates devastated small and medium-sized businesses.

The propensity of the international financial system to crisis, however, is not the only problem. Access to capital for many investments associated with a middle-class economy is limited by a combination of undeveloped domestic capital markets, the perceived risk on the part of international investors, and the volatility and short-term bias of foreign exchange markets. But, as we show in this report, changes in the international financial architecture can reduce if not eliminate many of these constraints and obstacles as well as mitigate the risk of repeated crises.

In our view, the goal of middle-class-oriented development incorporates and reconciles all three dimensions of international financial architecture better than any other alternative development model. To begin with, middle-class-oriented development underscores the need for the kind of economic principles and neo-liberal reforms being advanced in official policy circles. Middle-class-oriented development depends upon the development of deeper, more efficient long-term capital markets in emerging economies. Thus, reforms to create greater transparency, more uniform accounting standards, better bankruptcy and property laws, and more prudent bank regulation are all critical to the success of middle-class-oriented development, as are sound macroeconomic policies and a liberal trade and investment regime. At the same time, middle-class-oriented development supplies what has up to now been the missing ingredient for many of these reforms—namely, a popular

basis of support. From the beginning, a policy aimed at putting ordinary people in homes of their own would be politically popular, making it easier for emerging economy politicians to build broader coalitions for sustainable reform.

Creating democratic long-term capital markets in developing countries for such popular purposes as home ownership and small business development is thus both good politics and good economics. And this combination makes for a sound and durable financial system as well. There are, in fact, a number of reasons financial systems are more stable when they serve the long-term credit needs of an emerging middle class. Consider, for example, how making thirty-year mortgages widely available would strengthen the domestic financial systems of emerging markets. Any system involving securitization of mortgages would involve the imposition of serious regulatory controls—to ensure that all mortgages conformed to underwriting guidelines. Such controls are now absent in most emerging economies. It would also involve a fair and orderly bankruptcy system, which again is absent in most developing countries.

More generally, banking systems resting on numerous loans to individual homeowners and enjoying access to strong secondary debt markets are inherently more stable than systems resting on a handful of loans to large borrowers. The United States, for example, has what is widely considered to be the most flexible and best-developed capital market in the world. Yet mortgages remain the cornerstone of this market. Mortgage lending accounted for 30.2 percent of all borrowing in the United States in the third quarter of 1999—by far the largest single component of the credit market.⁶ In fact, 25.8 percent of all debt in the United States, excluding open-market paper and Treasury securities, is mortgage debt.⁷ The existence of this large, stable pool of finance—with a diversified

⁶Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 2000* (Washington, D.C.: Board of Governors of the Federal Reserve System, 2000), p. 11.

⁷*Ibid.*, p. 8.

risk basis, much of it insured—was absolutely critical to the development of U.S. capital markets. Only the large and liquid market in U.S. Treasury obligations has played a greater role in the development of the American capital market. Financial instruments involving securitization were initially developed for the mortgage market, and the experience in this relatively tame market gave firms and investors the experience and the confidence needed to venture into other forms of capital market innovation.

As to the second dimension of international financial architecture, middle-class-oriented development, by its very nature, serves a number of widely recognized social goals: the vesting of ordinary people in property ownership, the alleviation of poverty, the creation of a vast array of both skilled and entry-level jobs, and the reduction of trade tensions. Thus, it is more likely to command political support in both developing and developed countries than is the current emphasis on export-oriented growth. Moreover, it would serve a much larger world policy purpose. Just as Bretton Woods was critical to building a stable democratic peace in Europe and East Asia following World War II, an international financial architecture that supports middle-class-oriented development in populous emerging economies would help create a more stable world by facilitating the growth of a large and sustainable middle class in these countries.

Not without reason, U.S. foreign policy experts see the growth of a strong middle class in developing countries as the basis for sustainable progress toward stable democratic government—and for a peaceful world. Globalization has promoted rapid change in many emerging economies, but it has not yet delivered a sustainable middle class. Such a disparity is a prescription for greater instability. Most emerging economies have disproportionately large populations under the age of twenty-one. In order to avoid disruptive change, they will need to produce a far larger number of jobs as well as greatly expand their infrastructure of schools, roads, and sewage systems. Only a program aimed at expanding home ownership and public infrastructure to complement export-oriented manufacturing and services has a chance of meeting this daunting challenge.

The development consequences of this kind of middle-class-oriented program should be obvious: expanded job growth, improved infrastructure, and less export dependency, to name just a few. The surge in home-building alone would provide major economic stimulus in developing countries, creating new jobs and opportunities for everyone from day laborers to construction companies to refrigerator factories and shingle-makers. The social and political consequences also bear noting: the creation of an independent middle class of homeowners, the promotion of small and medium-sized business, and the development of new growth zones outside major metropolitan centers. The spread of home ownership in the developed world has been critical to the development of stable middle-class societies, giving hundreds of millions of people increased security and dignity. Indeed, the creation of a homeowner class is one of the surest methods known to help a society achieve long-term political stability. Homeowners have a stake in the system, a piece of property that is very real and important to them. They are thus resistant to crackpot utopian schemes and intolerant of reckless government policies that raise interest rates or otherwise threaten security. Indeed, as one study shows, middle-class voters tend to eschew extremes on both sides of the political spectrum.⁸

Particularly in emerging economies where both democratic institutions and market-oriented economic institutions are relatively new, the importance of mass property ownership for good governance is hard to exaggerate. It is not only the U.S. example, where independent small farmers were the basis of the emerging American democracy, that underscores the link between mass ownership of property and mass support of market economies in a democratic context. The land reforms of the French Revolution created a basis for France's development of democratic and market-friendly institutions in the nineteenth century; similarly, land reform in postwar Japan played a significant role in that country's democratic development. The survival of small farmers helped Poland

⁸See Peter Mateju, "Winners and Losers in the Post Communist Transformation," *Innovation*, vol. 9, no. 3 (1996).

make one of the most successful transitions from socialism to a democratic market system in Europe; many observers see the key to South Africa's future in the resolution of currently unanswered housing and land questions. Many reformers in China view the development of a housing market characterized by individual ownership as critical to the further development of both political and economic reforms.

Under contemporary conditions, agriculture can provide only a diminishing minority of the population with a livelihood and a property ownership stake. Thus, in today's modernizing economies it is home ownership rather than agricultural land ownership that becomes the form of property most important for the consolidation of pro-market policies in a democratic social order. Most advanced Organization for Economic Cooperation and Development (OECD) economies have recognized this by devoting significant resources and energy to increasing the rate of owner-occupied housing. As noted earlier, many emerging economies have surpassed the levels of productivity and per capita income that western Europe, the United States, and Japan had at the time the latter societies made the housing question a central element of national economic policy. Developing countries thus have the physical resources to give greater priority to home ownership. What they lack are the credit markets and policies that can make home (or apartment) ownership possible for a majority of their working families.

Finally, as to the third dimension of international financial architecture, middle-class-oriented development offers a much-needed alternative to conventional, manufacturing based export-oriented development. As world economic conditions continue to change, export-oriented development has approached the limits of its success. Indeed, future world economic growth will depend upon tapping pent-up internal demand in emerging economies and that means enlarging the middle classes in those economies.

Export-led development worked remarkably well when, in the early 1980s, there was just a handful of mostly small countries—Japan and the four Asian tigers, Taiwan, Hong Kong, Singapore,

and South Korea—that followed the strategy. But by the early 1990s the export output of these countries had begun to outstrip world demand, which was still largely provided by consumers in the United States and Europe.

As more economies joined the export pack, competition tightened. Late emerging, export-oriented countries, like the Philippines, no longer compete against factories in high-wage economies like the United States and Germany but with even lower wage counterparts in Bangladesh, China, and Sri Lanka. The result has been the buildup of excess capacity in many basic manufacturing industries—from textiles to steel to electronics. And with so much excess capacity, the terms of trade for those manufactured goods has declined, as has the return on investment.

Unfortunately, for export-oriented emerging countries everything points to a continuing deterioration in the returns on investment and terms of trade for many manufactured goods. The parallel to an earlier transition from agriculture is instructive. When the manufacturing economy first developed in the nineteenth century, mechanization, transportation, and preservation technologies were opening new areas of the globe to the production of food and fibers. But the increases in agricultural productivity combined with vast expansion of land under cultivation led to a permanent fall in the price of agricultural commodities compared with other goods. Farm employment plummeted along with commodity prices; only well-capitalized and mechanized farms—along with those protected by tariffs and subsidies—were able to survive.

Something similar seems destined to happen in manufacturing. With the industrial revolution expanding into thickly populated districts of the developing world, manufacturing may face the sort of chronic over-capacity problems that agriculture has endured for most of the last century.

Indeed, this trend is already evident in the declining terms of trade for lower wage manufacturing goods, and for a number of reasons it is likely to grow worse in the coming years. One reason is that the demand for manufactured goods will presumably increase more slowly than demand as a whole in the developed

economies, which up to now have served as the main markets for the goods of export-led economies. Growth in demand for services has long outpaced growth in demand for manufactured goods in the advanced industrial democracies, and the demographic trends suggest that, if anything, the shift toward consumption of services will accelerate. As populations age, they spend more on medical care and less on stereos and sports cars. Slow population growth, or absolute population decline in countries like Italy and Japan, will also trim the demand for such goods as housing materials and home furnishings. Even where manufacturing demand remains strong—for computer components, for example—ferocious competition will squeeze returns.

While it is unlikely that the course of manufacturing in the next century will exactly repeat the history of agriculture in the last, problems of overcapacity, commoditization, narrow margins, and declining terms of trade are likely to dog the steps of economies that cannot find additional engines of growth to supplement the manufacture of consumer and even capital goods in the years and decades to come.

In short, without a shift in policy away from South-North oriented, manufacturing-based, export-led growth, more and more developing countries will be chasing diminishing export opportunities in the developed world. To suggest that developing countries must move away from dependence on manufacturing exports is not to suggest that they should abandon the export business—or that Western protectionism should be met with indifference. The export of manufactured goods will remain a major factor for many countries, and the availability of cheap manufactured goods from emerging economies will continue to play a significant role in facilitating the transformation to post-industrial economies in the advanced world. (By the same token, while it is no longer realistic to count on agriculture as one's long-term prime source of foreign exchange, many developing countries would benefit substantially from an end to the unconscionable restrictions on agricultural trade.)

With demand for manufactured goods in the North growing more slowly in the future, domestic demand and regional demand (or more broadly South-South trade) will have to expand to

replace demand growth in the North as the major engine of future expansion for manufacturing. And, for better or worse, emerging market consumers do have a lot of catching up to do. China, for example, has barely one-half the television sets per capita as Germany. In the United States, there are forty personal computers per one hundred people; in Brazil, there are fewer than three.⁹ The same pattern emerges when it comes to necessities. Effectively, 100 percent of U.S. households enjoy access to safe water. In many developing countries however, only one-fifth of households do.¹⁰ In Germany, there are ten hospital beds for every one hundred people; in Indonesia there is less than one.¹¹

Many developing countries face a situation similar to that of the advanced industrial economies in the middle of the twentieth century. Having built the means of mass production, they must now find ways to stimulate and finance domestic mass consumption to substitute for export demand. Such a shift from export-oriented growth will almost certainly require a reduction in savings rates in a significant number of emerging economies. Private and, in some cases, government consumption must rise as a percentage of GDP. And that will require big changes in spending patterns. In France, private consumption represented 79 percent of GDP in 1998; in the United States the figure was 83 percent. By comparison, private consumption in China was just 59 percent of GDP; in Malaysia, 56 percent; and in Singapore, 50 percent¹² Developing countries must be able to consume more while exporting a smaller percentage of their final output to the North.

Growth in demand for manufactured consumer goods in emerging economies is only part of the answer. Emerging economies will also need to participate in the most dynamic sectors of the new technology-based service economy. This implies that even as emerging economies increase the share of private consumption in

⁹*Statistical Abstract of United States*, The National Data Book, 119th edition, 1999, p.846.

¹⁰*World Bank Social Indicators of Development: 1996*, pp. 157 and 360.

¹¹*World Bank Social Indicators of Development: 1996*, pp. 127 and 159.

¹²*IMF International Financial Statistics Yearbook, 1999*. All figures referenced are from 1998.

GDP, they must also find ways of funding the considerable educational, technological, and infrastructure investments necessary for success in the industries of the future.

This new development agenda for developing countries has profound implications for international financial architecture. In order to both consume and invest more, emerging economies will need to import capital in order to run sustained external deficits. And in the face of such long-term current account deficits, the international financial system must be able to promote substantial long-term capital flows from the G-3 advanced industrialized countries to emerging economies.

Such an architecture, if properly designed, would help solve another major problem of the world economy: namely, the growing demographic-related imbalance between the savings and investment needs of an increasingly capital-rich group of advanced countries and a growing number of capital-hungry emerging economies.¹³ In Europe and Japan, and to a somewhat lesser extent in the United States, aging baby boomers, worried about adequate provision for their retirement over the next two decades, are beginning to produce a pool of savings and capital much larger than can be profitably invested in the G-3 economies themselves. By contrast, many emerging economies have burgeoning young populations, many with a large proportion under the age of twenty-one. These countries need more capital to educate and to create jobs and housing for their expanding populations. While some of these societies, especially those in Asia, have relatively high savings rates, they cannot both increase consumption and expand investment within the constraints of the current system.

An international financial architecture for the early 21st century must come to grips with this problem by facilitating long-term capital flows from the G-3 countries to the emerging economies. Thus, not only must systemic changes be made in the current system of global governance to help rechannel international

¹³Wendy Dobson and Gary Hufbauer, assisted by Hyun Koo Cho, "World Capital Markets: Challenge to the G-10," paper published by the Institute for International Economics, Washington, D.C., July 2000.

capital flows, but far-reaching reforms must be enacted in the financial systems of emerging economies in order to efficiently use those capital flows. Such a reform effort would entail a positive-sum bargain between aging savers in the developed world, who need profitable returns to prepare for retirement and maintain current consumption levels, on the one hand, and businesses and consumers in developing countries, who need access to more capital to build more efficient businesses to satisfy rising consumer needs, on the other.

OBSTACLES TO MIDDLE-CLASS-ORIENTED DEVELOPMENT

As attractive as it is as a development model for most emerging economies, middle-class-oriented development cannot succeed without changes in the international financial architecture that substantially reduce risk for both international and domestic investors. The current international financial system simply contains too many risks for there to be a substantial increase in long-term capital flows to emerging economies on a sustainable basis.

There are three features of the current international financial architecture that in particular pose obstacles to middle-class-oriented development: the lack of stable currencies, which not only makes developing economies crisis prone but also distorts their development; shallow and badly regulated capital markets, which tend to deny credit to small businesses and to ordinary citizens; and poorly capitalized national and international financial institutions, which lack the resources and legitimacy needed to promote real capital market reform and stem crises in emerging economies.

1. Lack of Stable Currencies

One of the most serious obstacles to middle-class-oriented development lies in the currency instability that afflicts nearly all developing economies. Currency risk may in fact be the single largest deterrent to long-term capital flows. Moreover, it may be one of the principal barriers to the development of deeper and more efficient domestic capital markets, upon which in turn middle-class-oriented growth depends.

Many emerging economies, of course, lack a stable currency because of a history of inflation and economic mismanagement, which has undermined investor confidence in the currency. Currency devaluations have been a frequent occurrence throughout Latin America, for example, and investors are naturally reluctant to hold assets denominated in a depreciating currency—especially for

the long term. To do so in the short term, they often demand large risk premiums that effectively price homeowners and small and medium-sized businesses out of formal credit markets. As a general rule, currency risk steepens yield curves, shortens maturities, and denies all but a relative handful of well-capitalized and/or well-connected firms and individuals full access to the international economy.

This problem is not limited, however, to developing countries with bad policies. Virtually all emerging economies have what are called soft currencies in that there is little foreign demand for assets denominated in the local currency and no liquid long-term markets denominated in that currency. Even residents of emerging economies, if they have a choice, often hold significant financial assets denominated in dollars or another hard currency. In other words, a currency is soft when it cannot be used to borrow abroad, or even domestically to borrow long term.¹⁴

By that definition, only the most advanced OECD economies with long histories of monetary stability—the United States, Britain, the Euro-zone economies, Australia, Canada, Japan, and Switzerland—have hard currencies. Nearly all other countries are presumed to have significant currency risk, which is reflected in the sizeable spreads at which they must borrow in international markets. In an age of open capital markets, the lack of stable currency is not just a question of policy, but also a function of the size of the market for any particular currency. International investors are reluctant to hold for the long term financial assets denominated in currencies with small and illiquid foreign exchange markets—in part, because they cannot properly hedge. This only adds to the short-term bias that troubles the financial markets of soft currency economies.

Because of this short-term bias, economies with soft currencies face risks and distortions in their economies that most advanced economies are able to avoid. To begin with, economies

¹⁴Edwardo Fernandez-Arias and Ricardo Hausmann, “International Initiatives to Bring Stability to Financial Integration,” Inter-American Development Bank, Washington, D.C., March 1999, p. 12.

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with soft currencies are prone to financial crisis. Financial institutions and firms in soft currency economies face what Pedro Pou, president of the Central Bank of Argentina, has called the “devil’s choice”: they must choose between borrowing short-term in their own currency domestically, thus creating a maturity mismatch, or they can borrow longer term in dollars and be stuck with a currency mismatch.¹⁵ As a practical matter, many emerging-market financial institutions end up with both currency and maturity mismatches.

In the 1997–98 Asian crisis it was just such maturity and currency mismatches that helped trigger the financial crisis that engulfed many emerging-market economies, beginning with Thailand. Asian banks borrowed short term in foreign-currency debt and lent long term in domestic currency. At the time, that seemed to be a rational business move. By borrowing short term from cheaper foreign markets, Asian banks and companies could substantially reduce their borrowing costs. But in so doing, they accumulated short-term foreign currency liabilities that were not backed up by foreign currency assets or covered by short-term foreign currency income streams. Thus, they set themselves up for devastating losses when investor sentiment turned sour and the currency depreciated, leaving them with foreign currency debts they could no longer service.

The fact that the borrowed funds were used for local speculative purposes or were invested in industries facing excess capacity obviously contributed to the crisis. But even more prudent borrowers from soft currency economies can end up with currency and maturity mismatches. By their very nature, many high-yield projects in developing countries, such as building a factory or a new highway, have only a long-term payoff, or do not have foreign exchange earnings. At the same time, much of the lending to developing countries will continue to be concentrated in short-term maturities.

¹⁵Quoted in Eduardo Fernández-Arias and Ricardo Hausmann, “Is FDI A Safer Form of Financing?” Paper prepared for the Annual Meeting of the Board of Governors, Inter-American Development Bank and Inter-American Investment Corporation, March 26, 2000.

As long as emerging economies face the devil's choice of either borrowing short-term or borrowing in dollars, it will be difficult for them to avoid ending up with weak and risky balance sheets. Any country with a sizable stock of foreign currency debt is vulnerable to exchange-rate movements, which can have very large balance sheet effects. When a country's currency depreciates, its foreign currency liabilities increase and its assets depreciate accordingly. A large enough depreciation can literally wipe out the capital of an emerging economy company or bank overnight.

This balance sheet effect of currency depreciation makes even well-managed emerging economies vulnerable to exogenously caused shifts in international capital flows. As a number of studies have shown, international capital flows to developing countries increase or decrease for reasons often unrelated to the investment needs or investment climate of a particular emerging economy. In the 1990s, changes in net capital flows were closely correlated with U.S. interest rates, with lower rates heralding an increase in international capital flows to emerging economies such as occurred in 1995–96 and with higher rates precipitating an outflow such as occurred in 1997.¹⁶ Faced with falling interest rates in more mature markets, or what is known as yield famine, many large institutional investors have in this decade sought to increase their return by seeking out higher rates of interest in emerging economy debt, a practice that is likely to continue in spite of recent crises.

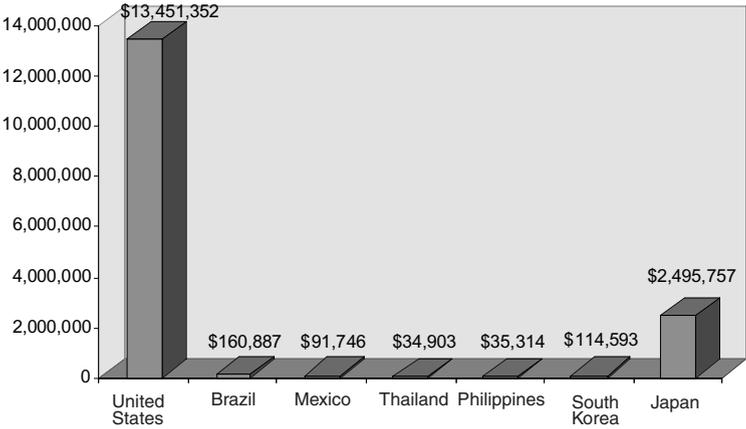
Because of the relative size difference between the financial markets of the most advanced industrialized countries and those of emerging economies, even marginal shifts in funds by international players can overwhelm the capacity of small economies and banking systems. As economist Stephen Roach has pointed out, the industrial world has enormous pools of savings and financial capital. By contrast, the developing world has very small capital markets. The combined equity market capitalization of the United States,

¹⁶See Eduardo Fernández-Arias, "The New Wave of Capital Inflows: Sea Change or Just Another Tide?", Paper prepared for the Annual Meeting of the Board of Governors, Inter-American Development Bank and Inter-American Investment Corporation, March 26, 2000.

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Europe, and Japan, for example, is close to \$30 trillion, compared with less than \$1.5 trillion for the leading equity markets of the developing world. As Roach notes, a mere 1 percent allocation out of the United States would mean a movement of \$150 billion.¹⁷ Even that modest shift would overwhelm many of the emerging debt and equity markets, leading to asset bubbles and serious instability.

Market Capitalization
(in millions of U.S. \$)



Source: *Emerging Stock Markets Fact Book 1999*, International Finance Corporation.

Such large inflows and outflows relative to the size of most emerging economies leave countries without an optimal exchange rate choice. If they let the currency float, inflows cause the currency to appreciate and the economy to lose competitiveness, widening trade and current account deficits, and leading eventually to a crisis of confidence. On the other hand, if countries peg their currencies, they risk their economy overheating from increases in the money supply. Moreover, as we saw in the Asian crisis, nominal pegs can be an invitation to speculation as well as to over-borrowing.

¹⁷Stephen Roach, "The Frothy Market Scene Looks Ripe for the Next Big Crisis," *International Herald Tribune*, Opinion Section, April 6, 2000, p. 10.

The combination of stable nominal exchange rates along with interest rates differentials between international and domestic rates creates a one-way bet for speculators seeking to benefit from international arbitrage. This combination also provides a strong incentive for domestic firms and banks to reduce their cost of finance by borrowing abroad. Everything works fine at first but over time the economy becomes extremely vulnerable to capital flight. When capital flows reverse themselves, as they often do when interest-rate spreads disappear or when the peg looks vulnerable, the currency collapses and domestic banks and companies are left with an unsustainable level of short-term debt.

The small size of emerging economies relative to international capital flows also prevents investors from being able to take normal prudential measures, thus making them more skittish at the first sign of trouble. Small, illiquid foreign-exchange markets for soft currencies, for example, make it difficult or too expensive for investors to properly hedge or to employ modern portfolio and risk-management systems. If they do hedge, it is often in a one-way direction that contributes to the eventual collapse of the currency. On the other hand, the central banks of emerging economies find that the small size of their foreign exchange reserves relative to capital flows makes it difficult for them to defend the currency. As we saw during the Asian financial crisis, while many Asian countries had more than enough reserves to cover imports, they did not have enough to both service short-term debt and defend the currency from speculative attack.

There are, of course, a number of ways that developing economies can protect themselves from the vicissitudes of international capital flows. They can adopt Chilean-style, short-term capital controls on inflows in order to stem inflows. But many countries are reluctant to do so for fear of discouraging much-needed foreign capital.

The fact that soft currencies are crisis prone is only part of the problem. An equally serious problem for middle-class-oriented development is how soft currencies distort an economy's financial system and consequently its development. In fact, it is very difficult for countries with soft currencies to develop the efficient, flexible,

and democratically accessible capital and credit markets upon which middle-class-oriented development depends.

The basic problem is that soft currencies breed an investment climate of short termism that effectively rules out a credit market for such important middle class purposes as home ownership or small business start-up and expansion. In emerging economies, yield curves are extremely steep, and maturities extend in many cases no further than three years (except perhaps for politically favored enterprises from a state-directed bank). For investors, especially international investors, there is no rate of interest that would compensate them for the risk of investing in a soft currency for, say, five years, let alone ten or thirty years.

As a result, interest rates and the cost of capital in most emerging economies are prohibitively high. Even the cost of capital for governments is very high due to the uncertainty over the future exchange rate. Since the Asian financial crisis, spreads on sovereign emerging market debt have averaged more than 900 basis points.¹⁸ Such a high cost of capital increases the cost of government-funded infrastructure and public investment as well as the cost of debt service. It imposes enormous costs and liabilities on all levels of government, making many social and infrastructure investments prohibitively expensive. By forcing countries to borrow short, it also exposes them to the risk of repeated financial crises when they must roll over large amounts of debt under adverse credit market conditions.

Consider what infrastructure in the United States would look like if state and municipal governments were not able to borrow at low interest rates. School bond issues, highways, sewer systems—all would become more expensive. Taxes would have to increase, and services would have to decline.

Capital is even more expensive for the private sector in emerging economies, if it is available at all. Even when world interest rates are low, domestic interest rates in emerging economies can be prohibitively high. In 1996, for example, real interest rates for

¹⁸J.P. Morgan Emerging Market Bond Index.

domestic companies ran as high as 25.3 percent in Brazil; 10.5 percent in Thailand, and 11.7 percent in the Philippines—in comparison to approximately 5 percent in the United States.⁴⁹ This high cost of capital reduces investment. It penalizes the private sector and stunts its development. The result is slower growth, fewer jobs, and more poverty.

The combined impact of high interest rates and short-term loans not only deters investment in general, but it is especially damaging to certain kinds of economic activities. In fact, the high cost of capital precludes a whole range of investments that would otherwise be profitable in the United States and other developed countries. Small businesses and ordinary citizens are unable to borrow at reasonable rates. That leaves small business to rely either on their families or on loan sharks and the informal credit market. Even small and medium-sized businesses find capital markets largely closed. Small entrepreneurs and common citizens wanting to buy houses and other durables are trapped by the high interest rates and short maturities characteristic of economies with soft currencies.

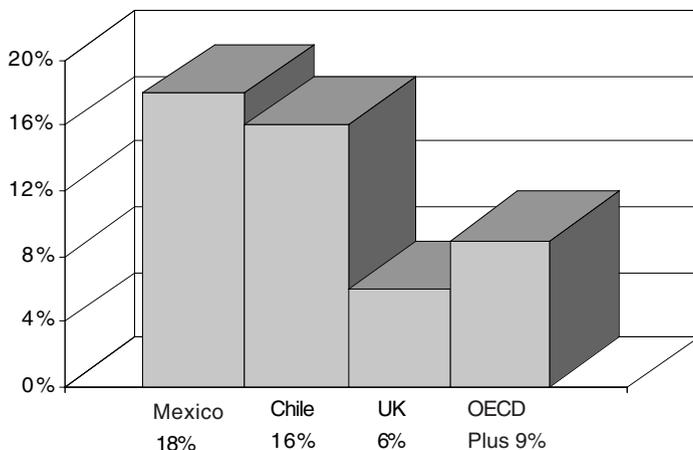
There are no lack of entrepreneurs and enterprising businessmen and women in emerging economies. What they lack is access to financial capital. The cost of capital for business start-ups in Brazil, Mexico, and other emerging economies, if it exists at all, is outrageously expensive. As noted earlier, the real rate of interest charged on a business loan in Brazil, for example—if you can find a commercial bank willing to make such a loan—generally exceeds 25 percent. Even the most brilliantly conceived business plan would be hard pressed to justify paying 25 percent to get the funds needed to service such loans.

This climate of short-termism and high interest rates seriously distorts the development pattern of many emerging markets. For one thing, it tends to favor big companies over small companies and families. In fact, as illustrated by the chart below, large firms tend to dominate the credit markets of most developing economies. This climate also privileges foreign-exchange earning

⁴⁹*IMF International Financial Statistics*, vol. 53, no. 3 (March 2000).

exporters over companies that produce for the domestic market. Additionally, it favors foreign firms with access to the international credit markets over local companies that must borrow in the local currency at much higher rates.

Credit to Largest 20 Firms As A Percentage of Total Credit



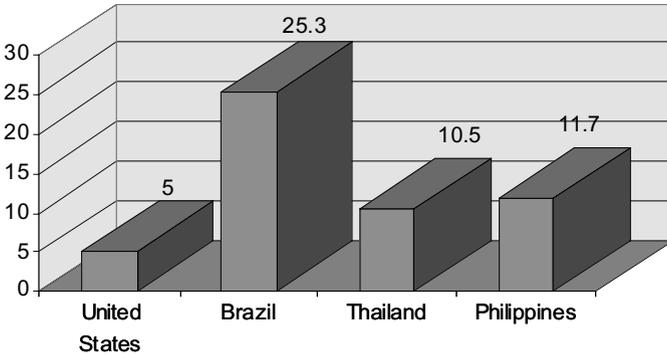
Source: Florencio Lopez-de-Silanes, *Investor Protection in Mexico: An Agenda for the Reform of Capital Markets*, unpublished paper, April 8, 2000.

As noted earlier, loans in U.S. dollars generally carry much lower interest rates and much longer maturities than do loans in soft currencies. Only the largest, best-positioned firms with foreign exchange earnings have access to international credit markets or to dollar-denominated loans. In many cases, even domestic banks are reluctant to loan in dollars to companies if they do not have foreign exchange earnings. Such discrimination in favor of the large export-oriented sector is understandable, given that lending in dollars to enterprises or individuals whose earnings or assets are denominated in local currency is too risky for banks and would expose them to the kind of crisis-creating currency and maturity mismatches noted earlier.

But however understandable, this discrimination smacks of a form of financial apartheid, which effectively eliminates most

households and small business from credit markets. While the wealthy have access to hard currency and reasonably priced credit, the rest of the economy is stuck with the local soft currency and denied access to the credit markets. It is now widely understood that the poor are the chief victims of inflation, and fortunately a number of countries have taken strong action against this long-time scourge. But it is even more true that the poor and the middle class are the victims of short-term, undeveloped capital markets, and much less has been done to address these serious problems.

Prohibitively High Borrowing Rates for Domestic Companies



Source: The Economist, SELIC rate & Financial Times

2. Shallow and Badly Regulated Capital Markets

Given their short-term bias, it is not surprising that soft-currency economies have shallow and underdeveloped capital markets. Nearly all emerging economies lack the financial institutions and instruments that one normally associates with middle-class societies. Consider, for example, the range of business and home credit institutions that created the U.S. housing market: among others, cheap and tax-privileged thirty-year self-amortizing mortgages; down payment programs so that veterans and low-income families could purchase homes; and the Fannie Mae system that bundles conforming mortgages into securities for large investors. Or take the variety of government-backed loan programs that have

given small businesses and farmers access to reasonably priced credit.²⁰ All these are absent in many emerging economies.

Also missing is the system of municipal and utility finance, which has funded much of America's schools, roads, and other public improvements. Because most emerging economies lack capital markets or financial instruments for these purposes, a critical sector of middle-class-oriented development is stunted. Education, public works, and housing are all non-tradable goods and thus a primary sector for domestic-driven growth. They are also principal generators of both skilled and entry-level employment, and thus one key to the growth of an aspiring middle class.

In addition to lacking these home- and consumer-credit institutions, most emerging economies have poorly developed equity and bond markets as well as secondary debt markets. The lack of secondary debt markets—for the securitization of home mortgages, for example—makes it very difficult for primary lenders to diversify adequately their risk, and thus makes the financial systems more vulnerable than those of more advanced economies.

With the help of the World Bank's International Finance Corporation, many emerging markets have in recent years introduced exchanges for the listing and trading of equity and debt securities. But because of their small size, these exchanges tend to be plagued by insider trading and lack of liquidity, and dominated by a few large companies. Disputes over minority shareholder rights are common, as are complaints about share dilution and other asset-stripping practices of majority controlling shareholders.

As a result of poorly developed equity and secondary debt markets, most emerging economies are still overly dependent on the banking sector, both domestically and internationally. This poses two kinds of problems: First, it tends to increase the risk of financial crises. Banks are pro-cyclical institutions: they lend more when times are good and cut back when things go bad. And their own fortunes tend to track those of the business cycle. As a

²⁰For further discussion, see Jane D'Arista, "Building the Financial Infrastructure for Middle-Class Emerging Economies," a paper from the Project on Development, Trade, and International Finance, Council on Foreign Relations, New York, 2000.

result, banking crises tend to be a more or less permanent feature of the business cycle. Banks are highly leveraged organizations—they have a slender wedge of their own equity capital supporting a large volume of business. As the business cycle advances, they attract more deposits, their equity bases expand, their lending capacity is upgraded, and they make more loans. But no matter how prudent individual bankers may be, many of those loans will be made at inappropriate spreads at the point of the business cycle in which they are approved.

As suggested earlier, banks in developing countries are particularly crisis prone because they must borrow short term, often in foreign currency markets, and lend to projects that have longer term returns in local currency. This leads to both currency and maturity mismatches, which makes the financial system vulnerable to currency depreciations. Moreover, banks in emerging economies are often structurally weak institutions simply by virtue of the high interest rates their loans carry, which substantially increase the risk of lending. They are also weak structurally because they are not able to diversify their risk among a large number of small borrowers and or through secondary debt markets, and because they suffer from a high degree of noncompliance and nonpayment, a reflection in part of poor bankruptcy laws and in part of bad regulation.

The second problem with the over-reliance on the banking system is that in many emerging economies banks are highly inefficient at allocating capital. Banks in some countries are subject to political influence, corruption, and cronyism. Special interest groups can easily capture banks, and have their loans distributed like prizes to a favored few. To be sure, banks can be effective instruments of state-directed industrial development in cases where there is a very conscientious bureaucracy to oversee them, and they are essential for funding small and medium-size businesses. But in practice, this tends to be the exception, not the rule. More often, they misallocate resources to nonproductive, politically protected enterprises and businesses.

Indeed, because many banks are state-related, they often serve as instruments for expropriating wealth from small working and middle class savers to finance politically protected state-directed

enterprises. Even when they are successful at promoting industrial development, they can easily become captive of large conglomerates that over time become inefficient, as is the case of the banks in South Korea.

One of the main problems, then, with the present international financial architecture is that it contains strong biases toward debt finance, especially intermediation by banks, and does not adequately support equity finance and direct investment. The need to redirect capital flows toward equity financing was supposedly one of the main lessons of the Latin American debt crisis of the 1980s. Yet, despite this consensus, bank lending and borrowing played a pivotal role in the financial crises of the 1990s. As economist Kenneth Rogoff has pointed out, if international capital flows to developing countries took the form of equity investment, there would be an automatic device for risk sharing. Currency depreciations could still lead to sharp drops in local stock markets, but there would be fewer liquidity effects and less risk of a full-blown financial crisis.²¹

Soft currencies, of course, are not the only reason for shallow, short-term capital markets. Indeed, most emerging markets lack the legal infrastructure and regulatory machinery upon which deeper and more sophisticated capital markets depend. The problems are well known, and do not require elaborate treatment here except to note what every investor with experience in emerging market finance knows.²² Although conditions vary in emerging economies, too often vague or ambiguous property laws with weak protections of minority shareholders and lax accounting principles deter equity investment. Poor bankruptcy laws, biased enforcement of existing laws, and poorly developed commercial codes deter bank and other lending. And inefficient and politically influenced judicial systems make enforcement of legal instruments haphazard at best and impractical at worst.

²¹Kenneth Rogoff, "International Institutions for Reducing Global Financial Instability," *Journal of Economic Perspectives*, vol. 13 (Fall 1999).

²²For further discussion, see Glenn Yago, "Private Capital Flows, Emerging Economies, and International Financial Architecture," a paper from the Project on Development, Trade, and International Finance, Council on Foreign Relations, New York, 2000.

The absence of an adequate bankruptcy law and court system can have especially deleterious effects on the financial system. It makes legal coercion less credible, exacerbating the willingness-to-pay problem. It also increases the costs of crises because it precludes concerted action to deal with bad debts and to restructure a bank's or company's liabilities.

The shortcomings of many developing countries' legal infrastructure is the focus of many of the proposed neo-liberal reforms taken up by the International Monetary Fund (IMF) and the Financial Stability Forum. These proposals call for greater transparency, for new bankruptcy and commercial codes, and new accounting standards. They also call for more prudent regulation. At question is not whether these reforms are necessary. They are. Rather, the question is why the international community has been so unsuccessful in getting developing countries to move more quickly on these basic reforms—a question to which we will return shortly.

Deep and efficient markets of the kind required for middle-class-oriented development depend upon an effective system of regulation and supervision, in addition to a proper legal infrastructure. But historically, such systems emerge only slowly as both elite and popular opinion learn from repeated experience that the inconveniences and costs of regulation and supervision are far less than the inconveniences resulting from their absence. Regulation in emerging markets is often suspect because it is subject to undue political influence and pressure from economic interests close to the government. This is particularly true in emerging economies like Indonesia and Mexico, where one party or group has dominated the institutions of government for a long period of time. But it also a problem in advanced emerging economies like South Korea, where there has been a long-standing interlocking relationship between the nation's banks, the largest *chaebols*, and the government bureaucracy. Even when political influence and corruption is absent, regulation and supervision may be inadequate because local administrators lack appropriate training or experience, or are so preoccupied with crisis management that they do not have the time or resources to exercise effective regulatory power.

In the aftermath of the Asian financial crisis, the IMF and the World Bank have been forced to devote more time and attention to questions of bank regulation and supervision. Accordingly, they have made their assistance contingent not just on certain macroeconomic targets but also on implementing certain microeconomic changes, including the adoption of appropriate supervisory and regulatory standards. Necessary though these efforts may be, it is unrealistic to expect the IMF to be able to fulfill or even substantially augment national regulation. The IMF, like most global institutions, is too distant and lacks both the mandate and resources to exercise effective oversight. Even when IMF officials have the time or detailed knowledge required for effective supervision, they lack the legitimacy and authority they need to operate national banking systems. Indeed, many of the reforms the IMF has proposed are considered suspect in the countries concerned because the IMF is perceived to be carrying out the agenda of its major shareholders. In particular, one such shareholder is the U.S. Treasury, which is sometimes suspected of being motivated more by the interests of U.S. banks and financial institutions than by the well-being of the country concerned.

The Asian financial crisis exposed a major regulatory gap in the global financial system. Regulating financial markets is increasingly beyond the capacity of many national governments—and certainly beyond the existing capacity of many governments in developing countries. Yet the IMF and Bank for International Settlements (BIS) do not have the mandate or resources to provide the kind of extensive oversight required. At best, a system of divided sovereignty is emerging; at worst, no one is really in control.

3. Inappropriate International Governance

This brings us to the final problem with the international financial architecture: namely, that national and international institutions as now structured are not able to provide effective governance for the development of integrated financial markets. Nor are they able to advance the reforms necessary for the development of financial markets for middle-class-oriented development. Part of the problem stems from the fact that both national and internation-

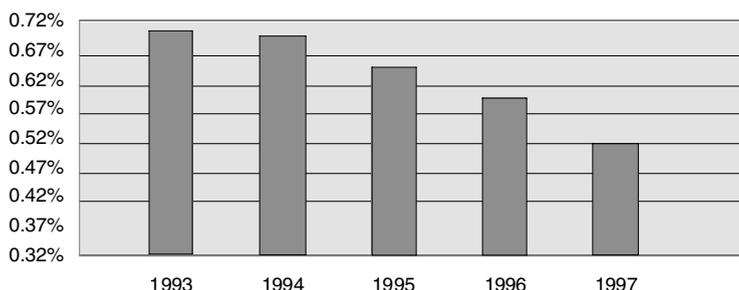
al institutions lack the resources needed for managing international financial integration.

At the national level, central banks often suffer from inadequate reserves, which make their currencies easy targets for speculative attack. By comparison to central banks in the most advanced OECD countries, most emerging-market central banks are poorly capitalized and not sufficiently independent from political influence to command credibility in the world's financial markets. What is worse, in today's world of open capital markets, it is very difficult for the national banks of developing countries, even the largest, to serve as effective lenders of last resort—to provide liquidity at a moment of crisis. Because emerging-market banking crises and currency crises are now often related, national central banks would need reserves large enough to be able to both defend the currency and to inject liquidity into the banking system. As a practical matter, that is virtually impossible for most emerging economies. Indeed, soft-currency economies have found that their ability to exercise an independent monetary policy has been negated by the vulnerability of their currency to speculative attack. As a result, when a banking crisis develops, emerging economies find that they cannot lower interest rates or pump money into the system. Instead, they must raise interest rates in an effort to restore confidence and to stem capital outflows. Raising interest rates, however, exacerbates the debt-servicing burdens of the nation's debtors, and produces an economic downturn.

The lack of an appropriate scale of resources at the national level is of course the reason why most emerging economies have been forced to turn to the IMF, not only to deal with persistent current account problems but to handle capital account crises such as those experienced by many countries during the 1997–98 crisis. Yet the IMF has not been prepared to handle the magnitude of the crises it has faced in recent years. In a world of extreme exchange-rate volatility and interlocked financial markets that are prey to herd behavior, what is needed is what economics columnist Martin Wolf calls, “a lender of last resort with deep pockets.” As Wolf points out, a true lender of last resort would stand ready to provide liquidity in support of any country deemed structurally sound

that was running out of reserves or suffering a currency crisis.²³ But because the IMF's capital base has not expanded to keep pace with the growth of international capital flows, it cannot perform this role with any assurance. IMF bailouts are simply too small in relation to the sums that can rush into and out of countries without controls.

IMF's Total Resources Relative to World GDP



Source: IMF *Annual Reports* (1994–1998) & CIA *Handbook of International Economic Statistics*, February 1999.

With its eleventh quota increase in 1997, the IMF has lendable resources of roughly \$283 billion.²⁴ As a percentage of world capital flows, this amounts to a fraction of the resources the IMF had upon its initiation in 1946. Because it has limited resources at its disposal, the IMF has few tools except high interest rates and austerity to deal with an economy suffering from a liquidity crisis. Only by shrinking domestic demand can it restore a country's external account to the black in order to generate a needed current account surplus and to replenish foreign exchange reserves. As numerous commentators have pointed out, there are good reasons why the IMF is so rarely, if ever, successful in restoring confidence in a country hit by a foreign exchange crisis. While the IMF has in recent

²³Martin Wolf, "Contagion and Capital Flows," *Financial Times*, October 6, 1998, p. 12.

²⁴International Monetary Fund, "IMF Quotas and Quota Reviews" (Press Release), July 31, 2000.

years put together sizable credit packages for crisis-stricken countries, it cannot freely lend to them at the time of greatest need. Rather, it disperses its funds only after countries have met a series of extensive conditions. And because these conditions are complex, it is not possible for private creditors and investors to know whether or when the funds will actually be available and thus whether a county will have enough foreign exchange reserves to meet its obligations and to defend itself against further speculative attacks.

In the wake of the Asian financial crisis, the IMF has taken some steps to improve its capability to act like a lender of last resort—or at least one with shallow pockets. In December 1997, it set up a special window—the Supplemental Reserve Facility—to deal specifically with capital account problems, a facility that was used to put together the Korean, Russian, and Brazilian rescue packages.

It has also moved toward the establishment of a contagion contingent fund for pre-approved countries, which would improve the IMF's ability to act quickly. Through this fund, the IMF would offer a new emergency line of credit, for which countries would have to prequalify by meeting certain macroeconomic and regulatory standards. The existence of this line of credit, it is hoped, would help stave off speculative attacks and runs on a country's reserves. But so far most large emerging economies have been wary about signing up for the fund for fear that would send the wrong signals to the market.

These are useful innovations and improvements, but in order to make a difference they will require further substantial increases in IMF resources. Given the tarnished credibility and diminished popularity of the IMF in many G-7 countries, especially the United States, such additional support is unrealistic. Even if such support were to become available, there is another question about the IMF's ability to act like a true lender of last resort, and that has to do with moral hazard. It is true that the growth of the global system demands an institution that provides liquidity in times of crisis, much like the Federal Reserve does in the United States. However, in order to avoid the risk of moral hazard, this institution also needs to have the ability to supervise its members, to detect problems, and to force remedial actions. As it is, the IMF's

conditionality powers, although seen as unnecessarily intrusive by some critics, are no substitute for effective supervision and regulation.

With each new crisis, the IMF and World Bank have taken on more tasks and charges, from financial-sector reform to poverty alleviation. To add yet one more function without rethinking others would only add to a serious case of institutional overstretch. Even as it is, the IMF and World Bank cannot cope with the variety of demands that the world has placed upon them. As the Meltzer Commission has warned, there is a danger in that by attempting to become “universal” institutions covering all problems in all countries, they are unable to focus effectively and thus undermine their own ability to effectuate real reform in the world economy.²⁵

Indeed, it is doubtful that the IMF can serve as the principal institution for promoting needed financial reforms in many emerging economies. For one thing, it lacks political legitimacy in emerging economies. Fairly or unfairly, the IMF is seen as unduly influenced by its largest Western shareholders, especially the United States. The whole purpose of independence in central banking is to remove political influence from the supervision of the financial system. Yet despite the high professional standards of their staffs, decision-makers at the IMF and, to a lesser extent, the World Bank are widely regarded as dominated by U.S. politicians. This gives us the worst-case form of international governance: the Bretton Woods institutions are controlled by politicians who are not responsible to the citizens of the countries most affected by their actions. The recent disgraceful row over the leadership of the IMF only underscores the degree to which the current system is political and not responsible or accountable to the billions of people who live in the countries where the IMF plays its major role.

Moreover, the IMF’s performance in the 1997–98 crisis has created a legacy of bitterness in Asia, which threatens its ability to

²⁵Report of the International Financial Institution Advisory Commission, Washington, D.C., 2000.

function effectively as a promoter of reforms in that critical region. Throughout many countries in Asia, there is a palpable desire to resist what is seen as the undue influence of the IMF, undermining the efficacy of IMF attempts to lead reform.

If the IMF lacks the moral leverage it needs to stimulate reform, it also lacks any substantial carrots by which to encourage reform in most emerging economies. In this sense, the IMF's underfunded capital base undercuts its leverage to effect real reforms in many emerging economies. Many of the reforms it proposes are either extremely painful to the population as a whole or threatening to the current power elite. Faced with the loss of power and popularity and without any hope of immediate economic results, many governments choose to put off many necessary reforms, doing just enough to win IMF funding. And despite the populist nature of some of the reforms the IMF champions, there is virtually no popular support for IMF reforms in most of the countries it serves, a legacy of its reputation for being a closed institution committed to austerity-oriented policies.

This helps to explain, then, why the international community has been so unsuccessful in promoting needed reforms in emerging economies. In short, profound popular and elite suspicion of existing international institutions and the lack of a stable currency conspire to make difficult and painful reforms even more difficult and painful. Well-meaning IMF officials can tell emerging economies that good policies create good results, but for many developing country leaders the evidence gets obscured by frequent international financial crises for which they bear little responsibility. Under current conditions, the connection between good policies and good outcomes is weak: in too many cases it takes a long time for good policies to bear fruit in better economic conditions. During that long time period there are too many possibilities for exogenous shocks that can derail economies even as they try to reform—or that can test the political will of countries when reforms become unpopular.

In short, good policies may not be enough in the short term to produce better economic results—although better economic results are needed to facilitate deeper reforms. The relationship between

Financial Architecture for Middle-Class-Oriented Development

reform and sound money is of course controversial. But on balance it seems that many emerging economies will be doomed to start-and-stop reform if efforts are not made to correct that part of international financial architecture that denies emerging economies sound currencies and supportive international institutions.

TOWARD A NEW INTERNATIONAL FINANCIAL ARCHITECTURE

Problems as deep and as pervasive as these will of course not be remedied easily or quickly. Nor can they be solved by good policies alone. Indeed, one of the central questions is how to create a system that facilitates what is often a painful and contentious process of reform in many emerging economies. The architecture of the international financial system does matter in this regard, and it especially matters if the goal is middle-class-oriented development.

As the previous discussion made clear, middle-class-oriented development depends upon institutional changes that substantially reduce risk for both domestic and international investors. It is not enough to focus on policies that, by making the financial systems more open and transparent, enable investors to better evaluate the risks. Nor is it enough to try to slow down capital flows, as other popular proposals would do. Reducing capital flows to developing countries or raising the cost of capital to borrowers in those countries are precisely the wrong steps to encourage.

Institutional changes, it is clear, do not occur overnight. But as we have seen with recent institutional innovations—the creation of the European Monetary Union, the coming into being of the European Bank for Reconstruction and Development (EBRD), and the establishment of the World Trade Organization (WTO)—they can evolve out of existing institutional arrangements or as a result of enlightened response to new circumstances and new needs in a remarkably short period of time.

Our analysis has led us to the conclusion that the creation of a new layer of regional institutions—led where appropriate by regional central banks—within a global system of international finance and governance holds the key to overcoming many if not all the obstacles to middle-class-oriented development. The regional central banks and other regional arrangements we propose would become the frontline institutions of the international financial archi-

ture in their regions. They would accomplish what national and global institutions are currently unable to accomplish. In particular, they would do the following:

- Solve the soft currency problem by adopting an external hard currency or by creating regional super-currencies;
- Overcome the lack of resources by taking advantage of economies of scale on a regional basis, by pooling capital from member governments, and by bailing in G-3 central banks, international financial institutions, and the private sector in a proactive way;
- Promote good governance and good policies by offering emerging economies regionally organized systems of financial market development;
- Provide mechanisms for the restructuring of existing debt, as well as debt relief for highly indebted countries willing to pursue good policies;
- Facilitate capital-market development by offering regionally organized market institutions and instruments, and by putting in place the legal infrastructure necessary for deep and efficient capital markets.

This emphasis on regional central banks is not to suggest that existing international institutions do not have a critical role to play in the proposed international financial architecture. By any standards, the IMF and the World Bank are among the more successful and well managed of the great international institutions. Much of the criticism that these institutions receive should be directed less at their policies or intentions than at an international economic status quo that has been unable to liberate billions of human beings from lives of extreme poverty. Any program of effective reform will require the continuing help and support of the Bretton Woods organizations. Yet the fact remains that the current international financial architecture does not and cannot provide all the support that the emerging world economy needs.

Today's international financial architecture essentially rests on two pillars: national governments and international institutions. A well functioning international financial architecture, in our view, needs three equally strong pillars—national, regional, and global. In today's financial architecture, the regional pillar, to the extent it exists at all, is by far the weakest yet the one potentially best suited for a broad range of policy matters.

For all the talk of globalization, much of the economic integration of the past decade has been regional rather than truly global. America's two largest trade partners are Canada and Mexico; the greatest proportion of European Union (EU) trade is among its member countries. Even intraregional trade in East Asia has increased dramatically in the past decade, despite its continued dependence on the American market, as has intraregional trade among the Mercosur countries of Latin America. The popularity of area-wide trade initiatives, such as the European single market, Asian-Pacific Economic Cooperation (APEC), the North American Free Trade Agreement (NAFTA), and Mercosur, is reflective of this underlying trend.

Moreover, despite the many common problems developing economies face, differences among regions—Latin America, Southeast Asia, Sub-Saharan Africa, Eastern Europe, and Central Asia—are quite large and have considerable influence on policy. These regions have different histories of development, different patterns of industrialization, different savings and investment patterns, different experiences with international capital flows, and different systems of law and corporate governance. Accordingly, they face different challenges, have different strengths, and need different policy mixes and even different institutional cultures. In fact, as was evident during the Asian financial crisis, there is a danger in trying to treat one region with the prescriptions designed for another—as many believe happened when the IMF dusted off prescriptions for Latin American-style current account and sovereign debt problems and applied them to the Asian capital account and corporate debt problems in the 1997–98 crisis.

To be sure, globalization in general, and international financial integration, in particular, require the development of certain

common global standards. As international financial integration increases, higher and higher degrees of regulatory and policy conformity among participating countries are needed. Just as increased trade liberalization has forced countries to conform their practices to WTO norms, continuing integration of capital markets will force countries to adopt common standards and practices in the management of their financial systems. But, in our view, regional institutions involving first a process of regional harmonization and then increased coordination among different regional bodies offer a better and more reliable path to this kind of convergence than does the current system of national organizations and weak international institutions.

Indeed, the regional level offers unique advantages from the standpoint of financial governance. Think of Goldilocks. The global level is too high and too distant; the national level is too close to the ground, and too subject to political interests and control. By contrast, regional institutions are “about right”: close enough to member states and their peoples in culture and orientation to have more legitimacy than global institutions. Yet they are also more independent than national governments in that the presence of different states and interests in the governance structure of regional institutions makes it harder for national elites to capture them in ways that undermine their credibility or effectiveness.

Regional institutions thus offer us a means not only to close the regulatory gap that is left by global institutions that are too distant and national institutions that are too close, but also to promote the kinds of reforms needed for the development of deeper and more efficient capital markets. It is not likely that global organizations like the IMF will either have the legitimacy or be granted the authority to effectively mandate these essential reforms.

At the same time, experience teaches that the state and political structures of many emerging economies make effective and transparent policing of the credit sector virtually impossible at the national level. This reflects not just the recent experience of developing countries but the historical experience of advanced industrial economies as well. Despite repeated financial market panics

and crashes, the United States did not establish the Federal Reserve System until 1913; a credible national system of small-saver deposit insurance took another generation to appear. The United States is hardly unique in this respect; the financial histories of Britain, France, and most other advanced economies show recurring patterns of regulatory failure—and the advanced industrial democracies cannot yet claim to have invented foolproof methods of regulating their capital and financial markets. Left to their own devices, emerging economies may take a similarly long time to voluntarily and consistently embrace the often painful disciplines associated with the sound management of a financial system.

No set of institutional changes can guarantee good outcomes without good policy and wise judgment. Nonetheless, there are good structural reasons why a regional institution, widely regarded as legitimate and accountable, offers a more benign climate for the growth of the kind of governance the world economy will need. For one thing, deeper regional economic integration gives each prospective member of a regional institution a greater stake in ensuring that its neighbors pursue good policies. Formal regional institutions would give each state the means to force good policies on its neighbors or to place checks on politically motivated credit abuses by neighboring states.

Second, because of the greater legitimacy this economic proximity accords them, regional organizations, we believe, are more likely to command the resources needed to promote reforms and good governance. By pooling their resources—their foreign-exchange reserves and their regulatory expertise—and by taking advantage of economies of scale on a regional level, regional organizations can overcome the lack-of-resource problem that now afflicts both national governments and international institutions. Better capitalized than either the IMF or the World Bank in proportion to their responsibilities, they would be more likely to be able to offer their members greater inducements for carrying out reforms than can these currently underfunded international institutions. Moreover, as many EU members have discovered, from union comes strength. Countries too small to protect their economies on a nation-

al basis from international crises, or to make their voices heard in international bodies, can gain more autonomy and authority as parts of strong regional organizations than they can acting on their own.

Finally, building up the regional pillar would also help strengthen the global pillar by allowing existing international institutions, like the IMF and the World Bank, to become more focused and thus more effective. If regional institutions become the front-line institutions of international financial architecture, particularly as it pertains to emerging economies, then the IMF and BIS can focus more upon the tasks of global surveillance and oversight and less on trying to micromanage the economies of developing countries. The IMF could also take on a major new role in coordinating policy and regulatory standards among regional bodies and devote more resources and attention to the potentially explosive problems arising out of the imbalances and failures of policy coordination among the G-3 economies.

Similarly, the World Bank would be able to focus more on poverty alleviation, human capital development, and technical assistance. Indeed, the significant expansion of the World Bank's ability to support anti-poverty initiatives under an effective regional architecture is one of the strongest arguments for moving in this direction.

Owing to geopolitical rivalries or historical animosities or differences in size or level of development among countries in a particular region, regional institutions are not the answer in all parts of the world. But regional integration is advancing in many areas, and there are a number of regions and sub-regions where strengthened regional architecture and policy seems both immediately feasible and desirable. In Latin America, one area is constituted by Mexico, Central America, and the Caribbean; the Mercosur economies plus Chile constitute another. In Asia, the Association of Southeast Asian Nations (ASEAN) perhaps with the addition of South Korea would be the basis of another set of regional institutions; already ASEAN represents the most sustained and far-reaching regional initiative in international politics other than the European Union. In Africa, southern Africa has had some positive experience in regional cooperation, and this success could serve

as the basis for stepped-up regional efforts. There have also been previous efforts at regional economic cooperation in both west and east Africa, although the current political turmoil in both areas suggests that real regional cooperation and integration lies some distance off.

Other potential arenas for stronger regional action would include the “outlying” candidates for EU membership, who face a decade or more before joining the European Union; the Euro-Med economies of Northern Africa and the Near East; as well as those members of the CIS for whom EU membership is, at best, a remote prospect.

China and India (possibly including willing neighbors like Bangladesh and Sri Lanka) are so large that they can and should be seen as regions on their own. In these cases, there may be no realistic alternative to an essentially nationally based approach to financial architecture. Yet because of their size, both China and India would profit by adopting on a national basis some of the strategies and institutional reforms we are suggesting that other countries pursue as part of regional coalitions. To a significant extent, many of the recently announced Chinese banking reforms, including measures to support securitization of mortgages and other debt instruments, anticipate many of the recommendations we make below.²⁶

In areas where regional cooperation is currently unlikely or inappropriate due either to political or economic factors, the international financial institutions would continue to act as the “frontline” institutions. But even in these cases, the IMF and World Bank would be well advised to seek to build regional cooperation and thus to lay the foundation for regional institutions to function in these areas in the future.

The priorities for regional agreements and architecture will differ among the various regions identified above. Furthermore, the roles of existing regional institutions will vary. In some cases,

²⁶For further discussion, see James Galbraith and Jiaqing Lu, “Sustainable Development and the Open-Door Policy in China,” a paper from the Project on Development, Trade, and International Finance, Council on Foreign Relations, New York, 2000.

such as in Asia and Latin America, the region's development banks—Inter-American Development Bank and the Asian Development Bank—could play a key role in establishing new institutions, or may themselves develop into much stronger and more influential organizations. Other regional organizations, such as regional stock exchanges, would also play a role in a growing and deepening process of integration and cooperation. Such regional alliances, unlike the European Union, would probably not aim at political integration; rather, the goal would be effective economic cooperation within a framework of independent sovereign states.

The path toward a stronger network of regional agreements and institutions will be a long and winding one—and no two regions will follow the same path or move at the same pace. The following recommendations are intended as guide posts to shape policy discussions and suggest priorities rather than as detailed proposals for immediate action. Much wider research, consultation, and investigation are needed before we can present detailed recommendations tailor-made for any, much less all, of the regions and sub-regions where some or all of our recommendations may apply.

Recommendation 1: Create well-capitalized and well-managed regional central banks to serve as the frontline institutions of an international financial architecture for middle-class-oriented development.

In light of the many advantages that regional institutions would have for international financial governance, our first recommendation is to create, wherever feasible, regional central banks. Such banks would serve as the frontline institutions of a new international financial architecture for middle-class-oriented development within a global system of international finance and governance. Regional central banks would perform for their members many of the functions associated with large advanced-economy central banks—managing a common currency and monetary policy, chartering and supervising member banks and branches, studying and reporting on financial and economic developments within the

region, and acting as a lender of last resort for regional financial institutions. In addition, regional central banks would facilitate capital-market development by offering regionally organized market institutions and instruments and by putting in place the legal infrastructure for capital-market development.

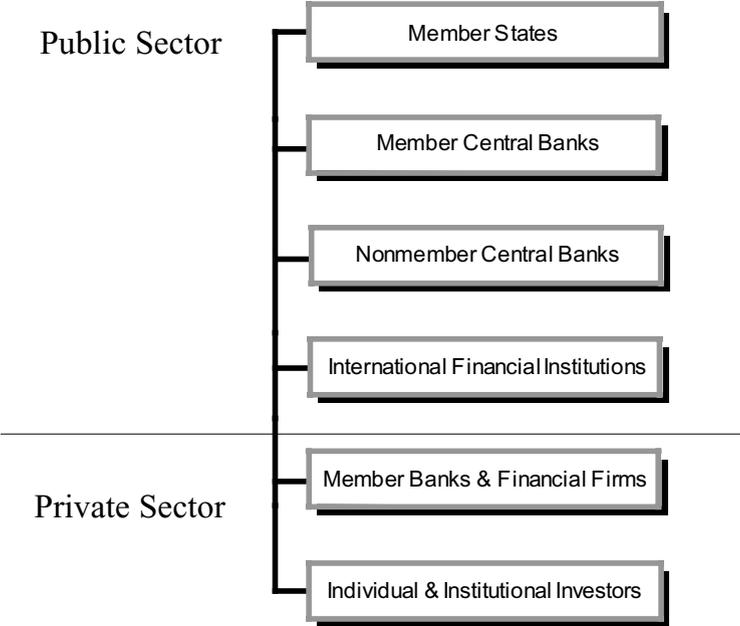
Regional central banks would be open to membership to all governments and their central banks in a particular region that were willing to abide by covenants of good governance and good policies. The process of accession to a regional central bank would include three agreements: a fiscal stability pact, which would set limits on the size, duration, and composition of fiscal deficits and overall debt levels; an agreement covering legal infrastructure and regulatory standards; and an agreement relating to the regional central bank's regulatory authority.

To be both credible and flexible, regional central banks would need to be well-capitalized and well-managed, and in the case of most regions this would mean extending the shareholding structure beyond member governments and central banks. More specifically, it would require bailing in the private sector as well as both member and nonmember governments, member and nonmember central banks, and the international financial institutions. Discussions about international financial architecture since the 1997–98 crisis have repeatedly examined the question of “bailing in” the private sector—ensuring that private lenders and investors bear their share of the risks and costs associated with international investment. Much of the debate has focused on proposals for incorporating so-called collective-action clauses in sovereign bond contracts, which would make it easier to gain support among bondholders for debt rescheduling and restructuring, a measure that some fear would slow down capital flows to and raise the cost of capital for emerging economies.

Here our focus is on bailing in the private sector as well as member and nonmember central banks in a way that reduces interest rates for borrowers in emerging economies. We propose bailing in these other actors by making them shareholders in regional central banks and giving them a say in their management. Indeed, the key to well-capitalized and well-managed regional central banks

is to have a diversified shareholder base. As the accompanying chart illustrates, regional central banks could have up to six classes of shareholders. From the public sector, the shareholders would include member states; member central banks; nonmember central banks, like the Fed, the Bank of Japan, and the European Central Bank; and international financial institutions such as the regional development banks, the IMF, and the World Bank. Private sector shareholders would include member banks and financial institutions, and individual and institutional investors.

**Regional Central Bank Capitalization:
Shareholder Structure**



This diversified shareholding base would serve two purposes. First, it would help ensure good governance. Each class of shareholder—public and private, regionally based and international—would want to control and limit the perceived excesses and abuses of the other shareholders. This would create a healthy system of

internal checks and balances, ensuring a more effective and transparent overall governance.

Second, a diversified shareholder base would significantly increase each central bank's capital and the reserves it has at its disposal. The principal shareholders of the regional central bank would be the member governments and their central banks, which would exchange their current hard currency reserves for a special class of RCB stock. In addition, the IMF might then allow these countries to deposit their newly acquired RCB stock to count against their IMF quotas as well; this "double counting" of reserves would not weaken the system but would increase the resources available to all countries and especially developing countries. The issuance of stock to member governments and central banks would provide the RCB with funds to buy up existing national currencies at an agreed-upon exchange rate and therefore would enable member countries to convert to a dollar or regional super-currency basis.

The pooling of existing member government reserves would create major economies of scale. ASEAN countries plus South Korea currently have foreign-exchange reserves totaling about \$300 billion.²⁷ The Mercosur countries have reserves of about \$80 billion—not substantial by Asian standards but still greater than the reserves Brazil had at the time of the Russian devaluation or that the IMF could muster in response to the crisis. By pooling resources in one regional central bank, member governments can defend one currency they all share more effectively than they can five or ten different currencies individually. One pool of \$300 billion is much more powerful than ten little pools of \$30 billion, especially when it comes to defending a currency or acting as a lender of last resort.

In most cases, the reserves of member governments would not by themselves meet all the needs of the new banks. Additional capital and reserves will be required. For that reason, the great central banks—namely, the Fed, the Bank of Japan, the European Central Bank, and perhaps such nonmember banks as the Bank

²⁷*IMF International Financial Statistics*, vol. 53, no. 3 (March 2000).

of China—should be encouraged to take up significant equity positions in the regional central banks. These nonmember central banks would do so by exchanging currency and reserves in dollars, euros, or yen for RCB stock, thereby further adding to the regional central bank's reserves. (By capitalizing the value of swap agreements or other arrangements, the available reserves of the regional central banks could be greatly expanded beyond their nominal reserves.) Cross share holding among regional central banks would provide additional levels of insurance and stability by diversifying risk across many regions and economies.

The nonmember central banks would have several incentives for making these investments. Holding stock would permit them to participate in the management of the new banks, helping them avoid a regional regulatory failure that might affect their own financial health. It would also enable them to influence the evolution of financial systems of large emerging markets, thereby also producing potential benefits for their own financial firms and institutions.

From the standpoint of nonmember governments, the investment approach resolves some painful problems. Investments are not foreign-aid giveaways. Profitable investments that stabilize financial markets in developing economies are more beneficial than many types of conventional foreign aid, and they are much less politically difficult to get through legislatures. Such investments would also greatly reduce the need for emergency bailouts—while substantially increasing the funds available for financial emergencies.

Existing international financial organizations would also participate in the ownership and governance of the Banks. They would thus constitute another source of capital for the new institutions. In some cases, the existing development banks might evolve into regional central banks. The international financial institutions, including the IMF and the World Bank, would in any case play vital roles in providing policy advice, working to identify best practices, and otherwise contributing to the establishment of credible, solid institutions.

Finally, there would be the capitalization provided by private sector investors. At first glance, bailing in the private sector in this fashion may seem unorthodox. But in fact it is nothing new.

Many of the great central banks—including the Banks of England, France and the United States—began their lives as private institutions or with significant private equity. Indeed, private equity increased the reserves and credibility of these organizations, and allowed them to evolve into strong public institutions.

Central banks are profitable organizations and could attract significant flows of private capital. The Fed last year reported profits greater than the combined profits of the top four Fortune 500 companies.²⁸ The Bank of France was more profitable than any private company in the world. The Bank of Japan had a 1999 profit of \$14.1 billion; the Bundesbank was a relative laggard, with profits of just \$8 billion.²⁹ Assuming that the profitability of a regional central bank would resemble that of other central banks, a regional central bank for Latin America would see profits of more than \$10 billion per year. And assuming it would have a price/earnings ratio similar to GE, a world-class financial services company, it would command a market capitalization well in excess of \$500 billion. The limit to private-sector capitalization of regional central banks would not be their profitability, but rather a policy argument. For reasons relating to maintaining public control over these institutions, it would be desirable to limit the private sector's stake in any regional central bank to 49.9 percent of the equity. But even then private-sector investment would substantially increase the reserves and credibility of these institutions, and movements in their stock prices would provide the bank managers, as well as investors and the citizens of member countries with transparent performance measurements to consider when evaluating the banks' effectiveness.

In sum, by bailing in the private sector, regional central banks could command substantially greater resources than do the central banks of even the largest emerging economies. Regional central banks with hundreds of billions of dollars in equity and with many hundreds of billions more in reserves and swap and “rediscount” agreements to draw on would be powerful institutions.

²⁸www.federalreserve.gov/boarddocs/press/general, January 6, 2000.

²⁹www.boj.or.jp/en and www.bundesbank.de.

They could operate currency board arrangements without the artificial limits on monetary policy endured by, say, Argentina. They could also make provisions for lender-of-last-resort functions that are both more credible and less disruptive than the arrangements that now exist in most developing countries.

Recommendation 2: Create or adopt hard regional currencies.

One of the chief aims of international financial architecture reform should be to reduce long-term currency risk in emerging economies as part of a broader program of building more democratic capital markets. For that reason, our next recommendation is that regional central banks should create or adopt hard regional currencies as a way of overcoming the problems caused by the current system of soft national currencies.

By hard currency, we do not mean a currency with an overvalued exchange rate. Rather, we mean a currency so respected that regardless of a temporary exchange-rate fluctuation, lenders and investors are willing to make long-term commitments in that currency. Hard currency economies like the United States, the European Union, Switzerland, and Japan enjoy a singular advantage: foreign investors are willing to hold assets denominated in dollars, euros, Swiss francs, and yen for the long term, facilitating investment and avoiding the destabilizing currency and maturity mismatches mentioned earlier. The U.S. government can borrow on international markets in its own currency. Now with the euro so can most European governments, including Ireland, Spain, and Portugal, which only a decade ago were considered high-risk, low-investment-grade economies.

Currency questions are difficult. There are no perfect regimes, no one-size-fits-all solutions. Every alternative entails disadvantages and drawbacks. In seeking to establish a regional hard currency, then, regional central banks will need to pursue the path best suited to their region's development, trade, and investment needs. Over time, all regional central banks are likely to seek the goal of hard currencies with flexible exchange rates. However, each region will find its own path to the goal.

One short- to medium-term option for some regions would be to “dollarize”—to adopt a foreign hard currency as their own national currency. Under the dollarization option, a country would actually replace the banknotes in its own currency with banknotes from the hard currency country. Under today’s conditions, that could mean not only the dollar but also the euro and yen. Given that no solution is perfect, for small countries with a history of inflation and currency devaluations, dollarization may be the fastest and perhaps only way to establish a hard currency. It may also make sense for countries and regions whose trade and investment flows are closely tied to one major reserve currency. For Mexico, Central America, and the Caribbean, for example, the dollar might well be the most logical currency for a regional bank to adopt. Similarly, a North African or East European regional central bank might find it makes sense to adopt the euro.

Other countries, however, face a more complex situation. In much of East Asia, trade and investment flows are divided between the dollar and the yen, and to a lesser extent the euro. The Mercosur countries of Latin America are oriented to both the euro and the dollar, as are southern and much of eastern Africa.

For these “mixed” regions, there is another option that would make more sense: namely, that regional central banks create “super-currencies.” Regional super-currencies would be based either on a basket of the core currencies or on a simple parity rule—i.e., the regional currency would always be equal either to one dollar or one euro, whichever was lowest. These regional super-currencies—call them the yendo, the eurdo, and the euryendo—would replace national currencies among the member states of the regional central banks.

In choosing between dollarization and regional super currencies, regional central banks must look beyond the simple question of trade and investment flows. The two currency alternatives work very differently. Dollarization delivers the fastest results, and in the short term provides, where feasible, a quick and effective answer to the currency problem. Some of the common drawbacks associated with dollarization, such as the loss of seigniorage, can be eliminated or at least minimized through arrangements between

the regional central banks and nonmember institutions like the Fed, the Bank of Japan, and the ECB.³⁰

Moreover, the arguments that countries that dollarize would sacrifice monetary autonomy and lose the flexibility to use exchange rates to soften competitiveness losses are often exaggerated. In much of the world, these disadvantages are more apparent than real. As Ricardo Hausmann, chief economist of the Inter-American Development Bank, has pointed out in a comparative study of Latin American exchange-rate regimes, those countries operating under more flexible exchange-rate regimes, which were presumed to enjoy monetary autonomy, found themselves unable to use that autonomy when they needed it.³¹ As noted earlier, the interest rates of emerging economies tend to track U.S. interest rates. But contrary to what one might expect, the correlation between U.S. interest rate increases and those of Latin American countries was somewhat higher under flexible than under fixed rates. Such an outcome suggests that—at least in the case of Latin America—flexible rates may actually provide less monetary autonomy than is conventionally assumed.

Yet, as currency board economies like Hong Kong and Argentina have discovered, the shift to hard currency regimes can create problems and can impose competitiveness-related costs on the economy. Some of the competitiveness-related costs would be avoided under a regional central bank scenario, because most if not all of a country's major trading partners would be adopting the same exchange-rate policies. But while the problems associated with dollarization should not be overstated, neither should they be made light of. In fact, over time, the straitjacket of dollarization will grow tighter than is good for a growing economy. The seigniorage problems and the problem of monetary dependence on a foreign central bank become more severe as a growing economy needs an ever larger money supply.

³⁰U.S. Senator Connie Mack (R-Fla.) has introduced a bill under whose terms the United States would rebate seigniorage to dollarizing economies.

³¹Ricardo Hausmann, Michael Gavin, Carmen Pages-Serra, Ernesto Stein, "Financial Turmoil and the Choice of the Exchange Rate Regime," Working Paper 400, Inter-American Development Bank, Washington, D.C., 1999.

With regional super currencies, however, the calendar works differently. Regional currencies must earn the trust of skittish markets; and, for that reason, interest rates in regional super-currency economies many fall more slowly than those in dollarizing economies. Meanwhile, in order to win the trust of markets, regional central banks would need to pursue more rigid exchange-rate policies to build confidence. As a practical matter, that means many of the regional central banks—whether they dollarize or create new regional super-currencies—may need to follow currency board rules. They will also need to be transparent in their operations and subject themselves to outside auditors in order to reassure skittish investors.

Over time, however, the inherent advantages of regional super-currencies would manifest themselves. Assuming prudent, solid currency management by the regional central bank, markets will learn to trust the new currency and interest rates will fall. Seigniorage problems would not exist. Because the profits of seigniorage would fall to the regional central bank, they could be used to increase the confidence and strength of the regional institutions or could be returned to governments to reduce indebtedness. Finally, regional super-currencies would allow the regional central bank some flexibility in maintaining the region's trade competitiveness with countries outside the region. As mentioned earlier, the yendo, for example, could track the lower of the dollar and the yen, thereby helping to insure countries within the region against currency-related trade shocks, such as those that hit the Southeast Asian economies prior to the Asian financial crisis.

Whatever policies they start with, the ultimate goal of regional central banks would be to enjoy the same monetary independence and policy flexibility that the Fed, the Bank of Japan, and the European Central Bank now have. This flexibility will become possible as the currencies gain credibility—as investors became comfortable in holding these currencies long term, and as long-term markets and foreign exchange markets denominated in these currencies develop.

Almost certainly, different regions would find different paths—and take different amounts of time—to reach the final goal of a hard currency that enjoys a significant degree of flexibility. In some

cases, dollarization may be a necessary first step in this process: sending a powerful message both to markets and to the citizens of the member countries that a new era has dawned and that the old ways are gone. But once the new institutions and practices have established themselves, the dollarizing central bank might choose to introduce its own currency, under a currency board system, in parallel circulation with the external hard currency. Over time, the public could be encouraged to shift from the dollar (or euro or yen) into the regional currency, and by measured, slow, and prudent steps the regional central bank could move toward true monetary freedom.

For a country to give up its currency and monetary independence—whether by dollarizing or by joining a regional super-currency—is of course a radical step. But in a world of open capital markets and international financial integration, the advantages of having a hard currency clearly outweigh the short-term problems associated with dollarization or the adoption of a regional super-currency. Indeed, a hard currency is a prerequisite not only for reducing a major source of risk for foreign investors and thus for increasing long-term capital flows but also for developing the kind of deeper, more efficient capital markets needed for middle-class-oriented development. It is no coincidence that the only developing country with a thirty-year fixed-rate mortgage market is Panama, a dollarized economy.³²

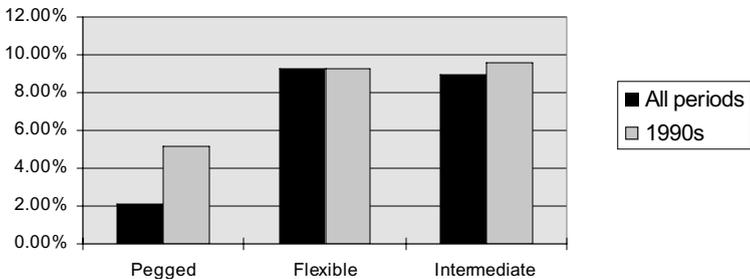
As a general rule, hard currency economies have a more stable and predictable business and investment environment and are less subject to the periodic financial crises that afflict soft currency economies. Achieving a hard currency would eliminate currency and maturity mismatches and thus one major source of crisis for many emerging economies. It would also lower the cost of capital and would permit companies as well as governments to borrow long term both domestically and internationally. Consider the beneficial effects the adoption of the euro has had even for heavily indebted countries like Italy. Bond yields, historically the

³²Juan Luis Moreno-Villalaz, Minister of Economy and Finance for Panama. Information taken from his congressional testimony statement on June 22, 2000.

highest of any major euro-zone country, fell from nearly 14 percent in 1995 to below U.S. levels by late 1997. The Italian government can now borrow ten-year money at less than 6 percent, dramatically reducing its debt-service burden and freeing up money for other public investment purposes.³³

Again the experience of Panama, a dollarized economy in Latin America, is instructive. Real interest rates in Panama have been relatively low and steady in comparison to other Latin American economies. Panama's sovereign spreads have been consistently lower than those of other Latin American countries. According to the JP Morgan Emerging Market Index, the average stripped spread on Panamanian bonds for a period from July 1996 to April 1999 was 405 basis points, with a brief spike to about 700 basis points in late August 1998 at the time of the Russian devaluation. Other major Latin American countries—Brazil, Mexico, Peru, and Venezuela—all saw higher average spreads in the period and higher peaks in 1998. Even Argentina, which enjoys lower interest rates as a result of its currency board arrangement, had a much higher average spread: more than 700 basis points. Only Costa Rica had lower spreads than Panama.³⁴

Average Real Interest Rates Under Alternative Exchange Regimes In Latin America



Source: Inter-American Development Bank

³³J.P. Morgan Emerging Market Bond Index.

³⁴See Zeljko Bogetic, "Official or Full Dollarization: Current Experiences and Issues," unpublished paper, June 1999, available from the author at the International Monetary Fund.

But perhaps most importantly for middle-class-oriented development, the adoption of a hard currency would facilitate the deepening of domestic capital markets, including the development of a corporate bond market and a market for long-term mortgages. It would expand the access of ordinary citizens and small and medium-sized businesses to a whole range of financial services that are now available only to wealthy individuals and large companies, thus effectively ending the financial apartheid that exists in soft currency economies. Finally, by making it possible for utilities and other entities to borrow long term, adoption of a hard currency would greatly facilitate environmentally sound long-term investments. Energy efficient and/or renewable investments are often more capital intensive to build and only pay off over the longer term. Thus, soft currency countries are often forced to forego environmentally beneficial alternatives. With a hard currency, however, governments, utilities, and other agencies would be able to borrow long term and at lower rates, thus enabling them to take longer term environmentally related savings into account in their investment decisions.

Recommendation 3: Establish binding covenants for good governance and good policies.

Creating a hard currency system built around regional central banks in which investors can have confidence is a major step in the direction of a new international financial architecture. Critical as this is, it is only one step toward a middle-class-friendly international financial system. In order to develop the deep and efficient capital markets necessary to provide greater democratic access to reasonably priced credit, regional central banks—along with other elements of a regional financial architecture—would need to use their size and influence to facilitate the legal, fiscal, and regulatory reforms needed for the development of such markets.

Prospective membership in a well-capitalized, well-managed regional central banking and financial system would carry with it enormous benefits and advantages for member countries in the region: restructuring of existing debt; reduction of future borrowing costs; currency stability and greater access to the international capital

markets; provision of a reliable lender of last resort; participation in liquid and efficient regional capital markets; increased technical assistance and financial help in the form of credit guarantees. Conversely, exclusion from such a system would entail serious economic costs for any country in the region. The benefits offered by regional central banks create incentives, including increased popular support, for elites to undertake meaningful legal and fiscal reform. The prospect of owning one's own home or starting one's own business ensures a popular constituency for reform now missing from IMF-led reform efforts.

For these reasons, a regional financial system would have significant leverage over prospective members, and it could use such leverage to promote real reforms. The positive inducements for reform that a regional central bank would be able to offer would make the reform process more like that entailed in the EU accession process than like the current system of IMF conditionality. The European Union requires that all prospective members participate in a lengthy accession process whereby they bring their economies, regulatory standards, and legal systems into conformity with EU standards. The EU accession process has thirty-one chapters of conditions and standards that prospective EU members must "close" before they are admitted to membership. In addition, those countries wanting to join the European Monetary Union must meet additional macroeconomic and debt-related standards. The EU process has been remarkably successful in transforming countries like Portugal, Spain, and Greece into law-based market democracies. Even the prospect of EU membership has spurred reforms in countries like Bulgaria, Slovakia, and Romania that many observers just a few years ago thought were impossible.

A similar but less extensive and onerous accession process should be established for membership in regional central banks and related regional financial institutions. As noted earlier, this EU-like process would create covenants of good governance and good policies for member governments. It would also establish an appropriate regulatory and supervisory framework for financial institutions operating under the regional central bank. It would do so

by requiring adherence to the three agreements identified earlier as necessary for RCB membership: a fiscal stability pact; an agreement covering legal infrastructure and regulatory standards; and a third agreement relating to the RCB's regulatory authority.

Fiscal Stability Pact. Countries wanting to join a regional central bank would have to accept a fiscal stability pact, setting limits on the size, duration, and composition of fiscal deficits and on overall debt levels. Larger deficits would under certain circumstances be allowed for public investment purposes and during periods of economic downturns. Such limits would apply not merely to central government debts, but to all debt by all governmental and official bodies. The stability pact would include procedures for monitoring adherence to the pact and would provide for regular independent audits of the member governments.

Agreement on Legal Infrastructure and Regulatory Standards. Member governments would agree to establish and enforce common codes relating to a broad range of issues ranging from commercial codes, bankruptcy laws, judicial procedures, accounting standards, bank operations, shareholder rights, and other legal instruments deemed necessary to the creation of smoothly functioning capital markets. In addition, they would undertake to adopt common regional standards and regulatory codes for brokerages, insurance firms, investment banks, and other financial institutions.

Regulatory Charter. Member governments would also agree to a regulatory charter that would give the regional central bank regulatory powers over banks and most nonbank financial institutions. As part of this charter, member governments would require all banks, both foreign and domestic, as well as certain nonbank financial institutions operating in their territory, to receive RCB charters and accept RCB supervision. The regional central banks would have authority to conduct independent audits of all member banks and of all member states, including any provincial, regional, and municipal bodies involved in issuing debt. And in cooperation with the BIS and other international organizations, the regional central banks would ensure the transparent, honest, and efficient management of a regional system of bank regulation, including a deposit insurance program that primarily protects small retail deposits.

Recommendation 4: Create mechanisms for debt relief and restructuring and make markets in long-term member country debt.

The economic prospects of many developing countries are seriously constrained by excessive debt levels acquired over several decades of economic mismanagement and repeated currency crises. Several Latin American economies—for example, Bolivia, Ecuador, Panama, and Uruguay—have an international debt equal to more than 50 percent of GDP.³⁵ This debt overhang imposes an enormous debt-servicing burden on many developing countries, and greatly restricts their economic freedom and their ability to meet reasonable budget targets. Other countries face high levels of debt related to the costs of recent financial crises.

Becoming part of a regional hard currency zone would help countries reduce their debt-service burdens and their future borrowing costs. But some countries have debt levels that are inconsistent with the fundamental principles of the fiscal stability pact discussed in the last section. Rather than exclude these countries for past sins, it would be better to use accession to the regional central banks to reduce and restructure existing debt.

Countries agreeing to the fiscal stability pact would be eligible for a two-part process of debt reduction and restructuring. First, as part of the capitalization of the regional central bank, we would propose that both official and private sector creditors convert excess government debt into RCB equity and debt. In this way, all member governments would be able to clear unsustainable and crippling levels of debt off the balance sheet.

Second, for member countries that adhere to the stability pact, the regional central bank would assist these members with the underwriting and placement of long and short-term debt in international markets. Either directly or in cooperation with the private sector, it would also underwrite, insure, and securitize municipal, provincial, and central government debt as a way of lengthening the maturity structure on outstanding government debt. It would do so in consultation with national treasury authorities and at times in coop-

³⁵United Nations: Economic Commission For Latin America and the Caribbean, *Economic Survey of Latin America and the Caribbean 1998–1999*, Santiago, Chile, 1999.

eration with regional development banks and the World Bank. By lengthening the maturity of existing debt and by reducing interest rates on all official debt, this process will make member governments less susceptible to future financial crises and thus less likely to put strains on the regional central bank's lender of last resort facilities.

Together these steps would drastically reduce the debt servicing costs of most emerging economy governments and open the doors to attractive new financing. As a result, member governments would find that they have more fiscal flexibility than before, even while observing fiscal stability pact limits.

One of the goals of the regional central banks in this debt restructuring process would be to create a long-term market for debt denominated in the new regional super-currency. At the beginning, this will require a clear RCB policy aimed at flattening the yield curve and extending debt maturities. Investors naturally will be cautious initially about making significant investments in long-term debt markets with only short-term track records, little liquidity, and considerable volatility. But at the outset, the regional central banks, in cooperation with the international financial institutions, can play a major role in creating and sustaining market confidence.

Market conditions for such an exercise may be favorable in the near-to-medium term, as the supply of investment grade, sovereign debt declines. The improved fiscal prospects of the European Union and the United States mean that the supply of long-term, high-grade government paper is likely to further decline over the next decade. Already the softening of long-term rates in gilts and U.S. Treasury bonds show the effect that a "bond famine" can have on interest rates. Thus, there may be a window of opportunity in the coming years for new institutions to develop new markets in new types of high-grade, long-term debt.

There are a number of steps the regional central banks, in cooperation with the international financial institutions, can pursue to take advantage of this window of opportunity. First, the regional central banks should issue investment grade paper of their own at a variety of maturities. Their substantial reserves would support a number of large debt issues. In order to help establish confidence

in these instruments, the IMF and World Bank, the regional development banks, and nonmember central banks should make the political decision to hold some portion of their reserves in this RCB paper and to use RCB paper as a normal part of their operations.

Second, the World Bank should assist the process of creating a market in new super-currency denominated debt by providing guarantees on long-term issues. By insuring this paper, the World Bank can help make it attractive to entities like pension funds in advanced countries, which would be able to hold high grade, long term paper at attractive rates. Though insured, yields would still be sensitive to international and regional developments. Thus, as the various measures outlined in this report come into effect, it is likely that spreads between regional and G-3 long term paper would decline steadily, offering very significant rewards to those investors hardy enough to come in at the beginning. This payoff in itself would go far to bringing more participants into these markets.

There are other steps that can and should be taken to draw private participants into long-term regional debt markets. Favorable tax treatment on certain classes of long-term obligations would be a politically less sensitive and economically more effective form of development assistance than many traditional forms of aid. Governments in advanced countries could make commitments to place some of their current pension reserves in high-grade paper. This move would increase the yields that advanced countries receive on their pension trusts, and assure private investors that the market for regional paper would remain liquid far into the future.

Finally, the regional central bank in collaboration with interested member governments should explore ways of directing the savings of the region toward long-term investments in high-grade regional paper. Compulsory savings programs and state and private pension programs could be encouraged where they exist, and established where they do not, and authorized if not required to invest a given percentage of their assets in certain classes of securities. Once again, this would help reassure external investors of the security and stability of demand for these debt instruments.

At the same time, by using their retirement savings to fund such instruments as mortgage-backed securities and infrastructure bonds, the populations of these countries would in effect be borrowing money from themselves to build houses and improve their living conditions.

Recommendation 5: Create the financial markets and infrastructure for deep and liquid capital markets on a regional basis.

One of the main arguments of this report is that the availability of long-term home mortgages and financing for small and medium-size businesses is the key to both financial market development and middle-class-oriented development. Creation of mortgage-backed securities and other credit institutions for small and medium-sized businesses would lower borrowing costs for working people while empowering the banking system. The regional-based financial architecture outlined above affords an opportunity to develop these kinds of financial markets and instruments. But there will need to be a concerted effort to build a new infrastructure in RCB-member countries in order to take advantage of this opportunity. This effort will require cooperation with the IMF, the World Bank, regional development banks, member and non-member governments, the private sector, and civil society.

Many of the financial institutions and markets envisioned here would need to be organized on a regional basis to take advantage of economies of scale and to ensure necessary liquidity and diversification of risk. Others, such as the popular financial institutions, would take on a more local or national character. But even in these cases, regional central banks would need to provide regional oversight and encourage securitization on a regional basis.

The primary tasks for regional central banks to build a middle-class-oriented financial markets in emerging economies include the following:

- 1) Create a long-term mortgage and small-business credit market by chartering and spinning off regional Fannie Mae-like

institutions for the insuring, bundling, securitization, and sale of mortgages and other debt;

- 2) Expand and deepen equity and debt markets by chartering and supervising investment banks aimed at underwriting corporate debt and initial public offerings, as well as by chartering and supervising for-profit pension management companies linked to compulsory savings programs;
- 3) Build a popular financial sector serving the needs of small and medium-sized businesses by chartering and supervising retail banks aimed at expanding credit to small and medium-sized enterprises, and by chartering and supervising popular financial institutions for mini-lending (loans up to \$25,000) for ordinary working people.

Long-Term Mortgage Market. The development of a secondary debt market is essential for the expansion of reasonably priced credit for home ownership, small-business start-up expansion, and public infrastructure improvement. Once agreements on regional financial governance are in place, the regional central banks should have as a priority the chartering and launching of national and regional institutions, similar in some ways to U.S. institutions like Fannie Mae and Freddie Mac, that would securitize different types of securities: mortgage backed, small business loan backed, and infrastructure loans. These institutions, operating under close supervision and regulation, would bundle conforming loans into securities to be sold on regional and international capital markets.

As soon as would be feasible, these institutions would be privatized as for-profit publicly traded companies. Like the regional central banks themselves, they would be able to attract a substantial private shareholder base. As of the end of the second quarter 2000, Fannie Mae and Freddie Mac, the two largest such organizations in the United States, had a combined market capitalization of more than \$80 billion.³⁶ Some of this equity would be distributed to existing shareholders in the RCBs; the rest

³⁶ *Wall Street Journal*, June 30, 2000, p. A10.

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would be sold to the public. Member governments and central banks could retain their equity in these organizations or sell it to private investors, using the proceeds to increase or redeem RCB stock, or to further reduce debt.

Regional Equity and Debt Markets. The formation and effective regulation of nonbank capital markets would be another important objective of the regional financial architecture. As indicated earlier, most emerging economies are overly dependent on the banking sector and need to develop better regulated equity and debt markets. With the help of the World Bank's International Finance Corporation, the regional central banks could advance this goal in a number of ways. First, they could charter and supervise investment banks aimed at underwriting corporate debt and initial public offerings. Second, they could help create regional exchanges for the trading of equity and debt securities. Taking advantages of economies of scale, regionally organized exchanges would be better able to offer investors the liquidity and volume many larger investors need. Third, they could charter and supervise for-profit companies to manage pension funds linked to compulsory or state-assisted savings programs. These companies would become major investors in regional securities, and with certain limits, pension funds collected under compulsory savings programs could be invested in securities that promote socially desirable development, such as water treatment, mortgage lending, and small business loans.

Popular Financial Sector. The regional central banks would have a mandate to ensure the development of a healthy retail banking sector, whose mission is to provide banking and credit services to small borrowers. To this end, they would develop a system of bank charters for small retail institutions, with limits placed on the size of deposits they can accept and loans they can extend to a single borrower. Such loans might also be limited as to purpose. If regulated closely and supervised properly, these institutions can and should be capitalized on liberal terms with credits from the World Bank and regional development banks for the purpose of assisting such small organizations to meet capital adequacy standards. In addition, the regional central bank should charter nonbank

financial institutions to fund small and medium-sized business, with mandates ranging from mini-lending (loans up to \$25,000) to operations in support of medium-sized businesses with revenues in the range of \$50 million. The regional central bank and its branches would take care to ensure that applications for charters for these institutions would be issued to groups representing a variety of local and civic interests. Once experience shows that such ventures are profitable, the regional central bank would be able to issue debt for purposes of investment in these institutions without compromising its credit rating.

Regional central banks, development banks, national governments, international aid agencies, and the nongovernmental organization (NGO) sectors will all have a role to play in developing more efficient democratic capital markets in emerging economies. By working to train and assist ordinary people to harness the full power of the modern credit system, they would help them to take control of their own lives and shape the destinies of their families and communities. In this and other ways, a reformed international financial architecture could stimulate a vast and unpredictable range of human progress and development, and give hundreds of millions if not billions of people new hope for a new century.

CONCLUSION: THE POLITICS OF INTERNATIONAL FINANCIAL ARCHITECTURE

If we have discussed financial architecture in three dimensions, the reason is at least partly because international financial architecture must ultimately function in the fourth dimension: the dimension of politics. Without a sufficient basis of political support in advanced and developing countries alike, no proposals for economic reforms, however well intended or conceived, can succeed in the real world.

The political challenges to international financial architecture are tough and getting tougher. In many important countries, both developed and developing, public support for current international economic policy and reform efforts is disturbingly low, yet the challenges facing the international economy suggest that more, not less, political commitment will be required in coming years.

Any consideration of the fourth dimension must begin with the United States, the country that remains the most important single actor in the field of international financial and economic policy. The end of the Cold War initiated profound changes in the politics of American foreign policy whose full effects are only beginning to be seen. Politically, the end of the Cold War has substantially reduced the willingness of the American people to make sacrifices of any kind for the sake of foreign policy objectives. Across the board, we see declining support for foreign aid, for international cooperation that is perceived to place limits on American unilateral action, or for trade agreements perceived as benefiting other countries at the expense of American workers.

Institutionally, since the end of the Cold War, executive authority in foreign policy has tended to diminish, while the authority of Congress has increased. In wartime or even Cold War-time conditions, Congress tends to defer to presidential authority; in peacetime, Congress historically is far more assertive. Trade

policy and international financial policy were once considered part of a broader Cold War strategy of wielding the Free World together into a coherent, prosperous, and stable anticommunist alliance. With this consideration removed, Congress feels much more free to question and counter executive proposals and policy.

At the grass-roots level, growing opposition to the current direction of international economic policy is found among trade unionists, environmental activists, churches, right wing populists, and some human rights activists. While originating in opposition to trade agreements and policies perceived as flawed, this opposition now focuses increasingly on the institutions and practices of international financial institutions such as the World Bank and the IMF. Thanks in large part to the power of the Internet, this opposition is increasingly international and coordinated, and may pose a significant long-term threat to the sustainability of current policy.

Taken together, these conditions and forces have substantially reduced the ability of the U.S. government to pursue a vigorous and consistent foreign policy. These effects are not limited to international financial policy. Rather, the failure of agreements like the Kyoto Protocol to gain congressional support, the defeat of the Comprehensive Test Ban Treaty, the loss of fast-track negotiating authority, and the long, slow, and apparently inexorable decline of foreign aid all point to decreased executive effectiveness in foreign policy generally, as well as in foreign economic and financial policy specifically.

For somewhat different reasons, both Japan and the EU nations also face serious obstacles in summoning the will and the resources for strong and effective action. Japan, while increasingly interested in supporting the development of regional institutions in Asia, is hampered by its own growing debt, recent poor economic performance, and the prospect of massive and costly measures ahead as its number of pensioners skyrockets while its active labor force shrinks. Additionally, Japan faces constraints on its ability to act independently; it prefers to act in association with the United States and it remains unwilling to transform the yen into a true international currency.

Preoccupied with the consequences first of monetary union and later by the institutional reforms and economic consequences of enlargement, the European Union also has relatively little political energy to spare for questions of global financial policy and reform. Moreover, key elements of the current international reform agenda are distasteful to broad and influential sectors of EU opinion. Concerned about both the “Anglo-Saxon model of capitalism” and the “Washington consensus,” both public and elite opinion in much of the European Union have serious questions about the viability or the desirability of the current international architecture and agenda. This doubt is reinforced by a growing desire on the part of some important EU institutions and member states to reduce what some see as excessive U.S. influence in the international order. Concretely, that has expressed itself as dismay over the degree to which the United States used the international financial institutions to bail out Mexico at the time of the 1994–95 crisis. Political conflicts and tensions between the United States and the European Union have already been exacerbated by growing trade conflicts, as well as by divisions over military and security issues (for example, U.S. interest in a national missile defense program). Such a situation is likely to weaken the ability of the international financial system to mobilize either the financial resources or the political commitments necessary for pursuing a vigorous policy of reform.

The internal problems and lack of consensus among the world’s leading economies are particularly troubling when considered against the degree to which the current reform agenda has run up against strong and resourceful opposition in the developing world. Western observers often underestimate the political obstacles that financial system reform faces in the developing world. The allocation of credit, for example, by government agencies or informal channels to favored borrowers has become in many countries one of the key pillars of state authority and national unity. In countries like Malaysia, where maintaining a balance among ethnic and religious groups is critical to national unity, any reforms that threaten the state’s ability to use credit allocation as a political tool threaten, potentially, the most vital interests of the state. Even where

the ethnic tensions of a Malaysia are absent, credit allocation in many countries remains one of the chief means by which political elites cement power and maintain national harmony.³⁷

Given this consideration, it is not surprising that most developing countries have moved slowly, reluctantly, and only very short distances when it comes to reform of their credit and finance systems. The link between politics and credit allocation is simply too strong for the forces arrayed against it to make much progress. Reform often is casual, spotty, and “*para o Inglês ver*,” in the old Brazilian expression: “for the Englishman to see.” Sheer financial necessity is likely to drive a continuing reform process in many countries, but the likelihood is that many will end up back in the “policy swamp” we described at the beginning of this paper, where necessity has forced the start of a reform process, but the political will and ability to carry the process through to a successful conclusion is lacking. Unless conditions change, for the foreseeable future many countries are likely to suffer the consequences of failed or incomplete reform processes, and the international system itself will suffer an increased risk of shocks, contagion, and disturbance as volatile international markets subject weak and poorly regulated financial systems in emerging economies to great stress.

The recommendations we make are intended, among other things, to improve the political context of the international financial system. Reinforcing the regional pillar of the international system and shifting toward middle-class-oriented development strategies can substantially strengthen the political support for necessary economic reforms and policies in developed and developing countries alike.

In the United States, moving toward market-based, middle-class-oriented development policies can attract support from a range of political positions and forces. From a trade-union perspective, encouraging middle-class development around such initiatives as mortgage banking and securitization represents a much desired shift

³⁷For further discussion, see Hilton L. Root, “Korea’s Comeback: The Thirst for Funds Drives Change,” paper from the Project on Development, Trade, and International Finance, Council on Foreign Relations, New York, 2000.

of policy away from encouraging export growth in emerging economies. Labor leaders can convincingly explain to their members that the new U.S. policy is aimed at reducing export dependency in the developing world and also at increasing demand for U.S.-made products in foreign markets. Increasing employment in developing countries based on growth in domestic demand will tend to raise wages in developing countries while reducing the importance of anti-union laws and policies. Environmentalists will find that these policies offer significantly greater scope for sustainable growth—yet business will find that these reforms increase opportunities for profitable activities around the world.

For the European Union, the policies we propose address some of the social model concerns that many Europeans have with the current direction of international economic policy. They also give European institutions, especially the ECB, an expanded global role. Our proposals also hold out the possibility of increased U.S. and Japanese commitments to the financial health of some of the peripheral European and Mediterranean economies (Morocco, Algeria, Egypt, Turkey, Ukraine, Belarus, Russia, the Caucasian states, Romania, and Bulgaria) whose well-being matters to the key EU members.

Similarly for Japan, the ability to pursue a program of regional cooperation and monetary stabilization in East Asia with the active blessing and support of the United States could help solve major foreign policy and economic problems.

In developing countries as well, the financial architecture proposals in this paper have the potential to win broad support from many sectors of society. Middle-class development programs will prove broadly popular among those newly able to purchase homes, to build businesses, to benefit from newly possible infrastructure programs, and to invest their money in a solid and sound financial system using a currency that can serve as a lasting store of value. These recommendations would end the association of reform with austerity and recession and make reform, potentially, a populist rallying cry. Nationalist and anti-colonial feeling would welcome the rise of regional institutions as an improvement—even if only an incremental one—over the current system in which the

IMF appears to serve as the de facto policy-making body of some developing country governments. For elites, the dangers of losing control over the credit allocation process would be offset to a large degree by the much greater availability of credit. Middle-class-oriented policies offer the prospect of enhanced social stability and reduced conflict even as economies shift to more market-based rather than influence-based methods of credit allocation.

APPENDIX: MAKING DOLLARIZATION WORK

As noted in the text above, dollarization, or the adoption of an external hard currency by a country or group of countries, has both advantages and drawbacks. The chief advantages—that dollarization may be the fastest way both to capture the public imagination for a new policy and to reduce interest rates for domestic borrowers in a dollarizing economy—are most important in the initial phases of a shift to a hard currency policy. Later, the disadvantages of dollarization over other hard currency strategies—particularly, the loss of seigniorage and the lack of monetary autonomy—begin to take a larger toll.

It is, however, possible to offset some of these disadvantages with the right policy mix and some assistance from the “home country” of the chosen hard currency. That assistance is most likely to be forthcoming when the dollarizing countries are close to the home nation or, in the case of the euro, the home region.

As an example, dollarization under certain circumstances could become a viable, long-term option for Mexico and the Caribbean if the United States and, to a lesser degree, Canada, were willing to support some policies that would ensure a steady flow of U.S. dollars into the Mexican and Caribbean economies. These policies would involve a substantial, long-term commitment but could well result in a successful long-term shift of Mexico, Central America, and the Caribbean to a dollar economy.

The first program would involve massive infrastructure investment. In the Mexican case, a tripartite “NAFTA Commission” made up of representatives from each of the NAFTA governments, would let contracts and, with government backing, guarantee bond issues for a series of infrastructure projects: highways and roads, water treatment plants and sewage facilities, electricity generating stations, among others. These projects would cumulatively be large enough to provide a significant boost to the Mexican economy during the early years of dollarization, while dollarization would

reduce the interest cost of the projects and extend the maturity of the loans.

It is easier to win political support for loan guarantees than for direct aid programs, and there are several additional steps that could be taken to gain the necessary political support for such an infrastructure initiative. Thus, for example, the projects funded under this initiative would have to meet environmental tests, and contractors participating in these programs would have to observe basic labor rights. Additionally, a proportion of the equipment and materials used by the projects would be purchased in the United States and Canada.

Second, simultaneously with such an infrastructure initiative, the United States, Canada, Mexico, and other countries in the region would embark on a “regional retirement program”—a series of measures aimed at facilitating and promoting the voluntary relocation of retired U.S. and Canadian citizens into the region. Agreements covering tax, property, and estate matters would be part of this package; so, crucially, would be agreements by the U.S. authorities to reimburse qualified health-care facilities abroad for the treatment of U.S. citizens covered by Medicare and other public insurance programs.

With seventy million U.S. residents expected to reach sixty-five years of age during the next thirty years, and with many retired households unable to afford the standard of living they desire in the United States, a substantial number of retirees will seek warmer weather and lower prices in Mexico and the Caribbean. These retirees and the insurance programs that cover their health needs would, ultimately, pump hundreds of billions of dollars into the regional economies.

The combination of an infrastructure program in the early years with a regional retirement program whose full effects would only gradually be felt would assure a constantly growing stream of dollars into the regional economies and substantially reduce any problems that dollar shortages or the loss of seigniorage would create for the economic development prospects of the region.

In the case of the euro, candidates for “euro-ization” would be countries that could ultimately be expected to join the European

Union. The removal of the currency risk for investors, together with the prospect of ultimate EU membership, would help bring in enough foreign exchange to maintain liquidity in these economies during the run-up to membership. Infrastructure programs and other forms of assistance from the European Union would also help; so too would euro-denominated remittances from citizens admitted as temporary workers.

Without this kind of policy support, however, it is likely that dollarization could only serve as a transitional economic regime for emerging economies; over the long term, more durable, less constrained answers to the currency question would have to be found.

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