FRAMEWORK FOR A DEVELOPMENT-FRIENDLY FINANCIAL SYSTEM

(based on Ocampo and Griffith-Jones, 2006)

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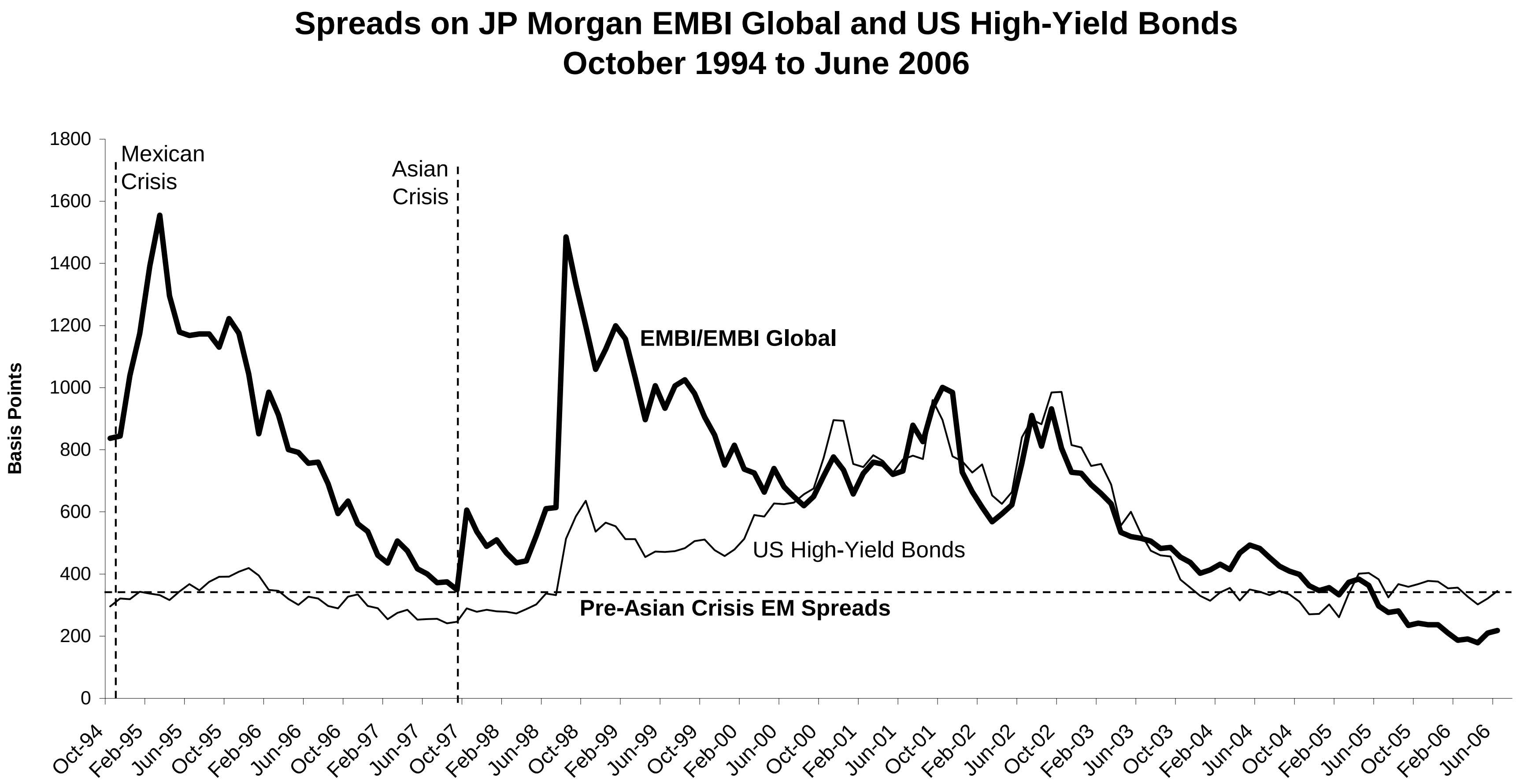
OUTLINE

1. Setting the scene
2. Countercyclical prudential regulation and supervision
3. Countercyclical official liquidity facilities
4. Market mechanisms: the case of GDP-indexed bonds

1. SETTING THE SCENE

- **Business cycles in developing countries are characterized by capital account volatility**
- **Investor herding and contagion**
- **Endogenously unstable dynamics of financial markets**

1. SETTING THE SCENE (cont'd)



Source: ECLAC, on the basis of data from Merrill Lynch's U.S. High-Yield Master II Index (H0A0), and JP Morgan's EMBI (until November 1997), and EMBI Global (from December 1997 to June 2006).

1. SETTING THE SCENE (cont'd)

- **Procyclical pattern of spreads**
- **Medium-term cycles**
- **Procyclical fiscal and monetary policies**
- **Problems for institution building and financial development**
- **The costs of volatility are high**

1. SETTING THE SCENE (cont'd)

- **Financial asymmetries**
- **Macroeconomic asymmetries**
- **Implications for the design of the IFA**
- **Towards a countercyclical framework**

2. PRUDENTIAL REGULATION

- **Current practices focus on microeconomic risk**
- **Procyclical bias**
- **Dynamic provisioning in Spain**
- **Limitations of Basel II**

3. OFFICIAL LIQUIDITY

For capital-account-led crises

- **Need for emergency financing**
- **Supplemental Reserve Facility and Contingent Credit Line**
- **Country Insurance Facility**
- **It is key strengthening the IMF resource base**

3. OFFICIAL LIQUIDITY (cont'd)

For compensating terms-of-trade shocks

- **Compensatory Financial Facility**
- **Poverty Reduction and Growth Facility**
- **Exogenous Shock Facility**
- **Lowering conditionality and expanding scale**

4. GDP-INDEXED BONDS

- **What is that?**

- **An example: $Coupon_t = \max [r + (g_t - g), 0]$ where r is interest rate paid on plain vanilla, g_t is the actual growth rate of GDP and g is the baseline growth rate of GDP**

- **An old idea already implemented to a limited extent**

4. GDP-INDEXED BONDS (cont’d)

Advantages for borrowing countries….

- **Stabilizing government spending**
- **Reducing the likelihood of default**

… and for investors too

- **Offering an equity-like exposure**
- **Benefiting from a lower frequency of default**

4. GDP-INDEXED BONDS (cont'd)

Potential concerns

- **Accuracy of growth data**
- **Moral hazard on country performance**
- **GDP revisions**
- **Pricing**
- **Market illiquidity**

4. GDP-INDEXED BONDS (cont'd)

Policy implications and the way forward

- **Draft a sample contract**
- **Jump-start a market**
- **Involvement of IFIs**
- **To ensure reliable and accurate GDP stats**
- **Further research**