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
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
Spreads on JP Morgan EMBI Global and US High-Yield Bonds
October 1994 to June 2006

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: \( \text{Coupon} = \max [r + (gt - g), 0] \)
  where \( r \) is interest rate paid on plain vanilla, \( gt \) 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