Financial Market Strategy

Inter-American Development Bank

Washington, D. C.

Sustainable Development Department
Sector Policy and Strategy Papers Series

Cataloging-in-Publication provided by
Inter-American Development Bank
Felipe Herrera Library

Financial market strategy / [prepared by the staff of the Infrastructure and Financial Markets Division of the Sustainable Development Dept].

p. cm.

Includes bibliographical references.

(Sustainable Development Dept. Sector strategy and policy papers series ; IFM-120)

1. Capital market- -Latin America. 2. Capital market- -Caribbean Area. 3. Financial institutions- -Latin America. 4.Financial institutions- -Caribbean Area. 8.Inter-American Development Bank. I Inter-American Development Bank. Sustainable Development Dept. Infrastructure and Financial Markets Division. II. Series.

332.6731 F46--dc21

This report was prepared by the staff of the Infrastructure and Financial Markets Division of the Sustainable Development Department (SDS). The final strategy benefited from comments made by the staff of the Regional Operations Departments, the Office of the Chief Economist, the Private Sector Department and other SDS units.

The Financial Markets Strategy (GN-1948-3) was favorably considered by the Board of Executive Directors on September 8, 1999. It is designed as a companion to the Capital Market Development Strategy (GN-1870-2) considered by the Policy Committee of the Board of Directors on September 28, 1995. Although capital markets are an important component of financial markets, their discussion in this strategy will be limited because they are more fully discussed in the companion strategy paper. Likewise, the very specific issues of microfinance, rural finance, and local government development are discussed in their respective strategies.

May 2000

This publication (Reference No. IFM-120) can be obtained from:

IFM Publications
Mail Stop W-0508
Inter-American Development Bank
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Washington, D.C. 20577

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FOREWORD

The *Financial Market Strategy* has been prepared to assist IDB staff in supporting the orderly development of financial markets in the Latin American and Caribbean region. While significant advances have clearly been made over the past decade, much remains to be done. Not all countries have advanced at the same pace, and there are elements of financial market development that need to be supported in each country. This s *trategy* specifically aims at establishing a better balance in the region's financial markets. To that end, it identifies dual goals - building upon existing reforms (and consolidating these as necessary) and developing the new instruments, institutions and markets needed to meet the savings, investment and risk management/risk transfer requirements of individuals and firms in the region.

The s*trategy* proposes that primary emphasis continue to be placed on the banking system; due to its critical role in facilitating payments, providing liquidity and credit, and in the transmission of monetary policy, the banking system will continue to be the backbone of the financial sector. Nevertheless, increasing attention must also be placed on the development of capital markets and risk management systems to support financing needs where bank loans and guarantees are not appropriate. The expansion of financial markets is aimed at facilitating investment that may not otherwise take place while reducing the cost of capital. Continued efforts will also be placed on supporting institutions and markets that meet the financial needs of those individuals and firms that have been excluded in the past from participation in formal financial markets, whether for reasons of size or geographic location. In both instances, market-based reform efforts will be needed to assure that the proper incentives are in place and that programs are financially sustainable. Specific support is also aimed at continuing the rationalization of the role of the state in financial markets -- moving away from the direct provision of financial services to ensuring the existence of appropriate enabling environments.

In the implementation of the *Financial Market Strategy*, consideration must be given to the differences among IDB member countries in terms of financial market needs and the development of their financial sectors. The individual country programs will differ significantly. The instruments used will likewise depend on the structure and depth of existing financial markets. The s *trategy* should therefore be viewed as an overview, indicating general trends and areas of concentration and not as a specific work program for any country.

The Inter-American Development Bank, must accelerate its efforts to develop enabling environments, encouraging the creation of stable macroeconomic conditions, supportive legal and regulatory environments, adoption of financial standards, and the institutional structure that will allow prudentially managed, competitive and innovative, private financial institutions and markets to flourish. The IDB has an extensive arsenal of tools that can be used. To be fully successful it must use these systematically. The s *trategy* thus encourages the regional operating departments and the central departments to work together to produce a combination of issue specific and country specific financial market strategies to meet the countries' needs. The challenges are great, but with a commitment of financial and human resources, the Inter-American Development Bank will be a key catalyst for change. While the strategy does not propose a specific allocation of resources for dealing with financial sector issues, it does provide guidance that can be used by the Bank's Senior Management and Board in setting priorities for allocating resources.

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I. BACKGROUND AND OBJECTIVES

During the last decade, the countries of Latin America and the Caribbean have achieved significant progress in the restructuring and development of their financial markets. With few exceptions, they have undertaken important reform programs built upon a foundation of political, legal and macroeconomic stability. Inflation and government deficits have been reduced, monetary growth is under better control and the external debt as a percentage of both GDP and export earnings has fallen. As the financial markets of the region have become increasingly liberalized, the countries have attracted increasing amounts of direct as well as portfolio investment from international investors. By 1995, their economies had solidified to the point that the Mexican crisis economy, though resulting in a temporary strain on some countries, did not spread. Likewise, the impact of the current Asian and Brazilian crises to date has been limited. The reforms undertaken by most of the countries in the region are recognized as substantive and lasting.[1]

Financial reform is a continual process. As the countries move forward, the initial reforms undertaken in the last decade need to be consolidated and extended by allowing more sophisticated markets, institutions and instruments to develop. The reform process in each country will depend, to a great deal, on their current level of development. While several countries have made important advances, in many others the reform programs are still in a very early stage. The existing reforms will have to be completed and the institutional structure solidified. In particular, the countries of Latin America and the Caribbean need to take steps to accelerate the prudential development of nonbank financial markets already underway. While commercial banks will undoubtedly continue to play the central role in financial markets, facilitating credit, savings and payment services, other institutions will be needed to meet the investment and risk transfer needs of the vibrant, growing economies of the region.

The Inter-American Development Bank views financial market development as a key ingredient to realize its overarching mission to accelerate economic and social development in Latin America and the Caribbean, by providing funding for development projects and supplementing private investment when it is unavailable. Financial markets provide the appropriate environment for capital mobilization to profitable investment opportunities. The Inter-American Development Bank, in its support for financial market development, must strive for balance with a continued concentration on the establishment of efficient and effective, safe and sound banking systems, while pursuing opportunities to motivate nonbank financial markets, institutions and instruments where appropriate.[2] It will need to address the issues underlying the development of complete markets (i.e., markets where financial instruments are available that will meet both the investment and hedging needs of individuals and firms, being well matched to the underlying financial risks they face). This *Financial Market Development Strategy* has been prepared to assist IDB staff in this process. It proposes methods in which the IDB can encourage the development of the market-based institutions to support the financial needs of individuals and firms as well as support innovation in the financial markets and institutions of the region. The underlying goal is an increased role for the private sector in the development of financial markets.

[1] For a discussion of the impact of the reform programs, see "Latin America After a Decade of Reform," *Economic and Social Progress in Latin America -- 1997 Report*, Inter-American Development Bank, Washington, D.C.

[2] As the development of financial markets has been central to the IDB=s lending and technical assistance programs, and both Senior Management and the Board of Executive Directors are familiar with these critical issues through their discussion as related to the IDB=s operations, a short annotated bibliography on financial market development will be included as an Annex to this paper (before presentation to the Board) in lieu of a background paper.

The main emphasis of the IDB's s*trategy* is related to the development and/or strengthening of a variety of intermediaries that operate in financial markets, including but not limited to depository institutions, insurers, pension funds, mutual funds, leasing companies, investment banks and guarantee funds. The role of institutions that are not intermediaries, but which play a critical role in the information environment underlying these markets, such as rating agencies, credit bureaus, electronic databases that provide market information and analysis, and similar sources of economic and financial information, is also included.

Much of the focus of the *strategy* will be on the development of the legal and regulatory environment needed to support efficiently functioning financial markets and institutions. The IDB=s role can best be described as supporting the creation of the enabling environment that will allow financial institutions and markets to develop and operate expediently. While the *strategy* concentrates on the instruments that the IDB has at its disposal, it also notes areas where it can develop new techniques and/or new instruments.

The *strategy* will place on critical emphasis the incorporation of international standards related to financial markets in borrowing member countries. The full incorporation of standards is essential to fully functional financial markets. The Inter-American Development Bank must therefore encourage the use of international standards ranging from the core principles for supervision of banks, insurers and capital markets to standards for payments clearing and settlement; from IMF standards for the dissemination of macroeconomic statistics to international accounting and auditing standards; and from international standards for corporate governance to the legal standards related to securitization of asset backed securities.

This *strategy* does not deal with the specific issues and details related to microfinance, rural finance, or financing local governments. Separate strategies have been or are being prepared to address these issues. Nevertheless, the underlying legal and regulatory issues and those pertaining to the role of state in the provision of financial markets and the role of financial markets in the pricing and allocation of financial instruments included in this strategy are common to all of these issues specific strategies. The *strategy* is designed to help guide the work of the Inter-American Development Bank during normal situations and to help prevent or lessen crises by supporting deeper markets. Nevertheless, it does not deal directly with crisis management; during times of crisis other considerations may need to be incorporated.

The Inter-American Development Bank's efforts to develop financial markets must be undertaken in close collaboration with the financial authorities of each country. For programs to be successful the governments must have ownership; they must support the underlying goals and the specific action plans. This require an ongoing policy dialogue, not only in times of crisis, but when the countries are doing well. It is also critical that the Inter-American Development Bank work in partnership with the International Monetary Fund, the World Bank and other interested parties. Each institution has a unique perspective and a comparative advantage. The IDB's comparative advantage includes its history and record of responsiveness to the needs of the region based on its close working relationship with entities in the region, its capability to work at the institutional level, and its ability to derive valuable synergies from the delivery and focus of its portfolio of activities, including those of the Multilateral Investment Fund. These advantages also help facilitate the IDB's efforts to promote financial integration within the region. While it is important to avoid unnecessary duplication of functions, as a regional bank, the Inter-American Development Bank has a special responsibility to maintain a constant presence when the attention of our sister institutions is focused elsewhere.[3]

[3] For example, during the recent Asian financial crisis much of the attention of the senior policy specialists of the World Bank and the International Monetary Fund was focused on that region. Only the largest countries of Latin America and the Caribbean were given their normal attention. This reinforced the importance of the attention paid by the Inter-American Development Bank staff.

II. The Role of Financial Markets: A Summary

The Changing Paradigm of Financial Markets in Emerging Economies

Financial markets are critical to the development of a modern economy. Indeed, effective and efficient financial markets are considered second only to macroeconomic stability within the hierarchy of development requisites. Just as equilibrium prices for goods and services are established and revealed in a competitive market economy, the prices associated with intertemporal exchange of uncertain cash flows are established and revealed in financial markets. Because of the uncertainty involved with future cash flows (both in terms of the probability that the cash flows will be received and their relative future value, the proper analysis, monitoring and management of risk are central to our understanding of and ability to develop and/or restructure financial markets. Financial markets allow these uncertain cash flows to be priced and traded in an orderly and transparent process. Moreover, they allow combinations of uncertain cash flows to be repackaged, transferring risk to those with the greatest ability and/or willingness to assume specific risks and meet the needs of investors with different levels of risk tolerance.

Properly functioning financial markets facilitate the investment process by allowing portfolio selection at a lower cost, providing a store of value, creating liquidity, and perhaps most importantly, allowing for an efficient incorporation of all relevant information regarding risky cash flows into the determination of a market price. Efficient and effective financial markets allow investors to make well-informed judgements regarding the risk-return combinations associated with investment opportunities and form investment portfolios that account for these trade-offs. The development of complete financial markets also facilitates the process of risk management and corporate finance; only deep liquid markets can provide the instruments needed to create the financial structures that most closely match the risky cash flows associated with a specific set of investment alternatives.

When financial markets do not operate properly, when information is not readily available, when the store of value is not trusted, or when liquidity is questionable, the willingness of investors (both small and large) to commit funds is constrained. The hurdle rate (the required rate of return needed to induce investment) will increase, reducing the expected profitability of investment alternatives. Due to the increased cost of capital and underlying uncertainty, some otherwise promising investments will not take place.

The high cost of capital has been a recurrent problem in Latin America and the Caribbean. Many of the distortions in financial markets have their roots in attempts by governments (e.g., interest rate controls or subsidies, intervention in the allocation of credit, the creation of special purpose state-owned and managed banks, etc.) to compensate for the high cost of capital and/or the unwillingness among investors to place their funds at risk. Therefore, the new paradigm of government involvement in the financial sector being adopted throughout the region is of particular interest. There is a growing recognition that the comparative advantage of government is in the establishment of an enabling environment; creating the legal, regulatory and information structures upon which private financial markets can develop and flourish.

Under this new paradigm, the role of the state has changed. Many government-owned and managed financial institutions have been reformed and others have been privatized. Interest rates and the allocation of scarce investment resources, previously set by administrative fiat, are now determined by market forces. While there are undoubtedly situations of market failure that justify government intervention in financial markets, such interventions should be limited, closely monitored and evaluated to ascertain that they are having an impact on the underlying market failure and do not create excessive distortions and misallocation of resources. (See section on privately owned and managed financial institutions in the next chapter).

Despite significant differences in the financial markets of the countries of Latin America and the Caribbean, reform efforts point in one direction; namely, the development of complete financial markets. Much has been accomplished, but the process is far form complete. The private sector is actively involved in developing the financial innovations that can build upon earlier progress. This is being supported by a public sector that is moving forward to provide an adequate regulatory structure. Legal reforms have strengthened financial market regulators and their oversight of bank, insurance, pension and securities markets.

Supervisory standards and practices in particular are moving, albeit slowly, toward international levels. The full adoption of the *Core Principles of Effective Bank Supervision* prepared by the Basle Committee of Bank Supervisors (BCBS), *Objectives and Principles of Securities Regulation* prepared by the International Organization of Securities Commissioners (IOSCO), *Insurance Supervisory Principles* prepared by the International Association of Insurance Supervisors (IAIS), *Principles of Corporate Governance* prepared by the Organization for Economic Cooperation and Development (OECD) and the *International Accounting Standards* prepared by the International Accounting Standards Committee (IASC) are first steps in this process. Enforcement powers, and in many cases the political will to use them, have increased. Still, countries need to provide adequate resources to implement needed regulatory and supervisory oversight. The consolidated supervision of financial groups is limited (or nonexistent) in most countries of Latin America and the Caribbean. Supervisors need to be better trained and compensated, in order to affect a greater degree of professionalism. Disclosure standards must be set to impose market discipline. Likewise, consistent standards for dealing with insolvent financial institutions need to be set. To avoid incentives toward excessive risk taking, the shareholder claims of such insolvent institutions must be terminated in a timely fashion so that the losses associated with poor investment decisions are borne by the responsible shareholder rather than the taxpayer. The greatest attention has so far been focused on bank supervision, but attention is increasingly being focused on the oversight of securities and, perhaps to a lesser extent, insurance markets. This trend of strengthened and well-focused, consolidated supervision must be reinforced.

To date, the development of nonbank financial markets has been limited. Insurance and capital markets remain underdeveloped in most countries. Capital market activity remains concentrated in a small number of firms in a limited number of countries. There is a relation between country size and capital market development; it is harder for a small country to support a well-diversified capital market. Similarly, there is also a strong relationship between the development of capital markets and the timing and consistency of its economic reforms. Those countries that started the reform process earlier and those that have been following consistent policies in support of financial market development have grown more rapidly. The development of privately managed pension funds have acted as a catalyst of capital market development in come countries, but this also depend on size, legal and regulatory structure, and the perception of political and macroeconomic stability.

IDB Goals for the Development of Financial Markets

In the 1990s, the Inter-American Development Bank's work in financial market development has been guided by the following five goals:

- fostering the emergence of new and varied mechanisms for pooling longer-term savings in the domestic markets;
- developing financial instruments and infrastructure to channel financing, both domestic and foreign, into private sector investment;
- expanding the access to financial services by potential users of those services, especially smaller businesses;
- providing maximum efficiency, mainly by encouraging competition among the providers of financial services; and
- assuring adequate prudential regulation and supervision of the financial system.

The centrality of these basic goals has been reiterated often by IDB Senior Management. Moreover, the central importance and commitment of the IDB to these basic goals can be inferred from an analysis of approved lending and technical assistance programs.

Despite the changes that have taken place in the financial markets of the region in recent years, the IDB=s underlying goals remain unchanged. The IDB=s actions and programs, however, must adapt to these new environments. It is time to add two additional goals to the above list:

- supporting the establishment of new institutions, instruments and markets that will allow for efficient risk transfer mechanisms, and
- motivating an increase in financial market liquidity through the development of effective secondary markets.

III. Scope of Financial Market Development Strategy

The *Financial Market Strategy* concentrates on the key issues surrounding the development of financial markets in emerging economies. These include issues related to: a) the development of enabling legal and regulatory environments which allow complete, liquid financial markets to develop within a competitive framework; b) the institutional structure, including both the structure and ownership of financial intermediaries and the role of self-regulation; and c) the activities of state-owned or managed financial intermediaries.

Development of Enabling Environments

One of the primary responsibilities of governments, an area where the Inter-American Development Bank can provide significant assistance, is the development of enabling environments that allow deep, liquid and competitive financial markets to thrive. Several major issues can be addressed by the IDB as it works to develop these enabling environments. These include: the maintenance of macroeconomic stability and policy consistency; the establishment of appropriate legal and regulatory environments (including financial market safety nets, the integration/harmonization of financial markets, the establishment of appropriate governance structures, and encouragement for financial innovation).

It is essential that macroeconomic stability and the establishment of legal, regulatory and supervisory frameworks are introduced in conjunction with the liberalization of financial markets. Careful attention must be given to the sequencing of reforms. Without macroeconomic stability and appropriate legal structures and oversight, the liberalization of financial markets may lead to chaotic market situations and force government interventions at a high cost to the economy. Likewise, without laying the groundwork for the prudential development of financial markets, macroeconomic reform programs will fall short of their goals.

Maintaining Macroeconomic Stability and Policy Consistency

The most basic requisite to financial market development is the establishment of a stable macroeconomic environment. Price stability and confidence in the consistency of future economic policies are essential for individuals and firms to make judgements regarding investment opportunities. This is a symbiotic relationship, as a healthy financial system is likewise needed for macroeconomic policies to be effectively implemented. Policymakers are just beginning to recognize the extent of the relationship between bank soundness and a country's ability to implement a macroeconomic reform program.

A critical relationship exists between the degree of financial repression (high levels of reserve requirements, interest rate controls, and other interventions in the operation of financial intermediaries) and the ability of private sector financial intermediaries to meet the investment needs in a country. High levels of financial repression will have a negative impact on the quality of the loan and investment portfolios of commercial banks and other financial intermediaries. This encourages disintermediation, to the detriment of the banking system, with funds shifting to other financial markets or institutions, or potentially out of the country. There is a similar impact on the development of traded securities. Macroeconomic instability creates uncertainty and a resulting increase in price volatility. As well as reducing asset prices, risk increases the cost of trading and reduces market liquidity. Moreover, to the extent that some financial risks cannot easily be diversified or hedged, artificial limits are placed on some economic activities. The cost of financing will increase (leaving local firms at a competitive disadvantage compared to foreign competitors). The increased risk and associated risk charges will result in some otherwise acceptable investment alternatives becoming infeasible.

Developing Effective Legal Environments

In promoting the enabling environments that are needed for financial markets to develop, policy makers need to focus on the legal and regulatory framework. This framework forms the foundation upon which all financial market activities are built. Financial markets require a clear definition of the rights and responsibilities of those who enter into financial contracts; a fair, effective and expeditious judicial system wherein property rights are enforced; and a regulatory structure that establishes the institutional framework that oversees financial markets. These three components work together to protect investors and consumers, providing clear rules and regulations, adequate disclosure, and market transparency.

The Inter-American Development Bank has been actively involved in the establishment and regulation of laws governing financial markets and institutions. Nevertheless, the process is not complete. Some countries are less advanced than others, and significant efforts are needed in the harmonization of laws governing the financial sector in ways that will promote competition or provide adequate protection to the investing public. Specific reform strategies could include the development of modern legislation for securities trading, standardization of financial instruments, rationalization and consolidation of different regulatory requirements, and strengthening institutions responsible for monitoring and enforcing discipline in the marketplace. Countries need to consolidate existing reforms and take the next steps to deepen and integrate their economies with global markets. They must also prepare to deal with new instruments and new kinds of risks, bringing laws and regulations up to international standards.

The legal reforms supporting banking systems are generally more advanced than those related to insurance and capital markets. Nevertheless, in all of these sectors, regulatory agencies often lack the legal authority to effectively monitor and control risk taking activities. There are still important gaps regarding the perfection and execution of collateral, securitization of financial instruments, and netting arrangements. The rights and responsibilities associated with derivative securities and other financial innovations are often poorly defined. In some countries laws regulating insider trading, money laundering and other financial crimes (and their enforcement) are below international standards.

Beyond the establishment of laws and regulations, significant efforts are needed in the area of enforcement. Any judicial incapacity regarding the enforcement of contracts associated with financial market transactions in an efficient manner will increase uncertainty and reduce the ability of markets to innovate. Judiciaries need to be trained, and possibly special panels should be established to meet the needs of the more innovative transactions.

THE ROLE OF THE INTER-AMERICAN DEVELOPMENT BANK IN DEVELOPING THE FINANCIAL SECTOR IN LATIN AMERICA

THE ADOPTION OF INTERNATIONALLY RECOGNIZED FINANCIAL STANDARDS

The underlying theme in this Financial Market Strategy is that capital markets are powerful and efficient allocators of resources, that all levels of society can benefit from capital available in the market, and that investors demand full and open disclosure of information in order to make rational decisions regarding risks and rewards. Capital markets tend to be self-regulating, and government regulation and intervention should be directed toward establishing clearly defined market procedures, promote scale economies, and facilitate market transactions.

The competitive advantage of the Inter-American Development Bank in the area of financial markets is that it can engage in policy dialogue with governments and play this role with continuity and commitment. In addition, particularly in the case of the poorest countries, it can provide financial support to the reform process. The Bank, an institution owned by borrowing member countries, can assure a broader vision and a perspective of financial and economic integration and help Latin American countries to move toward implementation of international financial standards in the various areas of banking supervision, risk management, disclosure, corporate governance, and insurance.

The Inter-American Development Bank should concentrate its efforts on developing enabling environments, encouraging the creation of stable macroeconomic conditions, supporting legal and regulatory systems, favoring the introduction of recognized international standards, and promoting the institutional structure that will allow prudentially managed, competitive and innovative, private financial institutions to flourish. Regional operational departments and central departments should increase their capability of producing a combination of issue and country specific financial market strategies to meet regional, subregional and each country's needs.

Reform of the financial sector is a continuous process. The Bank should be able to assure a homogeneous coverage of the so-called first generation issues (e.g., institutional and legal reform, and banking sector restructuring and supervision). At the same time, the Bank should achieve a deeper specialization both at the central and operational level, in areas such as risk management, development of government bonds, mortgage based securities, municipal finance, security markets, payment, clearance and settlements, and cross-sector work (e.g., aimed at developing capital markets to increase the financing of housing, education, small and medium enterprises and microenterprise).

In the past, the international finance institutions were mainly focusing on the fiscal and monetary policies to maintain the exchange rate and reach macroeconomic stability and there was little concern with the internal institutional arrangements of the banking and financial systems (e.g., banking supervision and regulation, payment clearance and settlements systems, auditing and accounting, bankruptcy procedures and corporate governance). It is now evident that the fragility of the functioning of the financial system prevents the implementation of a macroeconomic adjustment program. Therefore, far-reaching institutional reforms are needed, particularly in the area of bank regulation and supervision, auditing and accounting, insurance, insolvency codes, and corporate governance, to assure the efficiency payments and clearance, effectiveness of the financial sector.

International bodies in the public and private sector are in the process of developing Afinancial standards@ in their respective area of expertise, e.g., International Accounting Standards Committee (IASC); the International Organization of Supreme Audit Institutions (INTOSAI); the International Corporate Governance Network (ICGN); the International Organization of Securities Commission (IOSCO); the Basle Committee of Banking Supervision (BIS); the International Federation of Accountants (IFAC); the International Association of Insurance Supervisors (IAIS) and the Organization for Economic Cooperation and Development (OECD). The Bank should actively support their dissemination in the region, and promote their adoption as part of the dialogue with the various countries.

DEVELOPING AN ADEQUATE REGULATORY ENVIRONMENT[4]

The legal and regulatory reforms implemented by the countries of Latin America and the Caribbean have provided the basis for the safe and sound development of financial markets and have served as a catalyst for financial market development. Nevertheless, while most countries have adopted the basic recommendations of the Basle Committee on Bank Supervision governing credit risk, most regulators are just beginning to look at the capital requirements for market risk (e.g., interest rate risk, foreign exchange risk, commodity price risk, etc.)[5]. Consolidated supervision is weak or nonexistent in many countries, despite the fact that financial groups are active in a variety of markets and instruments.

Regulatory oversight should be aimed at ensuring the safety and stability of financial intermediaries that take deposits from the public, provide a fiduciary management of assets on behalf of the public (e.g., mutual funds, pension funds, etc.), or provide insurance, risk transfer or other financial services to the public. Ideally, regulatory systems should be designed to provide a balance: protecting the integrity of the financial system without being overly burdensome. The IDB must support markets that are transparent in their operations, provide adequate disclosure by financial intermediaries, protect the rights of small, unsophisticated depositors, policyholders and minority investors. Regulators need to exercise care to protect markets not shareholders, otherwise they risk creating incentives toward excessive risk-taking activities, where gains are privatized and losses socialized.

In protecting the integrity of markets, regulators must be able to monitor risk, to establish controls regarding excessive risk-taking, and to enforce appropriate disciplinary actions on a timely basis (including the intervention and/or liquidation of intermediaries that do not meet prudential solvency rule). Consolidated supervision of financial groups should be adopted to eliminate regulatory arbitrage. Self-regulation (with appropriate oversight) should be adopted where appropriate.

In the securities markets area, a review of the experiences of the countries in the region reveals varying degrees of success. In some countries, the basic legal structure governing capital markets and institutional investors has been established but regulatory bodies remain weak. Enforcement powers are poorly defined and the relationship between official regulatory agencies and self-regulatory organizations has not been fully established. The first generation of legal and regulatory reform has mainly focused on market definitions. Some of the countries in the region still need to complete this first phase and might benefit from assistance in building a basic regulatory infrastructure. While self-regulation should be promoted it must be done on a gradual basis and in tandem with increased investor sophistication and access to market information and reduced concentration of interests. The promotion of self-regulation must also be consistent with the evolution of the legal/regulatory framework as evidenced by the increased regulatory capacity of market regulators.

The international regulatory community is putting increased emphasis on the adequacy of capital to cover potential credit losses as well as market risk.

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[4] Many of the proposals on effective oversight of financial intermediaries are drawn from four sources: a) E. Gerald Corrigan, "Building Effective Banking System in Latin America and the Caribbean: Tactics and Strategy." IFM-107, Washington D.C.: Inter-American Development Bank, May 1997; b) Basle Committee on Banking Supervision, "Core Principles for Effective Banking Supervision," Basle: Bank for International Settlements, September 1997; c) International Association of Insurance Supervisors, "Insurance Supervisory Principles," September 1997; and d) International Association of Insurance Supervisors, "Guidance on Insurance Regulation and Supervision for Emerging Market Economies," September 1997. While the first two documents concentrate on reform in banking systems, and the second two on insurance, many of the observations and insights are equally valid for all types of regulated financial intermediaries (commercial banks, life and general insurers, pension funds, etc.). International banking securities and insurance regulators are working to coordinate their activities to avoid regulatory arbitrage.

[5] The Basle Committee on Banking Supervision, *A New Capital Adequacy Framework*, has also introduced a proposal for risk capital that would replace the 1988 Accord. Regarding minimum capital requirements, the proposal suggests a modified version of the 1988 Accord but recommends the use of internal credit ratings and portfolio models as more appropriate techniques for risk assessment of the capital requirement for sophisticated banks.

Capital is provided as a cushion to protect depositor funds from credit or investment losses. In addition, the establishment of adequate capital requirements is increasingly viewed as the primary mechanism for preventing excessive risk-taking activities by financial intermediaries.

To the extent that a financial institution is exposed to market risk (i.e., interest rate risk, foreign exchange risk, commodity price risk, etc.) from its market positions or trading activities, additional capital is required. International regulators are requiring the use of value-at-risk models, designed to measure the required capital based on exposure to market risk. The Basle Committee and some leading regulatory agencies have developed prototype models that their institutions are required to use.[6] Nevertheless, the trend is to allow commercial banks to use their proprietary models to the extent that the banks can prove that they have the sophistication to implement their own model and that their model measures and controls market risk as well as the prototype model.

The level of capital adequacy of the banking system is of concern in many of the countries of Latin America and the Caribbean for three reasons. First, while most countries in the region have adopted some version of the Basle standard, many bankers and regulators seem to view the 8% as a target and not as a minimum level of capital (even before adjusting for the higher economic and financial volatility in the region).[7] Second, the quality of accounting standards is low, especially regarding the level of provisions and the measurement of capital resulting in an overstatement of capital adequacy. Third, because of the complexities of determining the appropriate measurements of value-at-risk in illiquid emerging markets, most of the countries of the region have not yet adopted requirements for maintaining capital against market risk. The IDB must continue its efforts to assure the proper measurement and provision of capital.[8]

It is essential that the supervisory function be independent from other government activities, adequately staffed with qualified professionals who have the financial resources needed to accomplish their goals and the authority to act prior to the declaration of insolvency. In all cases, the regulatory authority must balance the costs associated with regulation with its benefits. Supervision must aim to strike a balance between maintaining solvency and protecting the system by allowing banks to adopt the innovations needed to remain competitive. The cost of adequate supervision is high, but the cost associated with a systemic banking crisis (the direct costs of bank failure resolution plus the economic drag associated with a crisis) is far higher. Indeed, the impact of a financial crisis can undo many years of efforts aimed at reducing poverty.

As the regulation and supervision of financial markets is strengthened, and as the financial markets develop beyond a reliance on depository institutions, policymakers will have to pay particular attention to seeking greater harmonization of the

[6] See: *Intra-Group Transactions and Exposures and Risk Concentration Principles*, Basel Committee on Banking Supervision (July 1999); *Credit Risk Modeling: Current Practices and Applications*, Basel Committee on Banking Supervision, (April 1999); and *Operational Risk Management*, Basel Committee on Banking Supervision (September 1998).

[7] Based on historic risk profiles in OECD countries (and assuming that prudent levels of provisions for loan losses were being correctly applied) the Basle Committee of international bank regulators has recommended that the minimum level of capital adequacy (prior to regulatory sanctions taking place) be set at 8% of risk-adjusted assets. Analysis by the Office of the Chief Economist at the Inter-American Development Bank suggests that minimum capital levels for banks operating in more volatile emerging markets should be much higher. See: Rojas-Suarez, Liliana and Stephen Weisbrod, *Towards and Effective Regulatory and Supervisory Framework for Latin America* [Washington D.C.: Inter-American Development Bank, September 1998]; and Gavin, Michael and Ricardo Hausmann, "The Roots of Banking Crises: The Macroeconomic Context" in *Banking Crises in Latin America*, edited by Ricardo Hausmann and Liliana Rojas-Suarez [Washington D.C.: Inter-American Development Bank, 1996] . Moreover, this minimum level, as established, only considers credit risk.

[8] In terms of the measurement of value at risk, the IDB, with resources provided by the Financial and Securities Market Development Program (ATN/SF 5275-RG) contracted the development of a *Model Risk Management System* that can help financial institutions and other firms develop and implement appropriate risk management systems. A book, *Gestión de riesgos financieros: Un enfoque práctico para países latinoamericanos*, (a joint publication of the Inter-American Development Bank and Banco Santander) was published in 1999 (English version available in January 2000).

legal and regulatory frameworks across the region, government's role in providing a financial markets safety net and managing financial crises, the role of corporate governance in assuring that financial markets function well, and supporting the process of financial innovation (especially with regards to the development of institutional investors). In each case, international standards should be used as the starting point.

FINANCIAL MARKET SAFETY NET AND MANAGEMENT OF FINANCIAL CRISES

Because of the central importance of financial markets to the functioning of the overall economy, most developed and emerging economies have established some kind of safety net, designed to protect the overall system and promote depositor confidence. The safety net, in conjunction with the regulatory oversight discussed above, usually consists of a lender of last resort facility at the central bank and limited deposit insurance.

While the general principles governing the two pillars of a financial safety net are well known, putting them into practice is far more difficult. A central bank, as lender of last resort, should only lend on a fully collateralized basis to solvent institutions in order to prevent contagion (bank runs with liquidity pressure spreading from insolvent to solvent institutions). Likewise, deposit insurance, when it exists, should be explicit, well defined in terms of who and how much it will cover and limited to depository institutions supervised by government authorities. This requires that financial market supervisors are able to judge when there is threat to the system as a whole, and should only act to protect the system and not protect individual institutions from poor management or investment decisions. Marginally solvent institutions must be closed before they place deposits from the public at risk.

While prudential regulation is designed to prevent financial crises, countries must be prepared to deal with crises as they develop. The IDB programs, which support the development of a financial market safety net, should assure that systems are created for crisis management. The development of deep, liquid markets, including secondary markets of tradable securities and markets for hedging financial risk should be a component of any crisis management program.

HARMONIZATION OF REGULATORY FRAMEWORK

The Ministers of Finance of the Western Hemisphere have charged the multilateral institutions with promoting the integration of financial markets in the region; harmonization to international standards is a crucial ingredient in that process. This provides a framework to expand tradable financial instruments, facilitate greater participation of institutional investors, encourage intra-regional cross-border capital flows, and reduce regulatory arbitrage. In order to harmonize regulatory policy for financial markets, policymakers must assure that common standard are set for, *inter alia*, the rules and practices for disclosure and trading, and centralized and standardized systems for clearance and settlement.

CORPORATE GOVERNANCE

Good corporate governance involves the protection of shareholder rights, including the rights of minority shareholders, and limitations on and disclosure of transactions with insiders. Legislation that fosters an improved corporate governance environment increases market attractiveness. Particularly in securities markets, it will be difficult to attract investors unless they can be assured that firms will be managed to their benefit and not that of management or of a few large shareholders. A market for corporate control, allowing investors to intervene and excise management that is considered ineffective is essential to properly functioning markets.[9] In May 1999, the OECD released its Principles for Corporate Governance. The Principles focus on publicly traded companies and are intended to assist governments in their efforts to improve the legal, institutional and regulatory framework for corporate governance. The Principles pertain to issues on shareholder rights, equitable treatment of shareholders, the role of stockholders in corporate governance, disclosure and transparency; and the responsibilities of Boards of Directors.

[9] See *Principles for Corporate Governance*, OECD (May 1999).

FINANCIAL INNOVATION

To be successful, emerging financial markets must be able to provide new products and innovations. For the Latin American and Caribbean whose financial markets are relatively more developed, these innovations will be similar to those offered in the financial markets of industrialized countries. In these economies, there is an important unmet demand for risk management and investment services that needs to be addressed. This will require the introduction of policies that allow flexibility in the types of instruments that can be traded on markets or offered by financial intermediaries. Innovation is also important in economies with less developed financial markets, but these innovations must be centered on providing basic credit and savings products more effectively while developing the legal and regulatory framework needed to assure safe and sound financial intermediation of investment funds and basic risk transfer and/or risk pooling mechanisms. In both mature and less sophisticated markets, this will require legal and regulatory reforms appropriate to current market structures and needs. The legal and regulatory environment must be responsive to and encourage financial market innovation.

INSTITUTIONAL STRUCTURE

The structure and effectiveness of financial markets depend on the number and variety of institutions that operate within a given economy and the relationship of these institutions to the international markets. Policymakers must address the important issues surrounding the role of competition, the development of appropriate information environments, the mobilization of savings through domestic institutional investors, innovation in capital markets, the development of capital market infrastructure, and the role of publicly owned and managed financial institutions.

DEVELOPMENT OF ENHANCED INFORMATION ENVIRONMENTS

The emergence of complete financial markets will require transparent information environments. The underlying information environment must assure investors and others that markets are efficient and financial instruments are priced appropriately. When information is not trusted, or when there is significant uncertainty regarding its quality, the cost of capital increases, preventing many otherwise acceptable investments from taking place. Enhancing the information environment of Latin America and the Caribbean will require improvements in the disclosure of macroeconomic information, a transition to global accounting and auditing standards, and the establishment and enforcement of disclosure requirements at international levels.

IMPROVED DISCLOSURE OF MACROECONOMIC INFORMATION

Investors need comprehensive and reliable information regarding the current status of the economy as a whole. When complete information is not available on a timely basis and there is the perception that negative information will be hidden from the market, the level of anxiety and uncertainty increases. There is considerable evidence that both the Mexican economic crisis of 1994 and the current Asian crisis have their roots in incomplete information or surprises regarding the overall macroeconomic condition and the financial condition of the banking system.[10]

TRANSITION TO GLOBAL ACCOUNTING AND AUDITING STANDARDS

Firms that expect access to international or domestic financial markets must commit to provide comprehensive and timely information regarding their financial condition. This requires the production and dissemination of credible financial information that can be easily understood and compared across investment alternatives. When the quality of accounting principles is substandard, allowing a variety of alternative representations of a firm's financial condition, when these principles are inconsistently applied, or when the verification practices of

[10]The International Monetary Fund has developed guidelines for the dissemination of macroeconomic information, the Special Data Dissemination Standard (SDDS). As of early 1999, of the countries of the Latin America and the Caribbean region, only Argentina, Chile, Colombia, Ecuador, Mexico and Peru have subscribed to the SDDS and some of these are still in transition to compliance with the full SDD standard.

external auditors are suspect, confidence is misplaced and the cost of capital is unnecessarily increased.

One of the most effective ways of improving the information environment is through the adoption of high quality, globally accepted accounting principles and auditing standards. The International Accounting Standards Committee (IASC) is finalizing a set of core accounting principles, which can be considered truly international. The International Organization of Securities Regulators (IOSCO) is working with the IASC to ensure that the core principles are sufficiently strong to be used for cross-listing purposes. Recognizing the importance of compliance with international standards for accounting, auditing and disclosure the Finance Ministers of the Western Hemisphere, in their December 1997 meeting, reaffirmed their support for "greater harmonization of accounting procedures and concrete steps toward consistency of information disclosure."

IMPROVED DISCLOSURE REQUIREMENTS FOR SECURITIES MARKETS PARTICIPANTS

A corporate culture that is open to sharing information is required before securities markets can be successfully developed. The improvement of accounting and auditing standards discussed above, is an important first step in this process, but enforcement of these standards is also essential. The securities and exchange commissions of the region must take steps to institute and enforce disclosure standards comparable to international levels.[11]

RATING AGENCIES AND CREDIT BUREAUS

While they do not replace the need for improving accounting, auditing and disclosure standards, rating agencies and credit bureaus can play a particular role in promoting a transparent information environment. It is likely that the role of rating agencies will continue to increase as private investors demand better and more credible information regarding the financial condition of smaller firms and subsovereign institutions.

The function of credit bureaus is entirely different. Rather than specializing in the in-depth analysis of specific (usually larger) firms, credit bureaus provide a unified and comprehensive source of information on the payment history of individuals and firms. Laws and regulations that permit the establishment of credit bureaus and allow creditors to share information, while protecting privacy rights, are still needed in many countries in the region.

INVESTOR EDUCATION

Potential investors, large and small, need to be educated regarding the risks and potential returns associated with available investment opportunities. They also need to understand the legal protections that are available, especially the protection of minority shareholders, and their rights to clear and comprehensive information regarding the financial condition and future prospects of traded firms. Education should also include the role of diversification (e.g., risk reduction via mutual funds) and hedging opportunities. Under the leadership of the Council of Securities Regulators of the America (COSRA), an investor education campaign was launched by several of the region's securities regulators across the Western Hemisphere in early 1998.

INSTITUTIONAL INVESTORS AND MOBILIZING DOMESTIC SAVINGS

Foreign capital and domestic savings are key to long-term economic growth. However, recurring problems such as the debt crisis of the 1980s, the Mexican currency crisis in late 1994, and the current East Asian crisis, demonstrate that overdependence on foreign portfolio investment, particularly mobile and short-term investment instruments, can threaten the economic stability of emerging markets. It is therefore imperative that emerging markets in the region increase the level of domestic savings.

Institutional investors who can operate in domestic currencies are critical to capital formation and furthering the growth of domestic savings. With the onset of macroeconomic stability and the legal and

[11] The Inter-American Development Bank sponsored a conference on the role of financial disclosure in the development of financial markets in late 1997. Several of the presentations are included in *Financial Disclosure: A First Step to Financial Market Development*, edited by Kim B. Staking and Alison Schulz [Washington, D.C.: IDB, 1999].

regulatory reforms that have taken place over the last decade, institutional investors are beginning to play a more important role in channeling domestic savings to investment opportunities. These investors, including pension funds, insurance companies and mutual funds are also critical to the provision of long-term funds for financing infrastructure and other long-term investments.

Innovation in Financial Markets

Financial innovation facilitates the development of financial markets in the region by providing a greater number and type of financial instruments and institutions. Financial innovation can be realized through a gradual process, as market participants respond to new needs in the market place. Regulatory reform and institutional development can also facilitate innovation. When government authorities do not understand new instruments, or their potential impact on markets, and the techniques in place to control associated risks, they will tend to oppose innovations. Regardless of the path adopted, sustainable financial innovation depends on the needs of financial intermediaries and investors and the government's support for the development of viable financial instruments. Some countries in the region, that have undergo significant financial sector development, are now confronted with opportunities to develop long-term bond markets, securitization, derivative markets, commodities markets, and credit enhancements.

There is an important link between regulation and financial innovation. Regulators must closely examine the effect of regulation on the institutions and markets they oversee. Regulations that protect the general interest of the public are highly desirable, but the regulations must not constrain the capacity and willingness of financial institutions to take appropriate risks and to diversify and/or hedge these risks. Excessive regulation may prevent innovation, and indeed, much financial innovation can be viewed as an attempt to avoid or circumvent financial regulation. Nevertheless, regulation that focuses on expanding market access and encouraging the development of new financial instruments can play a significant catalytic role in promoting financial innovation. When innovation is stifled, both financial institutions and the public they serve may end up with suboptimal risk arrangements. Some otherwise acceptable projects will not be undertaken or the financial cost associated with these projects will be higher than necessary.

Encouraging Competitive Environments

An important requisite to the development of deeper and complete markets is the establishment of a competitive environment. Taking into consideration discussions that occur in other forums (WTO, FTAA) and based on international agreements that member countries have undertaken, an effort will be made to complete a comprehensive evaluation of market structures, rationalize barriers to entry and exit, lift restrictions on activities and/or investment by foreign-owned financial institutions, and eliminate other legal or regulatory restrictions that impede competition.

Specific attention needs to be focused on how the IDB=s support can best be used to develop longer-term markets. The ultimate goal should be the development of competitive markets and an appropriate combination of institutions in each country that will voluntarily provide financial services to all potential users, regardless of size, at prices that adequately reflect the cost of funds; the costs associated with selection, analysis and monitoring of potential investment projects; the cost of risk; and the required risk-adjusted return on capital to the owners of the financial intermediary.

Provision of Financial Services by Intermediaries to Individuals and Smaller Firms, as well as in Rural Settings

In recent years, the development of financial markets, institutions and instruments in Latin America and the Caribbean has tended to concentrate on the needs of larger borrowers and high net worth individuals. Many market participants (or potential participants) have not been able to gain access to needed financial services due to the lack of an appropriate institutional structure. The Inter-American Development Bank has a special role in supporting the development of those institutions that provide credit, savings and other financial services to smaller firms, to the poor and in rural areas. In doing so, the IDB must be guided by market principles and sustainability. It must attempt to assure that these institutions are properly regulated, that they are properly capitalized, that they operate in a safe and sound manner to protect the interests of depositors, and that financial services are priced so that the institutions providing the services are sustainable.

While there is evidence that the development of more competitive financial markets will result in commercial banks and other financial institutions reaching out to portions of the populations that are not served, the IDB can, through an active approach, speed this process. By demonstrating that these are legitimate (and potentially profitable) markets, by supporting needed legal and regulatory reforms, and by providing technical assistance the IDB can support those institutions that are willing to provide services to marginalized sectors of the economy. Of particular importance is working with member governments to assure that laws and regulations do not prevent the development of financial services for these segments of the population. Technical assistance programs should concentrate on sustainability, developing more effective operating structures and introducing systems for the analysis and monitoring of credits, among others.

Because of the low level of competition in many of the markets (and the inability of individuals to use alternative services), reform programs, while recognizing the higher cost of working with these sectors, must guard against monopolistic practices. Credit unions, other cooperative financial institutions, and credit granting NGOs and other microfinance institutions may provide some safeguards to protect consumers, but must be operated professionally. Considerable efforts are still needed in this area.[12]

[12] These issues are addressed more fully in the Profile of the *Rural Finance Strategy* (GN-2022) currently under review.

Capital Market Institutions

As capital markets in the region continue to development, there will be an increasing need for a modern institutional structure that will provide investors with confidence in markets and appropriate transactional abilities. Organizations such as exchanges, securities depositories and clearing and settlement systems, among others. are required. The IDB Group can play an important role in making certain that such institutions are established, properly regulated and are operating according to international standards.

Publicly Owned and Managed Financial Intermediaries[13]

In the restructuring of financial markets, there is an ongoing discussion as to whether or not there is a role for publicly owned and managed financial institutions, especially first tier institutions. Questions are consistently raised regarding the role of public sector banks (and other financial intermediaries) and the extent to which public intermediaries distort financial markets. Likewise, there are questions regarding the role for the government in the development of longer-term financial markets and/or filling special market niches where the private sector is unable or unwilling to operate.

While there is ample evidence of imperfections in financial markets, especially due to information asymmetries, there are likewise a multitude of problems in the financial markets in developing countries that are attributable to government failure, where government actions prevent markets from working. While some forms of intervention may be warranted, the conditions under which they can be successfully applied are likely to be quite restricted and must be carefully analyzed and justified on a case-by-case basis. Moreover, any government

[13] The discussion in this section is based on Vives, Antonio and Kim B. Staking, "Financial Intermediation and Policy Based Lending: Policy Recommendations for Latin America and the Caribbean" `[chapter 10 of *Policy Based Finance and Market Alternatives: East Asian Lessons for Latin America and the Caribbean*, Washington D.C.: Inter-American Development Bank, 1997].

interventions should be temporary and carefully targeted to the market failure, using market incentives whenever possible.

When private markets are unwilling or unable to provide some service, governments must prove that the market failure will be corrected through their intervention.

- If there are information asymmetries, the government must demonstrate that is has better access to information (or is better able to use existing information).
- If there are externalities, the government must be able to justify that the proposed program corrects the market's allocation in ways that take the externalities into account.
- If private markets are unwilling to lend to a specific sector, the government must show that its programs are able correct the underlying cause of the problem and not just the symptoms of market failure.

Decisions regarding the restructuring or privatization of publicly owned and/or managed financial institutions must be based upon an understanding of the incentives facing public banks and the purported comparative advantages which they may hold *vis-à-vis* their private counterparts. The difficulties associated with the corporate governance of public banks, including conflicts of interest, moral hazard and adverse selection problems, need to be addressed. The IDB has worked to eliminate these distortions, supporting either the privatization of publicly owned and managed financial institutions or their conversion to second tier banks, limiting their actions to the selection of first tier institutions and facilitating the flow of long-term external funds to the private sector at market conditions.

As very few direct interventions in financial markets in Latin America and the Caribbean have proved successful and have often led to greater distortions in the allocation of credit, the Inter-American Development Bank should continue to encourage a rationalization of the activities of state-owned and managed financial institutions. The IDB should continue its support for the rationalization of state-owned banks operating as first tier institutions, promoting their operation along the lines of their private sector counterparts. Likewise, on-lending of IDB funds by state-owned second-tier financial institutions should be at rates that approximate market rates of similar terms and conditions and be limited to private first tier institutions that are able to demonstrate solvency, financial strength, and the ability to intermediate term funds. Funds should preferably not be directed at any specific sector of the economy, unless market failures are proven, and all subsidies should be fully transparent, funded and disclosed in the government's budget, and not be hidden in a below market interest rate or via other distortions.

While longer-term markets are developing and commercial banks are regaining access to international markets, there may, in some countries, be a temporary role for the government in intermediating longer terms funds to solvent, well managed financial intermediaries. In these second tier-lending programs, the private financial intermediaries should be responsible for the individual lending decisions and the monitoring of the investments and receive the reward and/or suffer the consequences resulting from their actions. Resources should be allocated at close to market rates in order to avoid subsidies to the owners of financial intermediaries.

IV. THE IDB=S ROLE AND STRATEGY

LENDING PROGRAM OBJECTIVES

The development of financial markets should not be considered and end in itself, but rather the development of complete, deep and efficiently functioning financial markets should be promoted because of their role in the development of the underlying economy. IDB involvement in supporting financial market development can be justified, but as noted earlier, the IDB is largely limited to indirect actions. Private investors must be willing to commit their time and financial resources. The program in each country will depend on financial sector requirements, existing market structure, and a careful diagnosis of current plans and resources (both human and financial).

Because of the differences between countries, no single approach can be used. The program that is appropriate for one country may miss the most critical issues in another. With this in mind the efforts of the IDB should be concentrated on the following types of initiatives:

- The establishment of an enabling environment for the development of financial markets;
- The establishment of an appropriate safety net (to protect markets rather than institutions and small depositors rather than shareholders);
- The establishment and enforcement of appropriate legal and regulatory environments, including the elimination of regulatory arbitrage;
- The establishment and enforcement of appropriate prudential regulations including strict capital adequacy regulations to eliminate incentives for excessive risk taking;
- Encouragement for the development of competitive markets and institutions that help determine market prices and promote their utilization;
- The reduction of risk in markets and in the investment decision process via adequate information disclosure and market transparency;
- An assurance of the development of a variety of well-regulated, solvent and efficient private financial intermediaries that will voluntarily provide financial services (including credit) to creditworthy projects regardless of size or location at a price that reflects the funding costs, operating costs, credit risk, and an appropriate return on capital;
- Encouragement for the creation of specialized, market-oriented and appropriately regulated financial intermediaries providing credit, savings and other financial services to marginalized populations (smaller business, the poor, and rural areas);
- A rationalization of the role of publicly owned or managed financial institutions;
- The elimination of market distortions and/or excessive government interference in the allocation and pricing of financial assets;
- Support for the adoption of appropriate technologies for the delivery of financial services;
- Support for the development of financial innovations along with appropriate risk control mechanisms;
- The establishment of appropriate financial crisis management tools; and
- The development of long term savings mechanisms (including pension funds and other institutional investors.

The objectives identified above should be viewed within the context of improving the overall efficiency of financial markets, the financial intermediation process, and the ability of markets and institutions to allocate scarce financial resources. The objectives must also be placed within the context of the more overarching goal to facilitate financial market integration. Liberalization of capital markets, increased international flows, financial and technological innovations drive financial integration. For many regions, the process of financial integration is facilitated by growth in regional agreements on finance issues, harmonization of legal and regulatory structures, and support for increased cross-border financial activity. This phenomenon is mainly North-South, with less significant intra-regional financial activity among emerging countries. The IDB[14] could play a major role in furthering financial integration by considering the following:

- As a first step support the introduction of a common and harmonized regulatory framework based on international standards;
- Coordinate work with regional and subregional entities that are also working at the regional and subregional level toward the objective of financial integration;
- Consider the appropriate mechanisms for risk management and management of financial crises due to contagion and spillover effects; and
- Promote sharing of experiences with the region and convene meetings and forums to develop an agenda for specific areas of cooperation.

The process of developing deeper markets is complex. The core reform programs undertaken in many countries will have to be consolidated and concrete, long-term programs of market reform and institutional development will have to be initiated. The establishment of priorities and sequencing of reforms must be carefully considered in the programs supported by the Inter-American Development Bank.

COUNTRY SPECIFIC FINANCIAL MARKETS STRATEGIES

The IDB will continue to work on the development of financial markets in the region. Most of this effort will be undertaken on an individual country basis according to the normal activities of the IDB. Such an approach is appropriate because the situation of each country is different and the eventual structure of each country's financial market will depend on its stage of development, its size and its needs.

While the individual programs will differ, they should be consistent with this overall strategy and specific financial markets issues. Linked to this is the need to put in place the mechanisms that will facilitate financial market integration. In the case of countries where financial market development is a priority for IDB involvement, it is proposed that the Regional Operating Departments, with the support of central departments, prepare a *Country Specific Financial Market Strategy* (in the context of the country paper). No single approach or blueprint can be applied to the individual circumstances of each country. These individual *country strategies* will take into account the level of economic development and financial market potential of each country. Each should include an analysis of current markets conditions, identify critical distortions in each country and propose a concrete financial market development plan. As a preliminary work program these strategies could be limited to those countries where the IDB will concentrate efforts in the financial markets. In these countries, the financial market strategy could be included as an *Annex* to the *Country Paper*.

The *Country Specific Financial Market Strategy* should be based on the development needs over the next five to ten years. This should be supported by a country specific work plan (incorporated in the programming documents) to cover the next two to four years, including an appropriate combination of the tools available to the IDB (investment sector loans, multisectoral credits and technical assistance programs as well as educational and dissemination programs. As noted above, they need to be individualized to target the needs of each country.

[14] The IDB has supported several regional initiatives that support the process of financial integration. These include: the on-going collaboration with the Council of Securities Regulators of the Americas (COSRA) on regional issues for securities regulators, the Western Hemisphere Payments, Clearance and Settlement Initiative that is being executed jointly with the World Bank, and its support for the implementation of financial standards pertaining to risk management, and bank and insurance supervision.

ISSUE SPECIFIC FINANCIAL MARKETS POSITION PAPERS

In recent years, the IDB has launched a number of important initiatives in support of the development of financial markets, some of which are still in the early stages of implementation. Many similar initiatives are being designed and funding sources are being identified. These programs are directed at assisting both the public and private sectors deal with new issues that arise as financial market develop and are increasingly integrated into international markets. In support of the private sector these include:

- The development of a model risk management system (providing a systematic methodology that can be used by financial institutions, or other firms facing market risk, to identify and incorporate these risks into their management information systems and decision making processes) which will enable management to understand, manage and control the financial risks faced by investors;
- Programs to improve internal controls systems in small- and medium-sized banks, allowing them to overcome the managerial and operational deficiencies too often noted by supervisory authorities; and
- The development of futures markets.

Even greater efforts have been placed on supporting improved oversight and creating enabling environments for financial markets. These efforts include:

- An expansion in training programs for bank and securities market supervisors (including a specific emphasis on regional/subregional efforts);
- The implementation of core supervisory principles for effective bank supervision;
- Encouragement for improved financial and macroeconomic disclosure by corporate and government entities;
- The identification of key issues and actions supporting the integration and harmonization of financial markets;
- Various tailor-made programs aimed at promoting the development of securities markets; and Support for a region-wide program of investor education, with an emphasis on investment opportunities and their associated risks.

The SDS/IFM publication, *Financial Market Development: Issues, Strategies and Inter-American Development Bank Activities* (August 1999), provides a detailed account of the IDB Group's activities aimed at supporting the development of financial markets, and the Groups use of the tools described above.

Some of the IDB's efforts will have to be addressed on an issue specific basis. Specific position papers or best practice papers will need to be developed to supplement the *Country Specific Financial Markets Strategies*. The topics will be developed by the Sustainable Development Department in consultation with the Regional Operating Departments, the Research Department, the Integration and Regional Programs Department, and IDB Senior Management. Topics currently being considered are:

- An analysis of legal, regulatory and judicial issues surrounding the development of new markets, institutions and instruments;
- A comprehensive analysis of the changes currently underway in international accounting standards, the effect of information disclosure and the role of information in a modern financial market, and proposals for the countries of Latin America and the Caribbean to fully adopt and implement internationally accepted accounting standards, auditing practices, and disclosure guidelines;
- The incorporation by financial intermediaries of best practices for risk management in emerging markets along with appropriate oversight by regulators;
- The development of primary and secondary mortgage markets;
- A better understanding of optimal investment management and asset/liability practices for institutional investors with long-term liabilities (e.g., insurers and pension funds), especially in

emerging economies where diversification opportunities may be limited;

- Identification of best practices in insurance supervision;
- Encouraging private sector involvement in municipal finance;
- A survey of compliance with *Core Principle for Effective Bank Supervision* (BCBS), *Objectives and Principles of Securities Regulation* (IOSCO) and *Insurance Supervisory Principles* (IAIS), with the intention of developing Bank-sponsored programs to fully implement these basic supervisory principles;
- Identification of best practices for second-tier financial institutions;
- The mobilization of local currency debt financing sources to fund private infrastructure projects; and
- Principles, policies and an implementation program for financial market integration.

These projects will be undertaken as resources become available and the results will be disseminated through conferences, seminars and roundtable discussions with policymakers and private sector participants from the region as well as IDB staff.

V. IMPLEMENTATION

PRIORITIES AND SEQUENCING

As noted at the beginning of this document, establishing an appropriate balance between IDB support for efficient and effective, safe and sound banking systems and support for the development of non-bank markets is critical. The situation in each country is different, and the IDB will have to adjust its programs to account for these differences. Nevertheless, there are a number of factors that must be taken into account in establishing the priorities and the sequencing of reforms.

First, as noted, the banking system will continue to be the most important source of financial intermediation in virtually every country in the region. Establishing and/or maintaining the integrity of the banking system must remain the IDB=s highest priority. As noted, the development of other markets will be constrained to the extent that the banking system does not operate efficiently. Second, it is critical that countries develop the legal and regulatory controls (including effective self-regulatory organizations) appropriate to their financial markets. Liberalization of financial markets, without effective oversight and without the requisite legal environment leaves the country overly exposed to a financial sector crisis. Third, financial markets must aim at becoming fully integrated with international markets. This will require the adoption of international standards for transparency and disclosure, international standards of corporate governance, international standards for clearing and settlements systems, legal systems that are compatible with international standards, and others. Fourth, there must be recognition that markets can and will adjust very rapidly to changes, new risks and new opportunities. IDB programs must be designed to take advantage of this speed and flexibility and not try to prevent natural market reactions. Finally, the IDB must act within the limits that are set by markets and its own Charter regarding its role in financial market development. Once the appropriate enabling environment is established, it is up to private investors to create the markets, institutions, and risk transfer instruments that are in demand.

The Inter-American Development Bank must support this process through an active program of policy dialogue with its member countries. Beginning with the development of the *Country Specific Financial Market Strategies* and best practices guidelines, country programming must take a proactive approach; being sensitive to each country's concerns, but not losing track of the agreed upon long-term plan.

ORGANIZATIONAL IMPLICATIONS

The implementation of this *Financial Market Strategy* will require significant coordination and communication (including a sharing of experiences) among Central and Regional Operating Departments and, to avoid the duplication of efforts, with the other multilateral and bilateral development institutions. The work programs related to the non-banking markets will also require some upgrading of skills both in IDB headquarters and in the country offices. Moreover, the work programs will require a greater interchange with private sector participants that are active in domestic and international financial markets.

For some of the strategies to be successful, the IDB must be able to react quickly to both private sector concerns and regulatory proposals. This will require the ability to process operations faster. If the IDB is to expand its financial market development activities, as is required to have an impact on these markets at this critical juncture, it will need to extend its scope of activities and commit additional financial and human resources. It is clear that the IDB could undertake the activities outlined in this strategy at several levels of effort; a marginal effort would have only marginal results, while a significant effort holds the promise of considerable long-term impact. The allocation of limited resources among competing priorities remains the responsibility of the IDB=s Senior Management and Board of Executive Directors.[15] This strategy is limited to a discussion of the importance of the financial sector to overall economic development with the hope that Management and the Board will find it useful in setting priorities. It should be clear that many of the activities associated with the *Issue Specific Position Papers* are included in the ongoing work programs of the Central Departments but have not yet been fully funded. Likewise, a portion of the expense related to the preparation of the *Country Specific Financial Market Strategies* is already included in the work programs of the Regional Operations Departments. This is not an area that will be ignored, but as the IDB sets its priorities, work on these topics can accelerate or decelerate.

The level of resources devoted to the implementation of the *Financial Market Strategy* will determine the degree to which the IDB is able to play a leadership role in financial market development in Latin America and the Caribbean. A comprehensive implementation of the strategies along the lines envisioned in the preparation of the *strategy* would require additional human and financial resources, but these efforts would likewise have a more far-reaching impact.

EVALUATION OF THE FINANCIAL MARKET STRATEGY

The *Financial Market Strategy* is designed to guide the Inter-American Development Bank in its support of the development of financial markets in Latin America and the Caribbean. Its success will depend on the extent to which it is used by Bank staff in the preparation of projects and by Bank Management and the Board in the evaluation of proposals. Since the major proposed outputs of the *strategy* are the *Country Specific Financial Strategies*, their quality will be an important element in the evaluation of the strategy. Perhaps more important, will be the extent to which the Bank is able to provide support for the development of new markets, institutions and instruments as needed for financial markets to meet the needs of individuals and firms in borrowing member countries. Such an evaluation would need to be somewhat more subjective, but should be part of the evaluation of the effectiveness of the *strategy*. Needless to say, the extent to which the issues included in the strategy can be dealt with in a comprehensive fashion will depend of exogenous factors, most importantly, developments in international financial markets and the availability of human and financial resources within the IDB.

[15] Earlier versions of the *Financial Market Strategy* included specific recommendations for increasing staff assigned to work on financial sector issues. These were objected to by various members of the Board and have been removed from this current version.

VI. Summary and Conclusion

The IDB will continue its active involvement in the restructuring of financial markets in Latin America and the Caribbean. While significant progress has already been made, it is important that the standard be raised, and that the IDB take a leadership role in the maturation process, including the development of more complete and deep financial markets with the necessary variety of markets, instruments and institutions.

Increased efforts are needed to promote the efficient and effective functioning of financial markets, their catalytic role on economic development in a wider sense, and the reduction of systemic risk and the high costs associated with financial crises and inappropriate crisis management. Moreover, the IDB needs to support the continued development of markets for equities, debt, other financial instruments, commodities and their derivatives. These changes are already taking place in the region, but the IDB can help assure a more orderly and well-planned transition, as appropriate to the size and level of development of each country. This *Financial Market Strategy* should be used as a guideline to address the key issues related to such a transformation.

ANNEX I
ANNOTATED BIBLIOGRAPHY

MACROECONOMIC STABILITY AND FINANCIAL MARKET DEVELOPMENT

1. Inter-American Development Bank. *América Latina tras una Década de Reformas*, Economic and Social Progress in Latin America, 1997 Report, [Washington, D.C.: Inter-American Development Bank, September 1997].

    This publication provides a thorough review of the economic reforms in Latin America and the Caribbean since the debt crisis of the early 1980s. In addition to reviewing the impact of the macroeconomic reform programs, it provides a summary of the institutional reforms undertaken throughout the region. It also looks to the future, considering the impact of continued reforms taking place in more democratic and decentralized settings.

2. Inter-American Development Bank. *Banking Crises in Latin America*, edited by Ricardo Hausmann and Liliana Rojas-Suarez, [Washington, D.C.: Inter-American Development Bank, 1996].

    This book presents an overall review of the roots of banking crises ranging from macroeconomic (the lack of a coherent fiscal and monetary framework and vulnerability to external shocks) to microeconomic (inadequate regulation and supervision) factors. It also includes a discussion of the management of banking crises and provides suggestions for their avoidance. The book also presents a review of the experiences of a number of countries in dealing with banking crises. Of particular interest is the common theme of the inherent instability of banking systems and the need for some kind of government intervention for crisis prevention.

3. International Monetary Fund. *Systemic Bank Restructuring and Macroeconomic Policy*, edited by William E. Alexander, Jeffrey M. Davis, Liam P. Ebrill, and Carl-Johan Lindgren, [Washington, D.C.: International Monetary Fund, 1997].

    This book lays the foundations for best practices by governments in restructuring banking systems. It deals with the practical details of setting up a reform program that is consistent with good macroeconomic management (and is designed to build on the foundation established by the book *Bank Soundness and Macroeconomic Policy* -- see following review). In particular, it addresses the issues of setting policies for reform (and the importance of timely interventions), maintenance of macro stability while reform programs are underway, transparency while avoiding moral hazard, and the process of restructuring individual banks. By providing a partial review of the restructuring experiences of a variety of countries, the book attempts to isolate sound policies and best practices without promoting a single model for all restructurings.

4. Lindgren, Carl-Johan, Gillian Garcia and Matthew I. Saal. *Bank Soundness and Macroeconomic Policy*, [Washington, D.C.: International Monetary Fund, 1996].

This book presents the argument that the health of the banking systems is inherently connected to overall macroeconomic stability. It shows that a macroeconomic reform program that does not take into account the structure and solvency of the banking system -- and the impact of the reform program on the financial health of the banking system -- will be unlikely to succeed. History has shown that countries will eventually depart from the agreed upon program in order to rescue a failing banking system. The book therefore argues that a joint program, one that takes into account the structure and solvency of a country's financial markets, although possibly a second best solution from a purely macroeconomic perspective, will have a greater probability of success. The arguments in the book parallel those used by the IMF Board of Directors when they indicated that the health of the banking system (and the impact of the program on the health of the banking system) must be taken into account in all macroeconomic reform programs supported by the IMF.

LEGAL AND REGULATORY ENVIRONMENTS

5. Corrigan, E. Gerald. "Building Effective Banking Systems in Latin America and the Caribbean: Tactics and Strategy," *IFM Working Papers Series #107,* Inter-American Development Bank, May 1997.

Starting from the premise that the banking system is and will remain the centerpiece of financial markets in emerging markets, Gerald Corrigan provides a detailed and systematic approach to assuring the solvency of a banking system. His prescription calls for strict supervision, especially in terms of capital adequacy, early interventions of problem institutions, and the development of the knowledge base needed to provide adequate supervision. Of particular interest is a summary of the characteristics of effective banking systems with a "grade" assigned by Mr. Corrigan for each characteristic (on average, he grades Latin America as having quite a way to go). The paper describes in considerable detail the life cycle of commercial bank credit, noting the critical points where supervisors would get involved in the process and the basic building blocks for comprehensive reform of the banking system.

6. Organization for Economic Cooperation and Development. *Principles for Corporate Governance, May 1999.*

The Principles focus on publicly traded companies. They are intended to assist governments in their efforts to improve the legal, institutional and regulatory framework for corporate governance. The Principles pertain to issues on (i) shareholder rights; (ii) equitable treatment of all shareholders; (iii) the role of stockholders in corporate governance; (iv) disclosure and transparency; and (v) the responsibilities of Boards of Directors.

SUPERVISION OF FINANCIAL MARKETS AND INTERMEDIARIES

The following three publications can be considered as companion pieces which (a) address the coordination of supervision across national boundaries; and (b) propose minimum standards for the supervision of bank, securities firms, and insurers. The three core principles have been coordinated to help prevent regulatory arbitrage.

7. Basle Committee on Banking Supervision. *Core Principle for Effective Banking Supervision*, October 1997.

The Basle Committee on Bank Supervision with the support of 15 regulators representing emerging markets prepared this consensus of minimum requirements for effective supervisory structures in smaller or emerging markets. It provides a critical look at the key elements that are required for a comprehensive supervisory system, and can be used to help determine priorities for strengthening bank supervision.

8. International Organization of Securities Commissioners, *Core Principles for Securities Market Regulation*, 1998.

The International Organization of Securities Commissioners (IOSCO) has developed a set of core principles for the supervision of securities markets. While not as detailed in its recommendations for implementation as the banking principles (there is less consensus on how securities markets should be regulated), the underlying principles are clear. IOSCO is developing a strategy to support the implementation of these principles.

9. International Association of Insurance Supervisors. *Insurance Supervisory Principles*, September 1997.

The International Association of Insurance Supervisors (IAIS) has completed a set of core principles for the supervision of emerging insurance markets. This is meant as a companion piece to the Basle Committee of Bank Supervisors and IOSCO *Core Principles.*

10. Nemirosky, Hugo and Jesse Wright. "Issues Surrounding Securities Regulation in Latin America and the Caribbean," *IFM Working Papers Series #101*, Inter-American Development Bank, May 1996.

This report summarizes the principal issues regarding the supervision of securities markets that need to be addressed in the IDB reform programs. Topics include the rationale for supervision, the role of the government in protecting investors (including setting standards for information disclosure), and issues regarding the role of the government in direct regulation and oversight of self-regulatory bodies. It also provides a brief description of the structure of securities markets.

11. Savage, Lawrie. *Emerging Markets in the Global Economy: Re-Engineering of Insurance Supervisory Agencies and the Regulation of Insurance Activities,* [Washington, D.C.: Inter-American Development Bank/World Bank, December 1998].

This working paper presents a comprehensive analysis of the requirements for adequate prudential regulation of insurance within the context of an emerging market. The author discusses the process of transformation from regulatory structures that are focused on compliance with myriad detailed regulations to one that concentrates on protecting policyholders by assuring the solvency of regulated insurers. Considerable attention is given to the re-engineering of the Canadian insurance supervisory system over the past decade, noting how this experience can be useful to regulators in emerging markets. The use of outside experts (external auditors and consulting actuaries) in supporting the work of insurance regulators is noted. Specific suggestions are provided regarding the size and structure of insurance superintendencies, with particular attention placed on the needs of smaller countries.

12. World Bank. *Financial Regulation: Changing the Rules of the Game*, edited by Dimittri Vittas, [Washington, D.C.: Economic Development Institute of the World Bank, 1991].

This early publication carefully examines the importance of regulation as a cornerstone of financial market development. The book focuses on the appropriate role of regulation, and champions the change from a regulatory structure that concentrates on compliance with central bank and supervisory norms to one that emphasizes solvency and uses market incentives to protect depositors and maintain the integrity of the financial system. The experience of regulatory reform in a variety of countries is presented along with the resulting recommendations for regulatory reform.

INNOVATIONS IN FINANCIAL MARKETS, INSTITUTIONS AND INSTRUMENTS

13. Castellanos, Jorge. "Developing Government Bond Markets," *IFM Working Papers Series #111*, Inter-American Development Bank, 1998.

In this paper, Jorge Castellanos discusses the importance of liquid markets for long-term, local currency government bonds and their critical role as building blocks for other debt instruments (e.g., mortgages, corporate bonds, etc.) and derivative markets. The paper discusses the steps that can be taken to establish these markets.

14. Fabozzi, Frank J. and Franco Modigliani. *Mortgage and Mortgage-Backed Securities Markets*, [Boston: Harvard Business School Press, 1992].

This book is considered one of the standard references for mortgages and mortgage-backed securities. It contains a review of the development of mortgage-backed securities in the United States. In addition it provides considerable detail on the application of traditional financial pricing models to mortgage securities.

THE MANAGEMENT OF FINANCIAL RISK

15. Federal Reserve Bank of Chicago. *The New Tool Set: Assessing Innovations in Banking*, Proceedings of the 31st Annual Conference on Bank Structure and Competition, [Chicago: Federal Reserve Bank of Chicago, 1995].

This publication provides an evaluation of both the usefulness of the new set of tools being used in the management of risk by financial institutions (futures, swaps, options and other derivatives, etc.) and the structures that need to be in place to control these risks. The authors include academics, practitioners and regulators. Still, the general consensus is that the "new tools" exist, that they will be used to develop new products, and that they must be used to manage risk. A variety of issues, including: accounting for new products, market disclosure, risk measurement, and the role of regulation/supervision and internal information systems are presented.

16. Soler, Jose Antonio, Kim B. Staking, *et al. Gestión de riesgos financieros: Un enfoque practico para países latinoamericanos (Financial Risk Management: A Practical Guide for Emerging Markets*— as of 1999 only available in Spanish), [Washington, D.C.: Inter-American Development Bank, 1999].

This handbook for the management of financial risk was commissioned by the IDB to meet the needs of emerging market institutions in implementing comprehensive risk management systems. The handbook provides recommendations on all aspects of risk management, based on a modern portfolio perspective (using the tools associated with determining capital-at-risk and risk-adjusted-return-on-capital). The discussion includes: (a) the role of the board of directors in determining risk tolerances and allocating capital to risky activities, (b) measurement, monitoring and communication of risk using management information systems, (c) the relationship between credit and market risk, (d) operating risks and related controls, (e) legal risks, (f) mathematical models for measuring market risk and their limitations in emerging markets, among many others. Based on the guidelines included in this handbook, Banco Santander is implementing risk management systems in its subsidiaries in Lima and Santiago, and a companion volume will be published next year that will describe the implementation process, note any problems encountered and evaluate the proposed solutions.

17. Inter-American Development Bank/International Swaps and Derivatives Association. *Latin American Derivatives*, [London: Risk and Emerging Markets Investor Magazines, April 1996].

This publication contains many of the papers presented at the 1995 IDB conference on the *Role of Derivatives in Latin American Financial Markets*. It includes discussions of the importance of derivatives for the management of risk, new opportunities for financial institutions, growth of derivative activities in Latin America and the Caribbean, the importance of control systems and legal issues in Latin America and the Caribbean.

18. U.S. General Accounting Office. *Risk Based Capital: Regulatory and Industry Approaches to Capital and Risk*, GAO/GGD-89-153, Washington, D.C., 1998.

This recent publication addresses the different perspectives of regulators and the financial industry (banks, insurers, and investment banks) with respect to the use of risk based capital requirements. The different perspectives of the two constituencies, risk based capital as a regulatory tool vs. risk based capital as a management tool, provides an interesting contrast.

19. Wright, Jesse. "A Primer on Risk Management: Application to Latin America and the Caribbean," *IFM Working Papers Series #106*, Inter-American Development Bank, 1997.

This publication reviews the role of risk management and some of the related techniques that can be used to manage financial risk in Latin America and the Caribbean.

20. Basel Committee on Banking Supervision, *A New Capital Adequacy Framework*, June 1999.

The Basel Committee on Banking Supervision has decided to introduce a new capital adequacy framework that replaces the 1988 Accord. This new framework includes three pillars: minimum capital requirements, a supervisory review process, and effective use of market descriptive.

DISCLOSURE AND TRANSPARENCY

21. Inter-American Development Bank. *Financial Disclosure: A First Step to Financial Market Development*, edited by Kim B. Staking and Alison Schulz, [Washington, D.C.: Inter-American Development Bank, 1999].

    This publication contains selections from the papers presented at the IDB sponsored conference on *Financial Disclosure and Financial Markets Development: The Role of International Accounting Standards* held at IDB headquarters in October 1997. Two chapters present the economic justification for improved accounting standards, based on lowering the cost of capital though reduced uncertainty associated with better disclosure of financial information and reduced transactions costs. The book will also contain two case studies, Mexico and Venezuela, with discussions on the need for, obstacles to, and the process of obtaining improved accounting standards. A final chapter provided an outline of a transition plan for moving to international accounting standards.

22. International Accounting Standards Committee. *International Accounting Standards (1997)*, [London: International Accounting Standards Committee, 1997].

    Contains the accounting standards issued by the International Accounting Standards Committee.

THE ROLE OF STATE IN THE PROVISION OF FINANCIAL SERVICES

23. Inter-American Development Bank. *Policy-Based Finance and Market Alternatives: East Asian Lessons for Latin America and the Caribbean*, edited by Kim B. Staking, [Washington, D.C.: Inter-American Development Bank, 1997].

    This publication contains a selection of the papers presented at the IDB sponsored conference of the same name held in November 1996 in Rio de Janeiro, Brazil. The conference was co-sponsored by the Japan Development Bank. Most of the papers conclude that while there are important lessons to be learned from the East-Asian experience (in terms of the need for professionalism and independence from political influence in the public banks), the East Asian approach of extensive government involvement in financial markets could not, for a variety of reasons, be easily transferred to the countries of Latin America and the Caribbean. Two of the chapters are of particular interest. First, in the chapter on "Credit Policies and the Industrialization of Korea," Yoon Je Cho notes that while the Korean experience of heavy government intervention in financial markets did allow rapid growth of the heavy industries sector, it did so at a very high cost in terms of economic concentration, underdevelopment of financial markets, and prophetically noted that the full cost of the intervention was not yet apparent, but would eventually have to be paid. Second, in the chapter on "Effective Financial Intermediation," Anthony Santomero of the Wharton School, University of Pennsylvania notes that there is little evidence that the government interventions in East Asia had an impact on the overall economic development. Rather, it was macroeconomic stability that was important, while policy-based loans had little impact, other than to at times postpone an eventual insolvency. Santomero concludes that instead of direct intervention, government should provide "proactive, promarket regulation," and "support innovation, transparency and disclosure, and constructive regulation, using market signals where appropriate, and maintaining market discipline."

24. Vives, Antonio and Kim B. Staking. "Financial Intermediation and Policy-Based Lending: Policy Recommendation for Latin America and the Caribbean," *IFM Reprint Series #107*, Inter-American Development Bank, 1997.

In this reprint of a chapter from the book on *Policy-Based Finance and Market Alternatives* (reviewed above), Vives and Staking present the conditions for effective government involvement in financial markets. This includes an analysis of the necessary and sufficient conditions for intervention in financial markets and a set of conditions for successful government involvement in policy-based lending. The chapter outlines ten conditions for the economic environment and ten conditions for program design that should be incorporated if a policy-based finance approach is to be successful.

GENERAL TOPICS IN FINANCIAL MARKET DEVELOPMENT

25. Corrigan, E. Gerald. "Building a Progressive and Profitable National Banking System in Argentina," unpublished manuscript, Goldman, Sachs & Co., April 30, 1996.

This document presents a comprehensive proposal for the restructuring of the Argentine banking system. While many of the specific suggestions are aimed at the structure of Argentine markets, the document provides a guide for diagnosing and resolving problems faced by most banking system in emerging markets.

26. Fleisig, Heywood. "The Right to Borrow," *Private Sector Development Department Note #44*, The World Bank, April 1995.

This brief note outlines many of the key issues surrounding the inability of firms in emerging markets to obtain access to credit due to limitations on their abilities to secure loans with collateral. It notes the importance of changing the legal and regulatory structure regarding the use of collateral as one of the critical supports for smaller enterprises gaining access to credit.

27. Inter-American Development Bank. *Financial Market Development: Issues Strategies and Inter-American Development Bank Group Activities,* Infrastructure and Financial Markets Division, August 1999.

The Infrastructure and Financial Markets Division prepared this publication for distribution at the 1998 IDB Annual Meeting and for presentation to the Deputy Finance Ministers of the Regions (Committee of Hemispheric Financial Issues). It reviews the IDB=s involvement in the financial sector from 1990 to the present, and provides a concise look at the issues related to financial market development. This is currently being updated.

28. Eichengreen, Barry. *Towards a New International Financial Architecture: A Practical Post-Asia Agenda*, Institute for International Economics, February 1999.

This book provides a critical perspective to demonstrate that existing institutional arrangements, including the institutions created by Bretton Woods Agreement, are not well positioned to cope with a world of high capital mobility. The text also analyzes competing proposals that seek to better predict and resolve international financial crises.

29. Knapp, Paul R. and Andres Velasco. *Liberalization and Integration of Financial Markets in the Western Hemisphere*, *IFM Reprint Series #97-10*, Inter-American Development Bank, 1997.

This paper describes the necessary conditions for the liberalization of financial markets with the aim of achieving financial integration. Discusses issues related to the liberalization of financial institutions, financial services, cross-border flows and foreign direct and portfolio investment.