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The Global Financial Crisis

Strategic Implications for Development Finance Institutions

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The Global Financial Crisis - Strategic Implications for Development Finance Institutions

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Prologue on the use of words

Emerging and developing economies

This essay uses the term “emerging” markets or “developing” nations interchangeably including all types of countries that are not high income.

Every few years poor country types have been renamed in recent decades. Once they were “underdeveloped”. Then they became “developing”. Distinctions were introduced ranging from “low income” to “higher middle income”. “Least developed” countries made an entry. As growth in emerging markets has accelerated and broadened the naming game has shifted. Some economies became “emerging”, others “frontier” economies. Individual countries evolve in ways that are not easily predicted by the category they were in initially.

Development Finance Institutions (DFIs)

This essay uses the term DFI to denote financial institutions that are state-sponsored with a mandate to pursue not just pure economic but also social goals.

DFIs may operate nationally (e.g. Fannie Mae and Freddie Mac). They may operate across borders in specific regions (e.g. Asian Development Bank) or globally (e.g. World Bank). They may be bilateral or multilateral i.e. represent the interests of one state (e.g. BNDES) or several states (e.g. Islamic Development Bank). They may be fully government owned (e.g. African Development Bank) or owned by private shareholders with implicit government backing through “sponsorship” (e.g. Fannie Mae) with mixed forms in between combining private and public shareholding (e.g. FMO). The key to understanding DFIs as distinct from “pure” private financial institutions is the effect of the state-sponsored social mandate.

At the same time the line even between DFIs and some private banks may blur when private banks are insured by taxpayers in some form because they pursue de facto a state mandate e.g. provision of safe deposits or may be instructed to pursue social mandates via directed credit. The line between DFIs and state-owned banks (e.g. in China) can, of course, also be blurred, because many such state-owned banks de facto pursue social goals in addition to economic ones.

The Global Financial Crisis

Strategic Implications for Development Finance Institutions

Executive Summary

The global financial crisis of the late “noughties” poses several fundamental challenges for Development Finance Institutions. First, problems in rich countries have thrown an extra 64 million people into extreme poverty, while the fiscal problems of rich countries may limit aid in the future. Second, the crisis has shown that the call for “access to finance” can lead to excess – as exemplified by US housing finance including the two largest development finance institutions (DFIs) in the world, the US mortgage giants. Third, the crisis has shaken confidence not only in individual financial institutions and whole classes of assets, but also in the capitalist economic system.

Lessons from the crisis. As the fog of the crisis lifts, some basic lessons are emerging.

- The growth momentum that had built in developing nations during the last few decades remains strong. Poor countries have been hit less and are recovering faster than expected with growth again projected at 6 per cent for 2010. Poverty rates continue to decline through the crisis, albeit at a slower pace during the immediate crisis.
- The crisis spread as demand collapsed in rich countries and was transmitted via a collapse in demand for imports from emerging economies. There was only limited contagion through a credit crunch via financial market channels.
- The few emerging markets that experienced a financial crisis with money market disruption and bank failures were almost entirely in Eastern Europe and Central Asia, except for Nigeria. In these countries pre-existing domestic weaknesses were exposed by the crisis.
- Most developing nations demonstrated that fiscal prudence, cautious foreign exchange reserve management and the development of domestic financial markets was sufficient to withstand the crisis and continue growth, even including a few in Eastern Europe.

Overall, fairly orthodox prudent policy prescriptions helped position emerging markets well for the biggest global crisis since the 1930s. Judicious use of special crisis measures was thus made possible, including fiscal stimulus, monetary easing and the deployment of capital controls to deal with very rapid capital inflows. Emerging markets showed that basic economic insights remain useful. At the same time it seems that there is no “great moderation” in the world and significant crises will recur.

In the coming years demand weakness, greater regulation and populist measures may slow growth in rich countries. How poorer countries will be affected remains unclear. Nationalist and protectionist reactions may yet come to pass. Yet, unless some unprecedented gigantic catastrophe unfolds developing nations should continue growing and the chances of vanquishing extreme poverty within decades remain higher than ever before in history.

Finance and poverty reduction. Some structural lessons also stick out. Economic growth of a country remains the key to poverty reduction. Domestic income distribution has been largely stable over decades in most developing nations. Helping lagging countries grow is thus the main challenge. Financial development helps, but it does so not by raising saving, the volume of finance overall, but by helping improve productivity. The quality of decisions about which ventures to support, which ones to restructure and which ones to close is the core contribution of financial institutions for income growth.

Pro-poor growth is best pursued by creating productive jobs by:

- helping improve the investment climate in regions where poor people live or can move, with cities of special importance; and
- supporting quality ventures with finance

Microfinance and other direct support operations for poor people can help, but do not appear to be the core mechanism to reduce poverty. To reach extremely poor people, with incomes below a \$1.25/day, judicious use of subsidies in these operations is required.

Just as financial development overall does not help growth via raising saving, cross-border finance per se is not related to growth. However, some types of finance, such as foreign direct investment, seem to support growth presumably because they transfer know-how well due the financial incentives of investors.

The promise and risk of DFIs. DFIs hold promise because they can support productive investments and job creation, where poor people are. They may help raise the effectiveness of “aid” at a time when aid budgets are under stress.

Yet, DFIs themselves can have weak incentives to be effective. They are a mechanism of choice for politicians to extend finance without going through fiscal appropriations and without full accounting for risks to its owners, the taxpayers. The fundamental pathology became evident during the crisis for the US government-sponsored housing finance agencies.

Most DFIs operating across borders are still in good shape following the crisis, helped by the strong performance of emerging markets and the capital cushions that several had going into the crisis. But even here it is now clear that during the run-up to the crisis DFIs behaved like private banks seeking market share in a bubble. During the crisis they

switched to “countercyclical” lending. This was helpful, but asymmetric behavior during booms and busts risk building up problems in the longer run.

Disciplines on DFIs. To ensure the DFIs do not take excessive risks and focus on productive financing four basic disciplines are useful:

- Requiring DFIs to meet ex-post a rate of return target related to their cost of capital
- Subjecting the countercyclical lending to the Bagehot rule of “lending freely at high rates” in times of liquidity crises
- Accounting transparently for all forms of subsidy including government guarantees; and
- Making subsidy payments subject to measurable results

Under such disciplines DFIs have decent incentives to focus on effective finance.

Strategic directions for DFIs. In the coming years the following strategic planks are worth considering for DFIs as successful post-crisis liquidity provision loses importance:

- For several years it will be important to make the best of existing assets through work-outs and restructuring before investing in new ventures. Greatest leverage will be achieved, when individual distressed asset operations are combined with improvements in the insolvency regime of poor countries.
- For the medium- to longer-term, focus on growth enhancing operations and the creation of productive jobs is the key. Here operations that stimulate improvements in the investment climate will have special impact. In particular, targeting currently poor countries with weak investment climates that are willing to reform holds the greatest promise – for the results of DFI investments and, most importantly, for poverty reduction. Properly implemented this would guide DFI investments to smaller and poorer countries in response to their willingness to reform.
- As governments seek to create jobs and manage public debt private ventures including public-private partnerships in infrastructure and other sectors will remain attractive notwithstanding current doubts about “capitalism”.
- As financial players anywhere seek to contain debt levels, equity investments by DFIs may have relatively greater value. However, shifting to equity makes it especially important to submit DFIs to sound financial disciplines.
- The success of developing nations is shifting the landscape in aid delivery. For example, major new players from China, India and Brazil are already active in Africa. Value-added by DFIs will be relatively less dependent on the provision of finance and more on that of know-how. At the same sensitive issues will need to be managed such as investment standards and a shift from North-South to South-South and then South-North investment.

The Global Financial Crisis: Strategic Implications for Development Finance Institutions

The crisis kept up to 100 million more people in extreme poverty...

The financial crisis emanating from the United States has hit countries all over the world. Poor people suffer. Development agencies estimate that due to the crisis 55 to 90 million people more are living in extreme poverty on less than US\$ 1.25 per day (World Bank, 2009a)¹. This is a massive 5 to 10 per cent of all people living in such poverty. The crisis thus requires extra efforts from the development community to help those at the mercy of global forces.

...just as pressures on aid budgets in rich countries are increasing.

At the same time the fiscal position of rich countries, the traditional aid donors, has suffered. Based on past experiences with banking crises in donor countries, development aid might decline by 20 to 25 per cent compared to what it might otherwise have been (Dang et. al., 2009). Even before the crisis, the aid promises made in 2005 at the G8 Gleneagles summit were likely to be met only halfway at best. Following the crisis even that outcome might not be achieved overall.

Yet, thanks to growth in emerging markets pessimism about poverty reduction is not in order...

So just at the time when the need is great, aid resources from traditional providers might become scarcer than expected. Yet, there might be opportunity in crisis. Poverty reduction has been proceeding strongly in recent years. Even with the global crisis the share of extremely poor people is set to decline. Without the crisis the share of extremely poor people in the population of poor countries was expected to decline from 21 to 17 % (Chen and Ravallion, 2009) or by well over 200 million people in a year. As a result of the crisis the decline in the poverty rate may slow to just 18 or 19%, but it will still decline.

...and finance for growth in poor countries can help even as subsidies are under threat

The challenge for development finance institutions (DFI) is to stimulate and reinforce more effectively the potent forces that are reducing poverty on a scale never seen in history, particularly in countries with weak growth so far. This requires emphasis on financial interventions that support growth through equity and loans combined with policy and institutional improvements while limiting the need for pure subsidy as fiscal pressures mount. Development finance institutions from traditional aid donor countries also need to adjust strategy to deal with more new actors from emerging markets.

¹ The latest World Bank estimate is 64 million people (World Bank, 2010)

This paper aims to contribute to this endeavor. It discusses the impact of the financial crisis on developing countries and emerging lessons for policy and operations of development finance institutions.

What happened to developing countries?

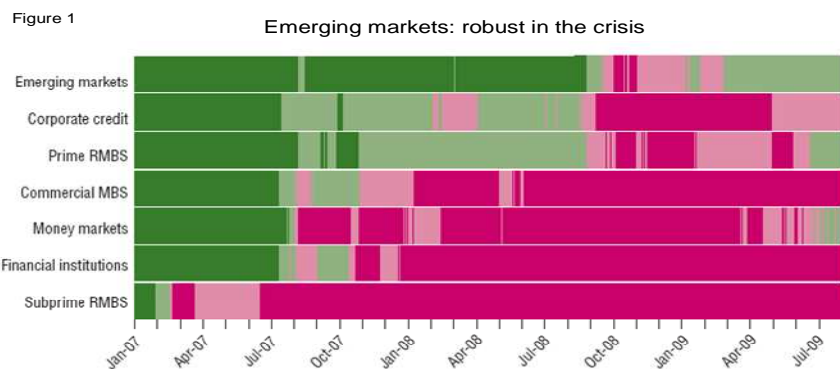
Contagion: Demand collapse via trade channels

In a global market the crisis affects all...

Before the crisis there was talk about “decoupling” of emerging markets (The Economist, 2008)² from the tribulations of rich countries. However, the crisis showed that in an interconnected world major crises affect just about everyone. Global economic integration carries the risk of propagation of shocks across economies.

...yet cross-border contagion of financial distress was limited ...

When the crisis hit, many feared that global financial integration would result in financial crises across the world. Yet, true financial market crises with money market disruption and banking crises did not spread far. Even in countries like Turkey – located in Eastern Europe and wrecked by financial crises a few years back – the financial sector withstood the crisis. In some countries like Russia, the central bank prevented deposit runs through energetic and timely liquidity support. Overall, emerging market assets remained the strongest asset class throughout the crisis – except for high-quality treasury paper by major OECD countries (Figure 1).



Source: IMF staff estimates.

Note: The heat map measures both the level and one-month volatility of the spreads, prices, and total returns of each asset class relative to the average during 2003–06 (i.e., wider spreads, lower prices and total returns, and higher volatility). That deviation is expressed in terms of standard deviations. Dark green signifies a standard deviation under 1, light green signifies 1 to 4 standard deviations, light magenta signifies 4 to 7 standard deviations, and dark magenta signifies greater than 7 standard deviations. MBS = mortgage-backed security; RMBS = residential mortgage-backed security.

² In this paper the terms “emerging” or “developing” markets are used interchangeably

...to those with home-made financial sector weaknesses

The countries that experienced banking crises and financial market disruptions suffered from homegrown weaknesses (IMF, 2009b). The problems exposed by the crisis might have come to haunt the respective countries at some time even without the global crisis. Several countries in Eastern Europe saw unsustainable credit booms prior to the crisis. In some cases, for example in Hungary, households borrowed in foreign exchange to invest in local currency assets, houses in particular. The crisis brought an end to such bubbles and maturity mismatches in several countries – the Baltic States, Ukraine, Hungary, and Kazakhstan among them. Most were in Eastern Europe. But even in Eastern Europe several countries escaped a financial crisis proper, for example Croatia, Poland, the Czech Republic, Slovakia and Slovenia. Essentially only Nigeria experienced a financial crisis in the rest of the developing world due to excessive risk-taking by Nigerian banks.

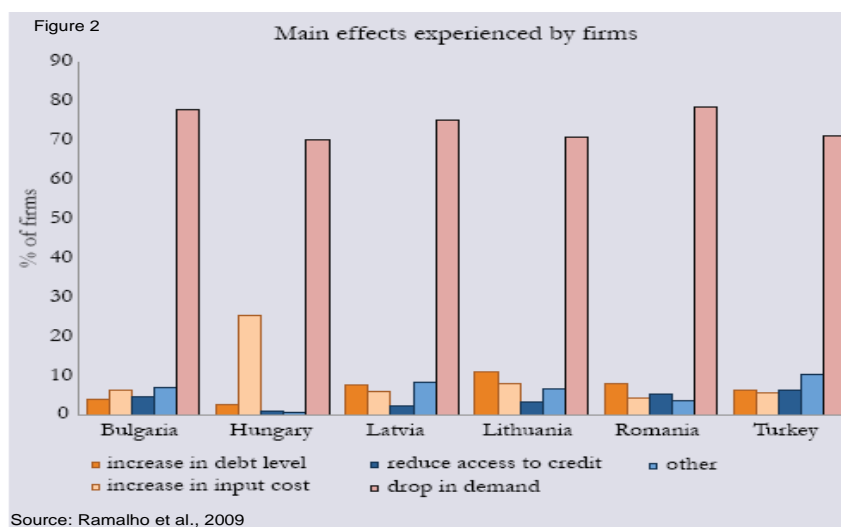
The global collapse in demand spread through trade channels...

The crisis did, however, spread through trade channels that transmitted a collapse of demand in rich countries. At the height of the crisis in the fall of 2008 panic broke out. The financial market disruptions in the United States resembled those of the 1930s (IMF 2009a). Fearing loss of access to finance, firms across the world stopped investment. In the first round, this hit imports from capital goods producing nations especially hard – Japan, Germany, South Korea and Taiwan. Overall in the fourth quarter of 2008, global trade fell to a degree not seen since the great depression of the 1930s. Many emerging markets were affected including commodity producers.

...while reduced access to credit remained a minor issue

Fears abounded that credit flows to developing nations would cease and drive them into a downward spiral of demand and credit decline. Financial flows slowed, but in retrospect the key driver of trouble was a decline in demand, not a credit crunch. This was the case for the sharp decline in trade (IMF, 2009b) and for the decline in firm investments and production. New survey results from the most heavily affected crisis countries in Eastern Europe suggest that less than 5 per cent of the total collapse in activity was due to credit constraints (Figure 2). Precisely, because the credit constraints as such were limited, supporting action by development finance institutions under the so-called Vienna initiative were relatively effective despite the limited resources at the disposal of the supporting institutions compared to the refinancing that would have been required had demand not collapsed.

Effects of the crisis in Eastern Europe



Remittances also declined, now estimated at some 6 percent globally for 2009 – again less than feared. Remittances to Asia held up well, in part driven by resilient economic activity in the Middle East (Ratha, 2009). Even the heavily remittance dependent Philippine saw growth in remittances in 2009. The main countries that suffered were those counting on remittances from the United States and Europe – in particular Central America and North Africa. The collapse of economic activity in the rich countries hurt jobs of immigrants and their remittances.

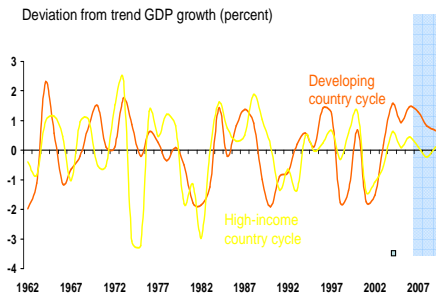
Resilience of emerging markets

Growth momentum in emerging markets...

As a result of global demand reduction output growth in emerging markets slowed. Still, the growth momentum in many developing economies remained much stronger than in rich countries. In recent years trend growth rates in these economies continue to rise and diverge from the declining growth rates in rich countries – a benefit of globalization (Figure 3a,b). Access to global markets and best practice allows poor countries to grow faster and thus catch up with countries that are already at the frontier of know-how (Brahmbhatt and da Silva, 2009).

Figure 3a

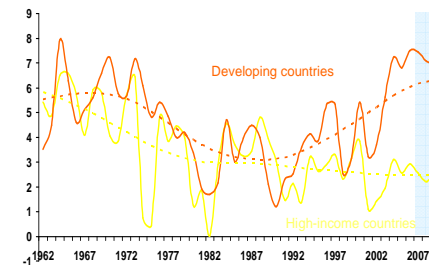
The cyclical component of developing and high-income country growth remains coupled



Source: World Bank, DECPG.

Figure 3b

Trend developing country growth has become decoupled from trend high-income growth



Source: World Bank, DECPG.

...carried them through the crisis relatively well, even Africa...

Emerging markets also had relatively strong fiscal and foreign exchange reserve positions. They could afford to support demand through fiscal and monetary expansion – and they did, notably China. As a result, developing Asia is pulling out of the crisis with relatively little damage and surprisingly strong growth both in China and India. The MENA region is also faring relatively well, notwithstanding troubles in Dubai. Gratifyingly, Africa seems to come through better than one would have expected just one or two decades ago. Eastern Europe is faring worst among developing regions (IMF, 2010). This is the pattern of vulnerability that was expected well before the crisis (Figure 4). Countries in Eastern Europe showed the greatest sign of fiscal weakness, rising current account deficits and rapid domestic credit growth.

Figure 4

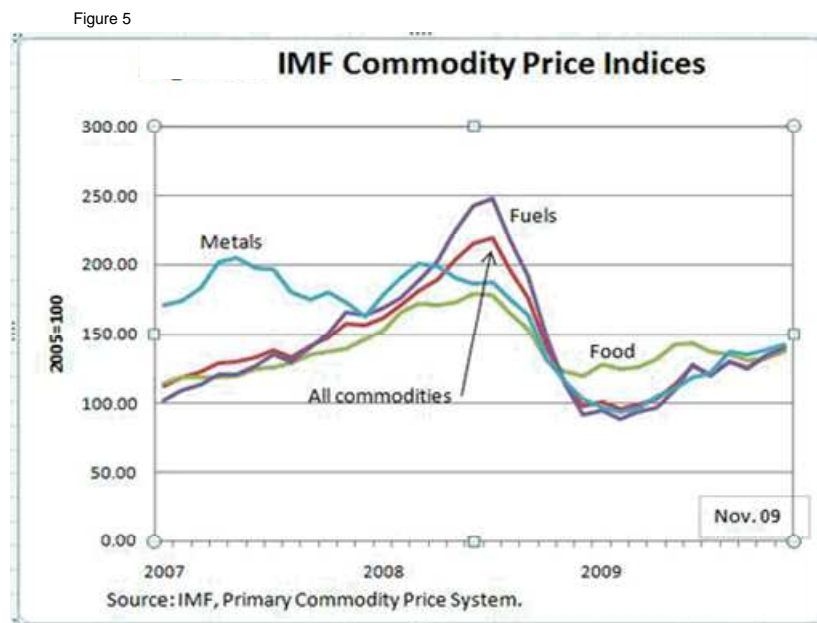
Patterns of Growth by Region

Growth in 2008	Growth in 2009	Least Decline 2007-2009	Growth in 2010
<i>Dev. Asia</i>	<i>Dev. Asia</i>	<i>MENA</i>	<i>Dev. Asia</i>
<i>SS Africa</i>	<i>MENA</i>	<i>Dev. Asia</i>	Adv. Asia
CIS	<i>SS Africa</i>	USA	<i>MENA</i>
<i>MENA</i>	Adv. Asia	<i>SS Africa</i>	<i>SS Africa</i>
LAC	LAC	Euro zone	CIS
CEE	USA	Adv. Asia	LAC
Adv. Asia	Euro zone	Japan	USA
Euro zone	CEE	LAC	CEE
USA	Japan	CEE	Japan
Japan	CIS	CIS	Euro zone

Source: IMF

...as commodity markets stabilized

Even commodity markets, the mainstay of exports for many developing nations did not collapse dramatically. The worldwide boom in the run-up to the crisis lifted them to new heights. Yet the subsequent fall did not push them below the levels seen just a little earlier in 2007, except for metals (Figure 5). Again this is an indication that the panic of 2008 affected the demand for investment goods above all.



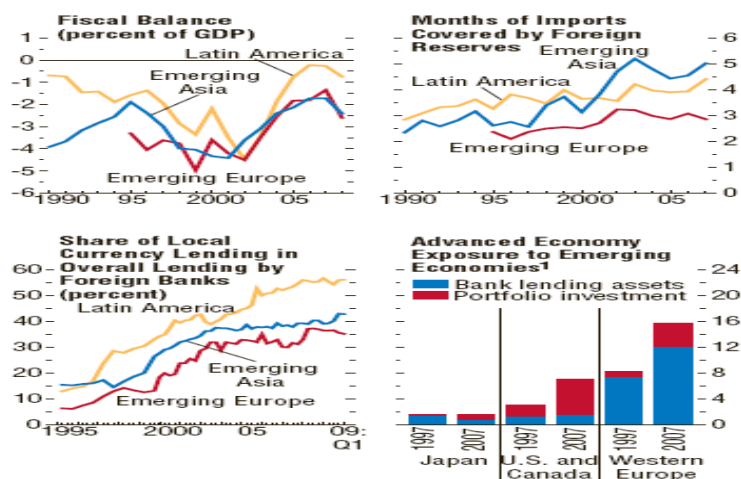
Resilience due to prudent macro-economic policy...

The resilience of emerging markets in the face of the biggest global crisis the world has seen in over 70 years is remarkable. What factors have contributed? (Figure 6)

- Macro-economic policy in most developing nations has been prudent in the run-up to the crisis. Fiscal deficits were reduced.
- Foreign exchange reserves were built up covering countries against sudden loss of access to credit from abroad
- Local currency markets were developed reducing dependence on foreign financing, particularly for longer maturities

Figure 6

Emerging Economies: Factors Affecting Resilience



Sources: Bank for International Settlements; IMF, Coordinated Portfolio Investment Survey; and IMF staff calculations.
¹Assets in percent of advanced economies' GDP.

...was matched by support from foreign financiers

Interestingly, greater “dependence” on foreign banks also appears to have helped (IMF, 2009b). In Eastern Europe foreign-owned banks made it through the crisis better than locally-owned ones. To some extent the “Vienna Initiative” that brought together regulators, development finance institutions and banks may have helped maintain confidence (IMF, 2009b). When the events since late 2008 are more fully understood the story may look as follows. In countries with banking problems foreign investors tried not to abandon their franchises. Fundamentally, financial investors – lenders and owners – did not desert emerging markets. They may have used some of their successful subsidiaries to prop up troubled operations in home countries as stories from countries like India and Mexico suggest. Yet, they tried to maintain their franchises in emerging markets and invested again as soon as possible.

Emerging markets have learned to cope with capital inflows...

Several emerging markets were flooded with foreign liquidity – during the pre-crisis boom, for example, Colombia, and again after the crisis, for example, Brazil. The monetary authorities in these and other countries tried to stem the inflow by imposing some type of tax on inflows rather than risking a hit to exports via sudden exchange rate appreciation. Such capital controls are by now a fully accepted part of the armory of monetary authorities in many countries (Buiters, 2009).

...and fortified domestic financial systems

As mentioned before, contagion via the financial sector was minimal. The reforms of financial systems, the strengthening of bank regulation and recapitalization of banks seem to have worked. A particular example is Turkey, which experienced a major financial crisis in 2001 including interbank market disruption as severe as in the United States in 2008. However, despite a downturn of about 6 per cent of GDP in 2009 the Turkish financial sector remained fairly robust.

Policy Lessons

The crisis has revived unconventional remedies for crisis times,...

The crisis has challenged received wisdom. Debates ranged from reconsideration of specific policy advice to talk about the “end of capitalism”. Yet, observations from developing nations suggest that orthodoxy was correct in many ways for positioning economies in normal times. During the crisis unusual, but known tools like “Keynesian” fiscal stimulus and liquidity provision by lenders of last resort have been dusted off and dominated headlines. For excessive booms well known “unorthodox” instruments were used. Capital controls on inflows had already seen a revival after the Asian crisis a decade ago and have now become a standard policy tool. In addition, various monetary authorities have experimented with “macro-prudential” tools such as limits on excessive credit growth in countries like Croatia and Serbia. Greater sympathy now exists for relatively heavy-handed regulation as practiced in China and India. Among rich countries Canada escaped a banking crisis despite a strong downturn. Canada has practiced more heavy-handed regulation than the United States (Freeland, 2010). Its approach has been dubbed “India-light” by some observers.

... reaffirmed the value of orthodox structural policy for positioning countries...

Overall, the experience of emerging markets gives hope. It shows we do know something about decent policy. Economies can be strengthened during normal times. Crises can be managed. Financial crises can be contained. Globalization has brought strong growth. On balance, the financial side of globalization accompanied by sound domestic financial sector development and regulation seems to help but can throw up special management problems.

...and put an end to hopes for a great moderation without crises.

Having said all this, it is now less clear that crises will just wither away in some “great moderation” (Bernanke, 2004). It seems the world has to live with periodic significant crises (Reinhart and Rogoff, 2009). One of the best predictors of countries that avoid financial crises is whether they had one in the last decade or so. Good times let policymakers and market participants relax. It may be a case of “once bitten, twice shy” or it may be that new imbalances that lead to the next crisis take time to build up again. Either way, episodes of success have the potential to sow the seeds of destruction. It has

happened in emerging markets repeatedly. It has now happened in the most advanced economies.

The shape of things to come

Initial Recovery

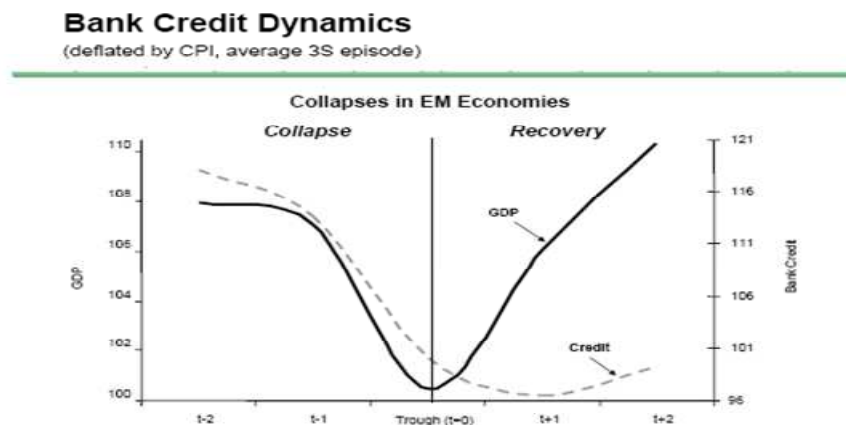
What goes down does come up...

Currently, economies across the globe are recovering. Policymakers have learned from the Great Depression. Massive liquidity provision and fiscal stimulus underpin a rapid discovery. The “Zarnowitz rule” that deep recessions are almost always followed by rapid rebound appears live and well (Zarnowitz, 1992).

...even when credit is weak

Fears that troubled financial markets might hold back initial recovery appear unfounded. Just two years prior to the crisis Guillermo Calvo published a study of “systemic sudden stops” (Calvo et al, 2006). The crisis episodes considered included all the major emerging market crises of the last decades as well as the great depression in the United States. The key finding was that during a crisis output and credit collapse together. However, during the upswing output recovers first, followed by credit (Figure 7). Presumably firms cut costs and postpone investment in the face of low demand. This improves retained earnings and allows firms to operate despite reduced access to finance. A healthy financial system would improve matters further, but in the recovery phase it is not quite as important.

Figure 7



Source: Calvo et al. (2006)

As demand picks up investment finance is again needed. Now healthy financial institutions have a more important role. Consequently emerging markets overall appear well positioned for the coming years. Domestic demand is picking up again. Their financial sectors are broadly intact. Those emerging markets suffering from significant output declines may see unemployment and work-out of distressed companies for some years. Yet, many emerging markets, particularly in Asia should do well, even though they may face problems of new bubbles, for example, China where credit expanded spectacularly in response to the crisis.

The medium term

Excess debt in rich countries

Working off excess debt in rich countries takes years...

Rich countries, however, face ongoing balance sheet problems. Consumers in the US are saving and paying off debt. The household saving rate rose from close to zero to some 7 per cent of income in a matter of months. Working out all balance sheet problems resulting from excessive borrowing typically takes between 6 and 7 years. Serious deleveraging may start only some two years after the initial crisis. Credit often shrinks by some 25 per cent during such episodes (McKinsey, 2010). Currently fiscal authorities in rich countries are leaning against this, but may need to consolidate public finances as well sooner than later. We may thus see prolonged sluggish growth in rich countries, reminiscent of Japan in the 1990s or of crises of earlier days such as the late 19th and early 20th century, when asset bubbles combined with excess debt rather than inflation brought about crises (White, 2006). None of this is certain – just a plausible benchmark view.

...as policy remains on knife-edge...

Depending on how well policymakers are able to adjust fiscal and monetary policy the road may be more or less bumpy. For example, premature withdrawal of fiscal stimulus may lead to a double-dip recession. Yet, belated action may just undermine the credit standing of rich countries and lead to rising yields on treasury paper. This may in turn choke off recovery a bit. Politically, the temptation may eventually be to inflate out of high public debt. Policy will remain on knife-edge for a while.

...barring positive surprises from a return to confidence

There is also a chance that developed economies do better. The crisis was triggered by troubles in a relatively small segment of the global financial markets – mortgage backed securities and credit default swaps in particular. The IMF financial stability report issued in October 2009 revised the estimate of total actual and potential write-downs globally in

banks and other financial institutions downwards to US\$ 3.4 trillion – “just” 2% of the global stock of bank assets and debt securities of about US\$ 180 trillion (IMF, 2009c). Such a relatively small volume of problem assets translated into generalized panic as troubles in one market segment led to distress sales leading to lower valuations, which in turn triggered further distress (Hellwig, 2008). As confidence returns, the damage in the financial sector may not be that bad in the full light of day. Nevertheless the panic had the consequence of depressing economic activity, and that has major consequences.

Financial Sector Regulation

Basic regulatory reforms are on the drawing board...

Following the crisis financial sector regulation will change. The nature of the change may remain unclear for some time. Initially, there are likely to be the following types of reform: multiple, tighter capital and liquidity requirements, mandates and incentives to move more over-the-counter derivative trading onto exchanges, greater information requirements from hedge funds and mandates for banks to retain some exposure to securitized products. Regulators may receive mandates to interfere with bank compensation schemes if they judge them to lead to undue risk-taking. In general regulators and monetary authorities will receive greater powers to deal with the build-up of system-wide risks, so-called macro-prudential regulation.

...while incentives for financiers to gamble persist...

At the same time some reforms clarify and expand the safety net for financial institutions and creditors in particular, for example, under the proposed financial sector congressional reform proposal in the United States. This may help deal with crises. It may also help increase the incentives of banks to gamble further and offset to some degree the discipline to be brought by capital requirements. Regulation of market structure to limit the size of financial institutions directly and to ensure effective competition has most notably been put on the agenda by the US government in January of 2010 with highly uncertain outcome, however.

...and fundamental doubts about the effectiveness of revised Basel accords remain.

This might not matter, if tougher capital and liquidity requirements work. Yet, that remains a bet. At the core of the Basel accords is the assessment of risk for financial institutions and products making use of the best possible information, particularly market prices. The ability of regulators and market participants to assess risks fully and systemically remains unclear. Market signals are by definition a poor guide for risk assessment in booms and bust episodes. It remains hard to see how anyone can assess the correlations among risks and returns of all relevant financial products as well as the changes to them that may occur in the run-up to a crisis. Astonishingly, ever since the first Basel accord was muted over two decades ago there has not been a thorough and

rigorous analysis of the relevant incentive effects (Hellwig, 2008). Unintended consequences may abound.

The memory of the crisis will bring initial stability...

So what will the future bring? For now and the next few years, greater caution reigns all around and regulators feel more empowered to deal with perceived excesses. As is typical, the aftermath of the crisis may bring a fairly stable decade to the crisis countries.

...as imbalances may build again or...

As the memories of the crisis fade unsustainable imbalances might build again. Monetary policy may again accommodate the build-up. Regulators may have an impossible time to call “an end to the party” while things are going well. Fundamentally, the Basel accords might not work. An analogy used by a prominent analyst paints Basel I as similar to Stalin’s five-year plan. Basel II (and now III) may come to look like Brezhnev’s version, relying more on market signals but as part of just another dysfunctional overall system³. The next crisis might be even bigger, not least because room for fiscal support may be more limited in rich countries. In this case, contrary to the plight of former centrally planned economies, there is unlikely to be a clear alternative. More intrusive regulation of financial systems will unfold.

...alternatively, decisive regulation may work

Under a second scenario, reforms might work after all. Proposed regulation might kill of excessive risk-taking. In countries that succeeded in avoiding a banking crisis, for example Canada, regulators intervened more forcefully exercising more discretion.

The first scenario leads the world to heavily regulated financial systems turning back the clock on much of the deregulation and liberalization seen since World War II. Regulatory oversight would have more the “feel” of that associated with China or India in the past rather than the United States of recent years. Under the second scenario, regulators and monetary authorities act more forcefully to choke off bubbles and the build-up of excessive systemic risks.

Most likely the future belongs to more discretion for regulators ...

Either way the future belongs to regulatory discretion. Currently policymakers still hold out hope that relatively simple rule-based regulatory systems can be constructed. The alternative seems too hard for them to contemplate. Yet for now, nobody knows how to create a convincing rule set⁴.

³ Martin Hellwig at BMZ conference on “The international regulatory reform agenda and its impact on developing countries, Bonn, October 29, 2009

⁴ For some of the most advanced thinking see Borio and Drehmann, 2009 and Tarashev et al, 2009

...and experiments varying across countries

Precisely because uncertainties abound, there is likely to be experimentation in different jurisdictions. A simple harmonized global rule system will remain elusive. Such experimentation may help find better solutions. It will also lead to new forms of regulatory arbitrage by market participants. Freshly empowered regulators will try to clamp down on those trying to evade regulatory strictures with new rules. National borders may come to be fortified rather than opened up further. Global co-ordination processes will not be able to wave a magic wand and make the obvious incentives to do so go away.

Global imbalances

While global demand may weaken...

In the medium term risks remain that global aggregate demand remains subdued due to an increase in saving in troubled economies, the US in particular. Whether consumption in emerging markets can make up for this remains unclear. At current exchange rates the emerging markets altogether are as large as the United States (World Bank, 2009b). It is conceivable that developing economies can indeed in the aggregate make up for lower consumption in rich countries, but it is not automatic.

...stresses on currency regimes are likely

The currency regime is critical for the adjustments that are likely in the coming years. As long as China retains a de facto fixed exchange rate with the United States the current account deficit in the US might start growing again as might the current account surplus in China. The Euro area is already under severe pressure from the relative depreciation of the “dollar zone” (incl. China) against the Euro. This in turn aggravates adjustment problems within the Euro zone for countries like Greece, Ireland and Spain. Questions about the sustainability of the Euro zone in its current form are back on the agenda. Emerging markets with currencies pegged to the Euro like the Baltic countries and Bulgaria face even tougher pressures. The Baltic countries already experience true depression-style problems with likely peak-to-trough reductions of output in the order of 30 percent – as bad as the United States in the Great Depression. The resulting unemployment and wage reductions risk undermining social peace. Populist politics have been astonishingly limited so far, but may yet emerge.

Political risks

Pressures to introduce border controls on economic transactions will persist...

With fixed exchange rates stimulative monetary policy in the United States and elsewhere may yet drive the emergence of unsustainable bubbles in countries like China or raise inflation. Countries that face strong currency inflows may well be reluctant to let

exchange rate appreciate for fear of loss of competitiveness and the implications for domestic production and employment. Protectionism “justified” by real or perceived exchange rate rigging may yet come to the fore. While countries in recession or depression may resort to trade protection, flourishing countries might well resort more to capital controls and exchange rate “manipulation”.

...at a time with diminished global leadership ...

These stresses on domestic and international politics come at a time when new powers rise, hastened in fact by the crisis. The world is more diverse, global consensus harder to achieve. In a number of rich countries the crisis comes after years of rising inequality. Remuneration in parts of the economy looks obscene, particularly some bank compensation schemes.

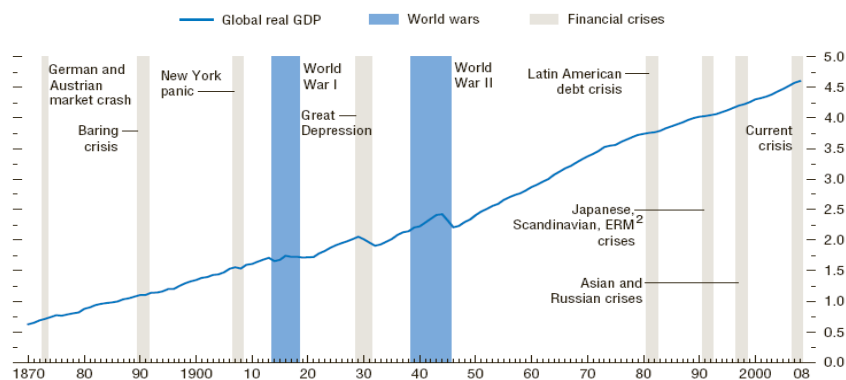
...and threats of populism

In the face of these “problems of capitalism” there has nevertheless not been a shift to “the left”. On the contrary, in Europe, for example, many elections have brought conservative parties to power. The absence of a coherent alternative to market economies is a key reason. But populism may come to haunt more countries including erratic attempts to find “new economic models”. Domestically and internationally politics are more fragile after the crisis. On average, country risk may well increase in various ways affecting trade, convertibility or transfer of currency. De facto expropriation may occur more frequently. Globalization may still suffer setbacks.

Yet, if the world does not descend into a historically unique catastrophe, the prospect for virtually eliminating extreme poverty remains real. It may happen within the next few decades. On current trends, by 2050 African incomes per person will reach levels that the latest EU accession countries had when their entry was agreed. Not even the great depression or the two World Wars have thrown the globe off its historically unprecedented growth path (Figure 8).

Figure 8

Global Real GDP
(Log scale)



Source: IMF, 2009a

What to do

The crisis has thrown new light on findings and rhetoric about the role of finance in the economy. It has, maybe unsurprisingly, shown that emphasis on the volume of finance and access may lead astray. The challenge is to pinpoint the mechanisms by which finance can help raise incomes and to focus the long-term developmental work of DFIs on them.

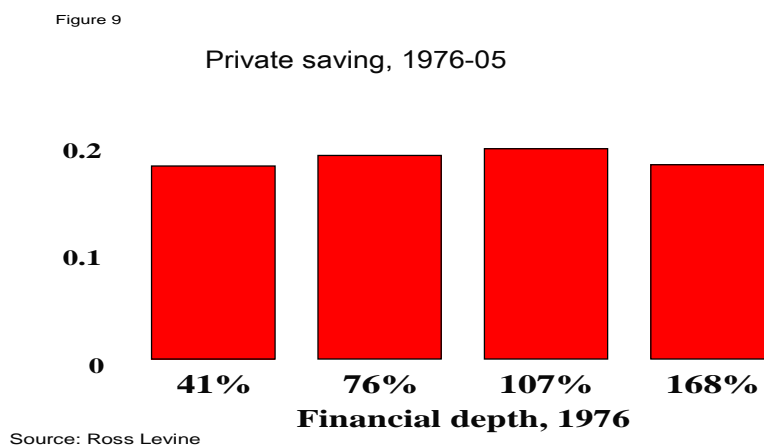
Finance and Growth

Financial market development promotes growth...

The preponderance of the evidence suggests that more developed financial markets help promote economic growth (Levine, 2005). That means incomes grow. Overall growth raises the incomes of the poor to different degrees in different countries. Yet, the pattern across developing economies over several decades has been that inequality within countries is relatively stable and “reverses to the mean”(Chen and Ravallion, 2009). When inequality rises it tends to decline again and vice versa. Nationwide economic growth is thus the key mechanism for poverty reduction. Without it the poor remain just that.

... not by raising saving...

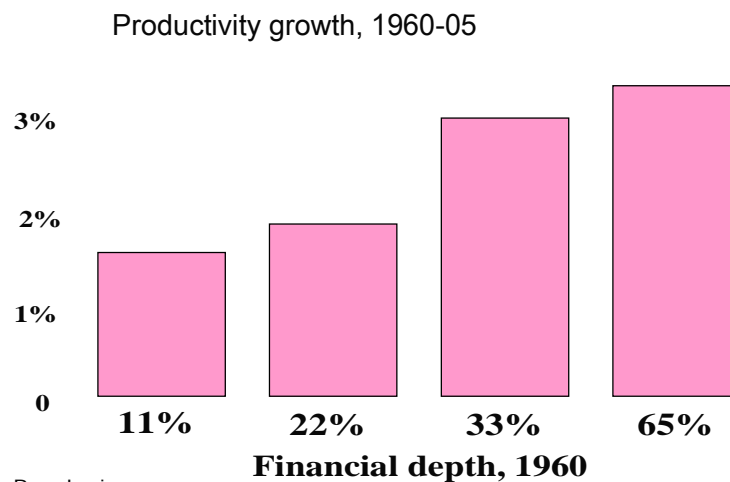
One mechanism by which financial development supports growth could be that it gives people more attractive vehicles to save. This then makes it easier to fund investments and thus drive growth. Yet, the evidence does not support this mechanism (Levine, 2005). Saving rates are independent of the degree of financial market development (Figure 9). Those who argue, for example, that developing pension systems will increase aggregate saving are wrong. Pensions help old people, not aggregate saving.



...but by raising productivity through improved decisions

Instead, the way financial markets support growth is by helping raise productivity growth (Levine, 2005). For this to work the key contribution of financial institutions is to make sound decisions on which activities to support and which to let fail. The quantity of finance or access to finance per se does not matter; it is the quality of decisions about projects and firms – new ones and existing ones (Figure 10).

Figure 10



An enabling legal and regulatory environment for business expands productive access to finance...

For finance to fulfill its promise there needs to be a legal and regulatory environment and the infrastructure that allows new firms to set up, good firms to grow and bad ones to fold or be restructured. Development finance maximizes its impact where it helps create improvements in the business environment. In turn, without a decent business environment development finance faces lower demand from productive ventures (World Bank, 2004).

...while closing and restructuring underperforming firms remains critical.

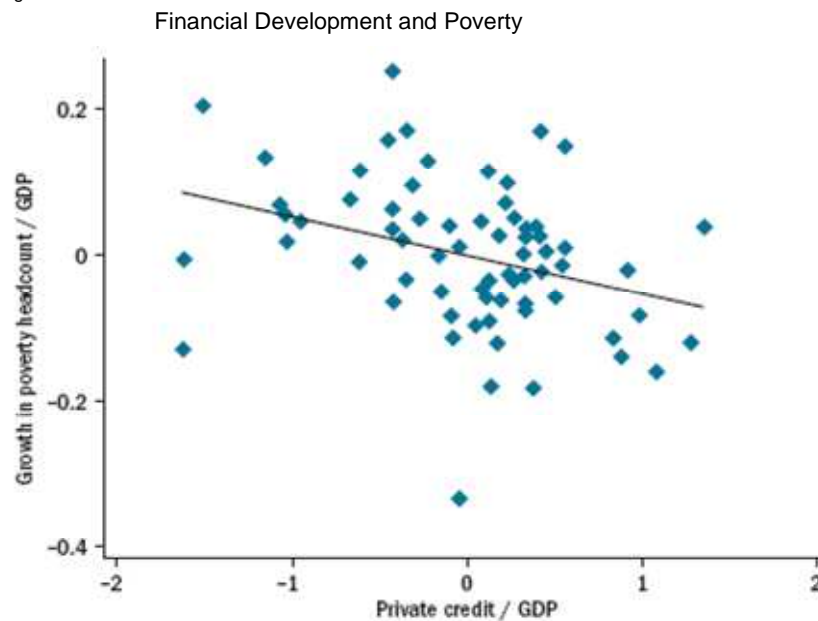
Firms in any particular market typically show a wide dispersion of productivity. Helping ensure that low productivity firms are either restructured or closed brings average practice closer to best practice – a key feature of fast growth. Cutting off access to finance to underperforming firms may be the thing to do in this case.

Access to finance and pro-poor growth

By giving poor people a chance ...

For development institutions the name of the game in finance is not just growth, but pro-poor growth. Financial development can help provide greater equality of opportunity. When poorer people can hope to get finance for worthwhile causes, they are able to do better even though they may not have the connections of the rich or the advantage of their upbringing (Figure 11).

Figure 11



Source: Beck, Demirgüç-Kunt, and Levine (2007).

...microfinance can clearly help ...

Microfinance in particular has brought hope for poor people. A handful of thorough evaluations of microfinance projects now exist, which assess what would likely have happened to their customers in the absence of microfinance. They show that such schemes can work well, that they also hold potential to improve social indicators such as health and education of children. This applies also to the programs that are run on commercial terms charging hefty interest rates (Karlan and Zinman, 2006) of 100 per cent per year or so.

...more by helping manage the vagaries of life than creation of enterprise...

At the same time simplistic notions of microfinance need to be questioned. Much of the folklore around microfinance cites examples of poor women who set up tiny businesses funded with micro-credits. These cases are real. And yet, most micro-credit is for consumption, not investment in the case of Indonesia and Bangladesh (Johnston and

Morduch, 2008 and Rutherford, 2006). In particular, credits help poor people cope with special expenditures related to illness, death and weddings. Women are often assumed to do better than men in micro-finance schemes. But the first study controlling for personal background and attributes in Sri Lanka suggests that men may make better use of credit and do better as entrepreneurs (De Mel et al. 2008). The latest randomized evaluation of microcredit in Hyderabad finds that it helps increase durable goods expenditures by business people, whereas it increases consumption expenditures by others. No effects on social indicators and behavior of women were discernible (Banerjee et. al. 2009).

...and not just with credit but a variety of services...

It also remains unclear, whether credit is the product most needed by the poor. The slightest shock, illness, harvest problems and so on requires ingenious financial management when one has hardly any money (Collins et al, 2009). The poor maintain multiple financial relationships to ensure that they have a little saving and access to credit when needed. Some now argue that saving is a more important service than credit. Yet others point to payment systems. Improved payment services allow the poor to manage cash flow better and may reduce the need for credit. In a new departure M-PESA in Kenya offered payment services to poor customers via cell phones starting in 2007. The company now processes more transactions than Western Union world wide. The average savings balance in these “checking accounts” is about 3\$. 40 % percent of adults use it, an unprecedented development anywhere in the world. The scheme was originally set up to help people make payments on credit more easily. Yet, the big demand there was for payment services (Mas 2009). Overall, the poor – like any other people – have multiple needs and, therefore, demand a variety of services.

... while reaching extremely poor people remains dependent on subsidies

Typically, commercially sustainable microfinance programs also do not reach the extreme poor living under 1.25\$/day. To reach the very poor, some form of subsidy seems required (Cull et al., 2009). The optimal subsidy design remains a challenge whether upfront as in BRAC’s ultra-poor program or on an ongoing basis via subsidized financing terms as in Grameen Bank. Strong evaluation results on subsidy design do not exist as yet.

However, reduction of overall poverty seems hardly affected by microfinance...

Overall, the microfinance movement has proven that better financial products can help poor people. Commercially viable programs have emerged. Innovations such as payment services are promising. However, for now, it is hard to see the effects of financial market development and microfinance in particular on inequality and poverty in aggregate time series of equality or poverty rates in developing countries (Cull et al, 2009).

... job creation seems more important

Access to finance may help with poverty reduction, but for now the main channel seems to go through job creation and productivity improvements (World Bank, 2008). The issue is opportunity and the ability to succeed on the basis of rules and personal effort rather than connections, not access to finance per se. As the World Bank's study "Voices of the Poor" made amply clear the poor themselves rank a job way above all other support mechanisms (Narayan and Petesch, 2002).

Critical is a better investment climate where poor people live or can move...

What seems to matter most is bringing a better investment climate to where poor people live or can move. Cities, in particular, are de facto the most effective job creating enterprise clusters and incubators. A decent investment climate expands the possibilities for entrepreneurs to obtain credit, expand their operations and create more productive jobs. It encompasses the financial market infrastructure that facilitates sustainable and productive access to finance, such as credit bureaus and collateral systems (World Bank, 2004).

...enabling the creation of productive jobs...

In countries without unemployment insurance, i.e. most developing countries, people typically find employment of some type in the informal sector because they have no choice. Job creation in the formal sector is an indication of greater job security and higher wages. Using the World Bank's Doing Business data, it has been possible to estimate for the first time the order of magnitude of formal job creation due to improvements in the business environment. Accordingly, reforms of business regulation may well account worldwide for some 10 to 15 million new jobs in the formal sector per year⁵.

As discussed before a key function of finance is decision-making about what to support and what not to. Sometimes this means supporting the closure of an unproductive enterprise or restructuring. This means jobs may be eliminated and unemployed people suffer. How does this square with a pro-poor orientation? If all one wanted to do is create and preserve jobs, it would be easy. One would create state-owned enterprises and hire everyone or force private firms to do so, which amounts to much the same. The experience of central planning and state-run economies suggests that this would undermine productivity and thus not lead to rising incomes. Not any job will do. Productive jobs are needed.

⁵ The numbers are extrapolated from results in Bruhn M, 2008. Development finance institutions can typically only measure the number of people employed in firms they finance, but not the net new jobs created. Typically even that number is an order of magnitude smaller than the job creation numbers due to a better business environment (see annual reports, for example of IFC or CDC)

...and with it access to finance for productive ventures

Lasting poverty reduction requires productivity improvement. Once productive activities flourish, the economy expands. With that access to finance expands and productive jobs. Pro-poor growth is about protecting people, not particular jobs. That should include, where possible, the creation of safety nets that are independent of the fate of individual firms, but it does not mean keeping underperforming firms alive.

Cross-border finance

For decades, finance has flow from poor to rich countries...

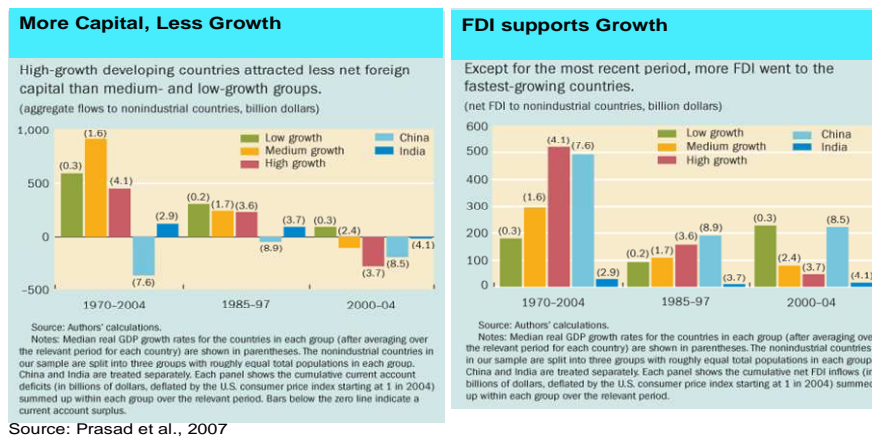
For decades a mantra for development finance institutions has been to fill financing gaps in poor countries where capital is scarce. Yet, already twenty years ago Robert Lucas pointed out the paradox that on a net basis finance has actually flown from poor to rich countries in recent times. The trend has gathered pace since. Fast growing poor countries have mobilized their saving internally and thus financed rapidly rising investment. The countries relying more on money from abroad grew less fast or stagnated. Just, making money available has simply proven to mean nothing for growth. Where people are hopeful and growth sets in, they have typically been willing and able to save (Prasad et al. 2007).

...while foreign direct investment helped growth in poor countries...

However, one component of net cross-border capital flows seems more tightly related to growth, namely foreign direct investment (FDI) (Prasad et al. 2007). Until recently the fast growing countries were the major recipients of FDI. Over the last decade, however, countries like China and India have also attracted less net FDI (Figure 12). One plausible story is that FDI typically brings technical or management innovation bundled with money. This directly helps raising productivity growth. China and India still rely on it, but now have more of their own sources of productivity growth and are starting to invest abroad themselves. A next tier of countries now attracts relatively more FDI and may prove to grow faster as a result.

Figure 12

Net foreign capital flows are irrelevant – FDI helps



...suggesting that transfer of know-how and incentives to deploy it matter most

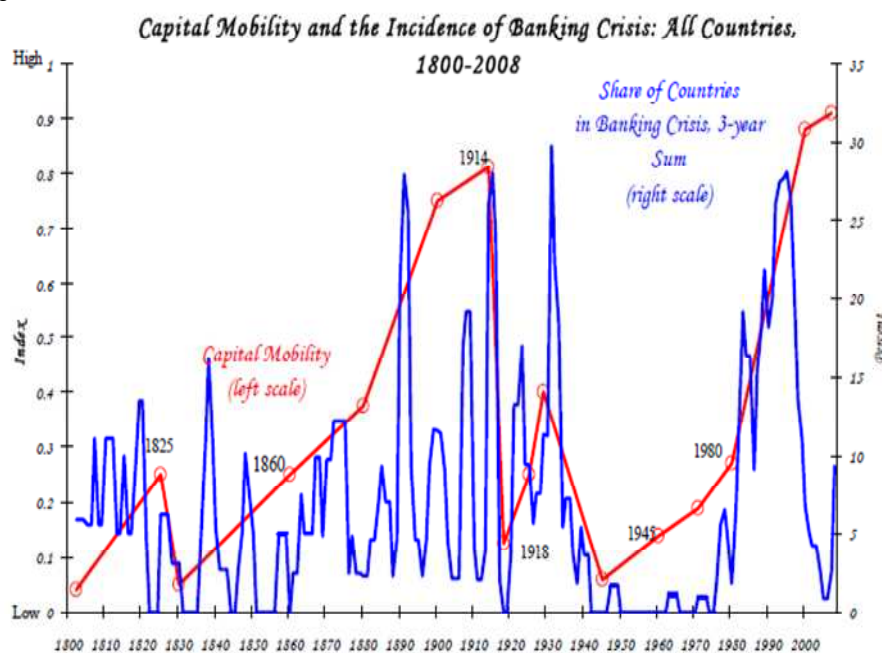
Again, it seems that financial market development – this time at the global level – works its magic to the extent that it helps productivity growth, not via the saving channel. The key to development is thus not transfer of money but transfer of know-how. It may not be so important that FDI transfers resources. Rather foreign investors, who transfer their resources, have fairly good incentives to see that their money is used well. From this perspective, when judging development finance the focus should be on checking whether it helps transfer know-how and whether incentives exist to apply it well– not on whether someone is short of money.

Historically, liberalization of cross-border finance coincided with banking crises...

In broader historical perspective capital controls on cross-border flows are correlated with a lower incidence of banking crises (Reinhart and Rogoff, 2009). The pattern is striking (Figure 13). De facto openness to cross-border capital flows has been associated with a higher frequency of banking crises. Over the last century periods with greater controls have nevertheless seen strong economic growth. The postwar productivity miracle in Europe occurred under capital controls. China and India grew fast with controls in place⁶.

⁶ Domestically, highly controlled financial systems have well-known pathologies – they risk giving rise to political patronage and corruption and thus repress access to finance for productive ventures. For example, state-owned banks in China tended to be concentrated in regions that did not grow fast. To a degree such lending may have smoothed the decline of traditional activities rather than helping create new productive ones. Even now, following the crisis China and India are proceeding with deregulation of their financial systems and cautious opening. India, for example, is considering the introduction of credit default swaps (Financial Times, Jan 23, 2010).

Figure 13



Source: Reinhart and Rogoff (2009)

...and surges of capital inflows complicate macro-economic management

As seen again in the run-up to the crisis and afterwards free cross-border movement of capital can complicate macro-economic management. For example, Colombia was faced with substantial capital inflows before the crisis that risked igniting inflation or alternatively undermining competitiveness through exchange rate appreciation. As long as such financial flows are volatile and do not represent longer-term trends they may disrupt productive enterprise unnecessarily. Hence, Colombia leaned against inflows through controls on inflows. After the crisis Brazil faced a similar dilemma and resorted to such controls. By now most countries stand ready to resort to capital controls on inflows as one tool in the armory of monetary and exchange rate management. At the same time the broad trend towards keeping borders open is likely to continue for some time.

Overall, liberalization of capital flows seems to help a little and is hard to avoid anyway...

Studies of the effect of liberalization of cross border financial flows on growth show positive, albeit small, benefits (Kose et al. 2007). If capital controls were intrinsically good it would pay to institute them within a country or monetary zone, but nobody is advocating this. Also, as a practical matter cross-border flows are hard to control. Liberalization of financial flows in the OECD area was not so much triggered by advocates of liberalization, but by the uncontrollable emergence of “offshore” markets

such as the Euro-dollar market in the 1950s⁷. Today, due to progress with information technology effective controls are ever harder to impose.

...but financial crises are here to stay requiring special policy efforts to cope

Overall liberalization seems sensible when combined with decent regulation, but financial crises are to be expected periodically. Monetary and regulatory authorities will keep a full armory to respond including exchange rate policy, foreign exchange reserves, issuance of foreign debt denominated in local currency and capital controls. The vagaries of international capital flows may further be managed by developing domestic currency markets with longer maturities. Globally, a lender of last resort system is helpful to deal with disruptions in cross-border markets. The crisis showed that swap lines among major central banks and liquidity provision by the IMF were the key features of the current system, which this time around was able to cope with disruptions.

How to do it

Governance and Strategy

DFIs hold promise, because they can focus on growth-enhancing investment...

Development finance institutions try to lift incomes. They tend to invest in firms and projects that promise to create productive jobs. They seek to expand access to finance. They can reach where poor people live.

Yet, they need to reflect on the lessons from the crisis so as to help solve problems and not aggravate them. In recent years, financial markets in a number of countries have failed to lift growth in a sustained way. Excessive lending has undermined market integrity –not only by private but also by public financiers. Financial institutions have, sometimes blindly, participated in euphoric value-destruction. Cross-border financial flows have complicated macro-economic management.

More broadly and before the crisis, study after study of development aid found that aid overall has in the past at best been moderately effective in raising income growth. However, when studying the effect of aid programs that have a plausible direct link to growth, like infrastructure projects, the evidence looks more promising (Clemens et al. 2004).

⁷ As it happens this was in part due to the dollar deposits that Moscow Bank Narodny made in the UK in the late 1950s. And so one may facetiously say that the current crisis was borne of liberalization triggered by the Soviet Union – a case of posthumous communist revenge against capitalism.

...under reasonably effective disciplines

To fulfill their promise DFIs need a governance framework that focuses them on the right path and a strategy that charts it. Aid effectiveness studies suggest that interventions are most effective when monetary payments are tied to success. For example, loans tend to work a little better than pure grants (Djankov et al. 2004).

DFIs can be subject to reasonably effective incentive frameworks, because their financing “technology” can be used to create reasonably effective incentives to achieve results. In light of the preceding discussion the financing features of DFIs are not just important, because they help raise money, but because they can provide incentives to make good decisions. Good decision-making is of particular importance in poor countries that suffer from corruption and related-party finance more broadly.

Operational risk management

The crisis has reaffirmed the value of basic prudence...

The crisis has driven home some lessons for financial institutions in general and DFIs in particular. Risk management has been foremost among them. Much is not new. “Back to basics” is the mantra in managing liquidity, asset quality, maturity and currency mismatches, interest rate and re-pricing risk and profitability. The experience from several Eastern European countries has yet again shown the dangers of excessive asset growth.

...while throwing up special challenges...

As always crises throw up special challenges⁸. For example, the microfinance industry in a number of countries is going through its first deep restructuring. First growth created new challenges such as the need for middle management and the limits of group lending. The popularity of micro-finance brought more foreign loans and thus maturity mismatch. Now problem loans need to be worked out, massive staff retraining is ongoing for the purpose and retail funding through saving has become sought after. More broadly work-outs of distressed assets are set to be a more important part of DFI work.

...and highlighting the need for a better understanding of risk management tools

Regarding techniques, the crisis has reminded of the limits of popular metrics like value-at-risk analysis. Sometimes the very existence of prima facie relatively sophisticated risk metrics has undermined attention to risks and lulled the senses of managers. For example, value-at-risk is assessed assuming a standard distribution of outcomes that tails off on

⁸ The 8th KfW Financial Sector Symposium held in December 2009 discussed various such challenges. For details visit: http://www.kfw-entwicklungsbank.de/EN/Home/Sectors/Financial_system_development/Events/Symposium_2009/index.jsp

both sides of the distribution. A much discussed issue was ignoring major tail risks. In some cases the time series to calculate default probabilities were too short or not meaningful, particularly in emerging markets, but also in the case of US housing prices. Correlations between outcomes may have been based on weak data. Correlations can also change when markets adjust. Finally, some managers may not have grasped what a particular measure can or cannot tell. As a result, financial institutions will need to ensure better understanding of risk management approaches at all levels of the organization. They will need to reduce complexity of products. “Good old” techniques like exposure limits that tackle the tail risk problem will regain importance as will efforts to improve underlying data.

Incentives on DFIs

Calls for better technique and better training of staff and management are all to the good. Yet, ultimately the key is whether incentives and systems are in place to monitor benefits and risks well and to make good decisions, i.e. the governance arrangements. In the rich countries affected by the crisis compensation of staff in banks has received major attention, bonus schemes in particular⁹. This is not a debate of much relevance for DFIs who pay relatively modest bonuses, if at all. At the same time the crisis in the United States has shown that elaborate legislation dealing with corporate governance like the Sarbanes-Oxley reforms has not helped prevent the crisis. Something else matters more.

Monitoring Incentives

Comfortable funding structures may go hand in hand with weak incentives to monitor...

A widely held practitioners’ view is that that stable and long-term funding is a good thing. Yet, some banks in Eastern Europe showed that problems were greatest where funding was dominated by retail deposits and foreign development finance institutions (Wisniwski 2009). One might have thought that retail funding tends to be stable and that DFI funding tends to be of relatively long maturity – correctly so. If such funding structures create problems it must be that the incentives of such financiers to monitor the bank are weak. This is a plausible conjecture, which points to the need to look beyond financial features per se to the mechanisms of governance and discipline they entail.

...when comfort is possible at the expense of taxpayers

Why would retail depositors and DFIs be less demanding than other shareholders or creditors? Retail depositors may rely on deposit insurance that exists de jure or de facto, much of it underwritten by taxes of one sort or another. DFIs are mostly owned by

⁹ This debate has largely been absent from emerging markets in the current crisis. During the Asian crisis, a decade ago, many failures were blamed on corruption and associated corporate governance problems. This continues to be the debate in some emerging markets that have actually experienced a financial crisis like Ukraine.

taxpayers. Furthermore, in cases, where they make loans with counter-guarantees from governments of the borrower, repayment is ultimately dependent on taxpayer support not on the success of the borrower. The crisis has shown that private banks may make lousy decisions. But it has not changed the fact that incentives to watch out for the money may not be stronger where taxpayers are at risk. Consistent with this, local, often state-owned or –sponsored banks tended to get in trouble in Eastern Europe rather than foreign-owned ones.

Some government-sponsored development financiers were key contributors to the crisis...

In rich countries private banks have been much blamed for the crisis. Yet, here also the performance of state-owned banks, for example German Landesbanken, has been problematic and most of all the performance of the two biggest development finance institutions in the world, Fannie Mae and Freddie Mac, the two government-sponsored housing giants in the United States with a combined balance sheet of some 5 trillion dollars at the time of the crisis. Government housing policy in the United States was driven by social imperatives to provide access to housing finance for all citizens. The state-sponsored financiers and the private banks were encouraged by policymakers and regulators to provide credit to low-income groups even when creditworthiness was a problem. In turn these DFIs willingly participated and lobbied hard to keep their prominent role. Instead of providing explicit fiscal subsidies for poor people, who were not creditworthy, underwriting standards for housing loans were undermined (Calomiris, 2008).

...more so than financial techniques like securitization...

Sensible financing mechanism, like securitization, fell in disrepute, because of weak standards in mortgage securitization. Standards for other types of securitization, for example, for credit cards did not suffer. The political impetus to provide access to finance for the poor was one of the key triggers for the crisis. Warnings about the potential risks of US housing finance policy were plentiful for several years in advance of the crisis (Calomiris, 2008). Yet, policymakers and regulators helped build the housing bubble out of concern for social policy.

...given the predilection of governments for off-balance sheet finance and shaky accounting

The case of Fannie Mae and Freddie Mac illustrates a general issue. DFIs allow governments to steer finance to solve problems without the need for fiscal appropriation. DFIs are de facto off-balance sheet funding vehicles for governments. Governments also shy away from prudent accounting, for example, of de jure or de facto government guarantees in the fiscal accounts. US housing finance provides a prime example of this pathology. Governments like off-balance sheet finance and shaky accounting no less than private bankers. Accounting standards for governments are actually less stringent than those for private firms. Overall, DFIs tend to have irresistible political attraction.

DFI behavior before and during the crisis

Cross-border development financiers ...

It takes time for problems to build until they explode. Many DFIs in the world remain in decent shape, but it may be worth observing some warning signs. Consider the behavior of DFIs providing cross-border finance for poor countries, the multilateral ones like the World Bank Group or the African Development Bank and the bilateral ones like KfW or AfD in the run up to and during the crisis. Usefully, one may distinguish between those providing credit to governments and those that invest in private ventures without a government guarantee.

...pursued market share in the run-up to the crisis...

In the decade before the crisis DFIs operating in the market for public or publicly guaranteed debt broadly maintained flat lending volumes. On the other hand, the DFIs funding private ventures quadrupled gross disbursement. Was this, because the former DFIs consciously stepped back, whereas the others strenuously drove private sector lending? In fact, it was the market that explains behavior best. The market for public and publicly guaranteed debt staid flat during the decade as emerging markets practiced fiscal discipline. The market share of DFIs operating in this market also remained broadly flat. The market for private sector investments exploded. Borrowing from banks and capital markets by corporates in emering markets roughly quadrupled . The market share of DFIs in this market hardly improved (World Bank, 2009a and d)

In the run-up to the crisis DFIs of all types strove to grow and pursue market share. They managed more or less well depending on the particular institution. DFIs did not withdraw from bubbles that built, for example, in Eastern Europe. They did not warn the market. Broadly, they followed Chuck Prince's maxim "as long as the music is playing, you've got to get up and dance". Stakeholders of all types admonished DFIs to use their capital more aggressively, to provide innovative finance, not least guarantees and other derivative products (World Economic Forum, 2006) and to consider being more flexible with desired credit ratings. The complaint was typically not that DFIs were too aggressive, but that they were too stodgy and risk-averse. They were asked to meet client demand faster and more flexibly including with more aggressive pricing – like the private sector.

...while acting countercyclical in response to the crisis...

When the crisis hit the strong credit rating of many DFIs suddenly became valuable as they still had market access when many others had not. In the case of weakened DFIs like the US housing giants, the US government made its AAA guarantee explicit. Across the world governments used DFIs to maintain lending at a time when private banks reined in lending. Those institutions like the IBRD, who had spare capital, because the

market for public debt had not grown, expanded lending drastically. Those who had used their capital more aggressively, because their private market had grown, were more constrained in their response. Pressure for DFIs not only to lend freely during crises but also to lower rates to provide support in the hour of need abound. Yet, liquidity provision per se does not require subsidy. On the contrary, lowering rates risks crowding out private markets when they are ready to lend again.

Luckily, the cross-border DFIs are nowhere near the plight of Fannie Mae and Freddie Mac. The strong performance of emerging markets and ample capital maintained to safeguard strong credit ratings have helped. Still, some of them are pushing the limits expanding lending at low rates, while asking taxpayers to validate the approach through capital increases.

Public support for private gain

Private financiers love risk cover from DFIs...

Private financiers also like DFIs – when there is trouble. They routinely ask them to be innovative. The standard call is for guarantees or other risk-absorbing financing structures that make private finance possible for a project. They are supposed to overcome market failure. That sounds good. Yet, private finance on its own often has problems when some fundamentals are missing, not just because of “market failure”.

...when risks are under priced and shifted to taxpayers

In some cases that means no more than accommodating regulatory constraints on banking clients. This form of regulatory arbitrage was reminiscent of private banks’ efforts to find new off-balance sheet ways to expand and economize on capital. De facto, it shifted risks to taxpayer supported DFIs.

In the much discussed area of private-public partnerships in infrastructure the typical problem is a lack of deals that provide adequate cash flow to repay investors (Klein, 2003). This in turn tends to reflect the absence of adequate tariff regimes that allow infrastructure companies to charge and collect sufficient revenues to cover all costs including the cost of capital. The request for innovative DFI involvement is often no more than the search for de facto subsidies to paper over a policy problem – the lack of decent pricing and regulation. In some cases DFIs are actually capable of delivering the requested support because they can better cope with regulatory risk due to their political influence. In other cases, they are capable of providing support because their products are artificially cheap on the back of taxpayer support.

Disciplines on DFIs

Disciplines are needed for DFIs to fulfill their promise...

The crisis has highlighted the usefulness of DFIs as flexible tools for government policy when markets are in trouble. At the same time the crisis has again demonstrated the specific governance risks that DFIs are exposed to as handmaidens of politics. A core question remains how best policymakers can bind their own hands so as not to succumb to the temptation to abuse DFIs at the ultimate expense of taxpayers. Four sets of basic and related disciplines can be written into the constitution of DFIs.

...with rate of return targets for regular development finance...

One role of DFIs is to solve market failures by picking up good, profitable deals left on the table by private markets due to risk aversion or information failures. This role is not about making losses. Where DFIs are meant to solve financial market failures, they should be expected to achieve basic target rates of return related to their cost of capital. In this way DFIs can be protected against pursuing politically attractive deals that provide net costs to society. While individual investments may fail when DFIs discharge their innovative role, the target return should be achieved for the whole portfolio, ex post¹⁰.

...while applying Bagehot's rule to countercyclical finance

Where DFIs are asked to play a countercyclical, they should be subject to the old Bagehot rule for lenders of last resort, namely “to lend freely at high rates against good collateral” (Bagehot, 1873). This is a variant of the market failure principle. Financial markets are disrupted when private parties exhibit excessive risk aversion and suffer from a loss of confidence in the creditworthiness of counterparties. The issue then is liquidity provision – not subsidization, because the underlying business is not insolvent.

Subsidies should be transparent...

Where subsidies are needed to support poor people or to provide public goods that one cannot charge for, such subsidies should be fiscally appropriated. In addition, many DFIs are subsidized, because they are exempt from dividend payments. If governments wish DFIs to keep the money, they might want to establish the equivalent of a dividend policy requiring DFIs to earmark funds for subsidies in lieu of dividends and subject such subsidy funds to general subsidy disciplines as outlined below. Finally, DFIs may enjoy a subsidy by virtue of explicit or implicit government guarantees of their liabilities. Ideally, the fiscal authority

¹⁰ The quality of investment decisions counts and, therefore, metrics like profitability. Profit has its own limitations. Good investment analysis would discount high profits due to undesirable market power or excessive risk-taking. Of course, more quality decisions are better than less. It is in this sense that volume matters for growth.

would explicitly account for the value of guarantees. When subsidies are allocated and accounted for ex ante, the likelihood of bad surprises and crises as in the case of US housing financiers is minimized.

...and delivered under incentives that ensure they reach their goals

Delivering subsidies can suffer from weak monitoring incentives and corruption. Special disciplines are useful. In infrastructure and a number of social sector projects payment of subsidies can be made contractually dependent on prior achievement of desired results (Brook and Smith, 2001). Examples are conditional cash transfer programs, where welfare payments are dependent on children attending school or getting health care or output-based aid projects in infrastructure where subsidies for the provision of water are paid out only once targeted poor people have actually received service. Developing better results metrics helps improve discipline, because now allocation of money can be made more easily dependent on hard data about success or failure.

Strategy for DFIs

Living with disciplines as outlined above, will help keep the focus of DFIs on sound investment criteria and would lead to greater attention to the delivery of subsidies. Within such disciplines DFIs need to develop their strategy following the crisis.

Post-crisis liquidity provision was successful, but is losing importance...

When the crisis broke, attempts to provide assistance with liquidity provision grew in importance, for example, support for trade finance, for micro-finance institutions or the “Vienna” initiative to support banks in Eastern Europe. Initially, fears abounded that massive refinancing problems might plague emerging markets, particularly in Eastern Europe. The problem could potentially have required resources in the order of a trillion dollars (World Bank, 2009d). Even the biggest DFIs like the IBRD could at best mobilize some tens of billions of dollars. The whole community of DFIs could not hope to provide the maximum possible requirements. Now we know that liquidity issues were nowhere near as important as the collapse of demand. Precisely, because they remained small it may be that DFI support was effective, because it matched requirements. The de facto success of the Vienna Initiative suggests that this may be part of the story.

...while restructuring of distressed assets is growing a medium-term need...

While liquidity may no longer be a prime issue the crisis has left a large number of firms and projects in trouble as a result of the collapse in growth, mostly in Eastern Europe. Bad loans need to be dealt with. Firms and projects need to be restructured. Typically it may take several years to solve them. Insolvency regimes in most countries are weak and may prevent effective restructuring or drive firms into liquidation that could have been saved.

...including reform of insolvency regimes

From a development perspective, it tends to be desirable to make the best of existing ventures before investing in new ones. DFIs have a significant potential role. First, as investors in troubled ventures, they are by necessity part of the restructuring process and have special information. Second, being public entities themselves they can help improve insolvency regimes and practices in the process. For several DFIs responding to the restructuring challenge may require special efforts to develop and deploy the relevant expertise. Possibly, groups of DFIs, for example, in the context of EDFI could engage jointly in this endeavor, for example when it comes to improving insolvency regimes and practices that have the potential to help all stakeholders.

A long-term focus on growth that reaches the poor...

The majority of DFI business should, of course, continue to be focused on longer term development priorities. The preceding discussion suggests that enhanced care should be taken to scrutinize projects for their effect on growth processes and on how well they reach poor people. For example, arguments about filling financing-gaps or those amounting to regulatory arbitrage may require stronger challenge.

...is made more effective and profitable as business environments improve

One of the strongest drivers for success in development finance is the quality of the business environment¹¹. Success is greatest when DFIs invest in firms in countries with a poor business environment that subsequently improves. If they invest in a bad environment that remains so, losses are likely. If they invest in good environments, they may perform, but competition is strong and they are less needed. The greatest chance for success is thus in economies that are likely to improve their business environment. DFIs can make a particular contribution in weak governance environments when they provide arms-length decision-making in investments and help promote reform.

Focusing on countries with improving business environments...

The trick is to identify countries that are likely to reform. One new approach is using “Doing Business” data to gauge reform effort. Studies at the IFC suggest that an emerging markets equity portfolio that weighs country shares with reform effort would have outperformed existing equity investments by the corporation. At the same time it would have shifted country allocations to smaller countries – away from the BRICs that fascinate investors but do not always deliver the requisite returns.

...tends to favor poorer and smaller countries

All this points to a practical DFI strategy that considers finance and business environment together, that targets the promising laggards and sheds excessive fascination with big

¹¹ This is the single most persistent and significant factor in evaluation of investment success, for example, at the International Finance Corporation (IFC, 2007)

markets that are developing anyway. It is consistent with what we know today about the links between finance, growth and poverty reduction.

While talk about state capitalism is rife...

The crisis has put private markets in disrepute to some degree. There will be more tolerance for regulatory interventions and more experimentation with state-owned institutions, which include DFIs. Yet, regardless of debates about the merits and demerits of private markets, the recovery requires creating jobs and generating taxes to pay off mounting public debt. Market-based solutions are the only promising ones for now.

... mounting debt may revive popularity of private solution.

As fiscal problems mount calls for privatization or public-private partnerships will mount again. Here DFIs can play particular roles in helping shape the complex relationships in such ventures. As discussed, public-private partnerships may require the public sector to paper over policy issues with state support that may later come to haunt taxpayers. DFIs have a particular role in nudging policy along to achieve good outcomes for society at large.

Equity finance will be in greater demand...

In terms of financial products the crisis has revealed that there was too much debt finance in the world. DFIs themselves may need to consider the balance between debt and equity finance and possibly shift towards greater reliance on equity-type products. This in turn may require organizational and skill adjustments. Most importantly, in shifting more to equity provision, DFIs need to guard against putting their owners, the taxpayers, excessively at risk. Sound rate of return targets would help.

...while debt finance can be enhanced through domestic bond market development

As the crisis has shown, developing nations will also benefit from diversifying financing sources, for example, via the creation of domestic currency bond markets. This would develop longer term finance inside a country. It would improve management of exchange rate risk and provide an alternative to bank finance.

Rising emerging markets ...

When the history of the 21st century will be written, it may become apparent that the crisis marked the shift to greater wealth and influence of emerging markets. The development business itself looks set to reflect this. As emerging markets rise, extreme poverty will be concentrated in fewer countries. Rising emerging markets are becoming development players. Development aid from rich countries may be challenged due to fiscal problems.

...are become major players and partners in development finance

New development partners have already made major steps, not least in Africa. China is now a major investor in Africa. Brazil and India are following. The four BRICs already account for 20 per cent of trade with Africa and may come to dominate by the middle of the century. Investment will follow.

As emerging nations invest in poor and also rich countries...

In the past foreign investment was considered mainly a North-South proposition. Now it is becoming also a South-South play that promises to cross-fertilize developing nations with solutions developed in poorer environments and potentially better suited for them. The development of markets at the “bottom of the pyramid” is taking off. Then there is incipient South-North investment. This will throw up new challenges to DFIs. Such investment may be good for development in poorer countries, but it may be resented in rich countries. If rich-country DFIs engage, they may face criticism at home. If not they may lose partners and in emerging countries they may be seen as handmaidens of rich country interests.

...the value proposition of rich country DFIs needs to shift further from money to know-how

DFIs will need to position themselves in a new game. They need to think carefully about the interests they associate with and the standards they practice. Most importantly, they need to think about what they have to offer the new players. Here again, money is not the key. Rich country DFIs are gradually losing the advantage of having more financial resources than others. More and more their value-added will have to come from providing better solutions.

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