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## **Harnessing Market Mechanisms for Development: International Best Practice Standards**

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### **Article at a glance**

- The fluidity and magnitude of modern capital flows poses new challenges for risk assessment and for maintaining economic stability around the world.
- In order to address these challenges, governments need to recognize the increasing role of the private sector in development and engage it in the implementation of common international best practice standards.
- Complying with international standards requires an active, ongoing dialogue between private and public actors to facilitate the shared responsibilities of building institutions for responsible risk assessment.

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## Introduction: Learning from Crises

In the second half of 1997, four East Asian countries – Thailand, Malaysia, the Republic of Korea, and Indonesia – experienced a massive reversal of the large foreign capital inflows they enjoyed through much of the 1990s. The outward swing amounted to more than \$100 billion and exceeded 11 percent of their collective GDP.<sup>1</sup> This capital flight precipitated large currency devaluations, severe financial asset and output declines, and impairment of financial institutions, rivaling Latin America's debt crisis in the 1980s. In a matter of months, countries that experienced unprecedented growth and prosperity over the previous three decades were suddenly and deeply troubled.

The Asian crisis revealed a new pattern of pathology; it was a capital crisis as opposed to a crisis caused by macroeconomic imbalances. The trigger event of massive portfolio investment outflow reflected a loss of confidence in the countries affected, resulting in depressed currency values, asset prices, and a staggering increase of non-performing assets in the indigenous financial sectors because of public and private sector defaults. It became evident that weakness in those countries' financial systems – owing to a lack of transparency, inadequate risk management disciplines, inappropriate lending to local corporations, and currency and tenor mismatches in liability structures – compounded and magnified the initial crisis of confidence. The ensuing deep recessions followed from depressed currencies, punitively high domestic interest rates, cessation of credit extension, corporate and financial sector defaults, and bankruptcies and liquidations.

In the months following the 1997-98 crisis period, the international community again focused on steps that could be taken to strengthen the financial system and considered stronger measures to prevent and/or manage crises. In the end, the G7 governments, international financial institutions, and existing standard-setting bodies with some private sector input, agreed on a core set of 12 best practice standards for key policy areas. Implementation of these standards, in addition to good macroeconomic policies, would make countries more transparent for investors; in turn,

the international financial system as a whole would be materially improved, more transparent, and more amenable to crisis prevention and management.

These particular standards are important because, as the Asian financial collapse demonstrated, when a country heads toward a crisis, deficiencies in key policy areas magnify exposure-at-risk, losses, and the complexity of managing recovery.

For instance, the Thai Government's publication of unreported foreign exchange forward sales changed the market perception that the country had abundant exchange reserves to one of an alarming, near-zero net reserve balance. Indonesia's lack of a workable bankruptcy and corporate reorganization regime made it impossible to resolve quickly the massive private-sector debt defaults and bring the country out of crisis. In Korea, the Daewoo Group's reports of a hidden \$26 billion net worth deficit frustrated stakeholders.<sup>2</sup>

## Increasing Importance of the Private Sector in Globalization

The Asian crisis provided new fuel to the debate over private and public sector roles in the global economy. A private sector-led market economy, driven by responsible domestic and foreign private investment and an open trading system, remains the only model that can achieve adequate levels of wealth and income creation. Government resources are not and will never be adequate to finance global development.

In support of the private sector led market economy, private and public actors must adopt and implement best practice standards for macroeconomic management, best practices in key policy areas, responsible principles of business conduct, and a prevailing value system that keeps countries away from corruption and unethical behavior. This framework must be augmented by a strong commitment to developing human capital, to implementing standards of good conduct by individual enterprises, and to achieving financial reform.

## 12 Target Areas for Best Practice Standards

### Macroeconomic Policy and Data Transparency

- Data dissemination
- Monetary policy transparency
- Fiscal policy transparency

### Institutional and Market Infrastructure

- Insolvency
- Accounting
- Corporate Governance
- Auditing
- Anti-Money Laundering
- Payment Systems

### Financial Regulation and Supervision

- Banking Supervision
- Securities Regulation
- Insurance Supervision

Source: [www.estandardsforum.com/jhtml/standards](http://www.estandardsforum.com/jhtml/standards)

The state of the international financial system is crucial as a network that mediates the cross-border flows of financial capital and trade, and that mobilizes domestic savings to finance development. Global growth cannot take place unless the financial system is safe, sound, and able to perform its vital tasks. This highlights several important questions.

The first pertains to the emergence of fully diversified financial intermediaries in many markets. While this evolution is desirable, the issues of effective regulation – especially of lending and investment activity to avoid system and institution-threatening abuses – and appropriate capital standards require priority consideration.

Second, the international community has not been able to agree on a protocol for dealing with financial crises. Each crisis now requires ad hoc processes and decisions to reach solutions, which causes greater losses and slows recovery. It is widely accepted that the roles of the World Bank and International Monetary Fund in crisis prevention and management, and in development and stabilization finance, need redefining.

Finally, the matter of standards and safeguards to assure that the core financial markets remain efficient,

trustworthy, and reasonably protected from crisis, needs attention. In dealing with these issues, the balance of responsibility between the private sector and government needs revision.

Managing globalization to improve development outcomes emphasizes adoption and implementation of specific best practice standards, conducting affairs with transparency, and the importance of supportive activities involving risk management, regulation, research, training and technical assistance, and enterprise conduct. This formulation, though relatively novel, embraces widely held views on important aspects of the globalization process.

## Are Best Practice Standards Universal?

Critics say that standards articulated in the 12 key policy areas are ‘Anglo-Saxon’ in character and therefore not relevant or applicable to many countries. While this characterization is correct in terms of where the standards were first formulated, they are nonetheless applicable worldwide because they represent the fullest elaboration of disciplines needed to protect lenders’ and investors’ fiduciary responsibilities in every country.

Lenders and investors conduct activity with third party sources of capital – deposits, borrowings, and fiduciary funds. They are accountable for the consequences of putting these resources at risk to earn a return. Private sector managers are required to invest resources (capital, credit) provided prudently to make acceptable returns without compromising principal. In deploying resources, management is obligated to act on the basis of the most complete, accurate, and available view of risks taken versus rewards expected. Sole reliance on macro information while ignoring standards information creates misleading, incomplete views of risk.

Since standards information is material to a proper explanation of risk, management has the obligation to obtain, utilize, and reasonably assist the development of standards information in private sector decision-making. Failure to obtain, utilize, and encourage such valuable information is a breach of fiduciary obligation.

Management has a fiduciary responsibility to encourage countries and institutions to adopt standards in their own interest, as well as standards in the interest of investors and lenders; to reward countries and institutions for improved standards compliance (i.e., better rates, longer tenors, fewer covenants, etc.); and to encourage ongoing communication and disclosure by countries and institutions about macroeconomic policies and standards compliance.

### Private vs. Public Capital Flows

The IMF calculates net private capital flows to emerging market and developing countries in 2007 to have been \$605 billion, up from \$231.9 billion in 2006. Of these flows, private direct investment accounted for \$309.9 billion and private portfolio flows accounted for \$48.5 billion. "Other" private capital flows, including official and private borrowing, accounted for another \$248.8 billion. Official flows are expected to continue their decline.

## The Practical Effect of International Best Practice Standards

Concentrating on enhanced macroeconomic models and the issues concerning use of confidential information has diverted private sector focus away from a comprehensive, ongoing monitoring of compliance with standards. Nonetheless, there is a strong case to be made for private sector initiatives to generate comprehensive, timely, user-friendly information, based on *public information only* concerning country compliance with standards in the 12 key policy areas.

1. Factually, no country in the world is in full compliance with the twelve recognized standards; regrettably, many countries have made no progress in adopting and moving toward compliance. Any country that does show movement toward compliance with these standards improves its risk and transparency profile to lenders and investors.
2. Countries that express a public policy and program of implementation to all standards signal a strong desire to improve their risk and transparency

position against global benchmarks. Intent, relative to the standards, is an accurate current proxy for a country's desire or lack thereof to be a full participant in the global economic system over time. Public silence on the standards by a country implies that the country either does not know or does not care about the standards – an important point for investors and lenders to consider.

3. A publicly available profile of country attitudes and programs relating to the standards adds a significant additional dimension to a country risk assessment process, strongly enhancing, but not displacing, models based on conventional macro analysis that attempt to assess ability to service investments and debts. This enhanced public profile will be an important step forward in establishing a more effective market discipline. A public profile of countries' positions on standards allows an explicit examination of specific risks involved in conducting private investment and lending activity in different countries. Since governments can no longer be relied upon to bail out private investors and lenders, careful analysis and understanding of these risks becomes vital to the decision-making process in private institutions.
4. Private investors and lenders have the capability to improve risk and transparency in the global financial system if they:
  - Require accurate, timely information about standards compliance from counter-parties under consideration for investments or loans; and
  - Differentiate terms, pricing, and allocation decisions to incentivize compliance.

## Supporting Country Compliance

Standards compliance complements responsibility for sound macroeconomic policy. A positive attitude toward standards evinces willingness to accept the responsibilities of membership in the global economy, while good macroeconomic policy and successful

## The Public-Private Sector Interface: An Action Plan

1. Form country-specific private sector coalitions and conduct dialogue with governments to improve each country's beneficial participation in the global economy.
2. Invite public peer review of financial and economic activities to ensure transparency, responsibility, and accountability.
3. Acknowledge and require the heightened fiduciary responsibility and accountability of the private sector for investment performance and business conduct.
4. Pursue ethical and responsible enterprise conduct, recognizing that good corporate governance and preservation of the interests of stakeholders sustain good corporate performance, rather than detract from it.
5. Include best practice standards in risk management processes, relying on market incentives to reward countries and institutions for implementing the standards.
6. Improve training and technical assistance supporting efforts to comply with best practice standards; support reforms that improve enterprise conduct and preserve trust in market actors.
7. Reduce harmful licit and illicit financial and human capital outflows from emerging markets and developing countries.
8. Support a leadership role for the private sector in financial and economic reform, monitoring country performance, crisis prevention and management, and debt restructuring.
9. Refocus the international financial institutions' mandates and activities toward facilitation of responsible private investment for sustainable development.

implementation of standards measures the ability to fulfill these obligations. Accessible country profiles serve as the basic resource for this assessment. They can be updated regularly so that the current position of a country is available to the large network of decision-makers and analysts who observe countries on a daily basis, thus introducing a new and effective source of market discipline.

Public sector incentives can and should include linking standards compliance with official approval of licenses, mergers and acquisitions, capital requirements, access to official financial support, and membership in global organizations. Governments should also publicly emphasize standards compliance wherever possible in ongoing regulatory, supervisory, and official policy consulting processes. The private sector must also assume a visible posture toward standards adoption and compliance implementation.

The private sector controls the preponderance of resources – capital, technology, and skills – to support economic growth and development. It is appropriate that the private sector (enterprises and rating agencies) set the terms and conditions of support to countries relative to both macro- and micro-performance and standards compliance. Technology has greatly mitigated practical information constraints; the private sector now has access to current, relevant, easily manageable, and easily usable information that allows evaluation of performance relative to standards.

At the micro level, the conduct of enterprises is an important dimension of the essential country risk profile and deserves special mention. As the primary agent of resource mobilization and allocation, the enterprise plays a central role in economic development. While the nature of that role has been controversial, there is a shift taking place away from pure profit-making to generating benefits for society at large. Rather than seeking to promote the interests only of shareholders, emerging norms of good enterprise conduct now also emphasize acknowledging and respecting the interests of a multitude of stakeholders: shareholders, creditors, staff, customers, suppliers, and the community and environment in which the firm operates. The emerging norms involve implementing best practices and managing enterprise affairs to ensure equitable accountability to all relevant stakeholders.

Enterprises that observe good governance best practices earn the trust and support of stakeholders, which in turn lead to lower operating costs, lower risks, and stronger performance. By accomplishing equitable treatment of all stakeholders, fairness of global outcomes at the level of the firm and its stakeholders

can be achieved. As with the other core best practice standards, monitoring good corporate governance through reliable, audited, and publicly reported self- and third-party assessments is required.

## Conclusion

The public-private interface needed for the implementation of international best practice standards starts with domestic and foreign private entities initiating and maintaining a dialogue with government. The market economy, responsible private investment, and liberal trade are the keys to improving a country's well-being. The government should listen to the private sector's views on how to improve the country's attractiveness for domestic and foreign investment and expanded trading activity. Country leaders should be invited to express public support for the market economy model and a desire to work constructively with private investors.

The next step in the interaction pattern is for the private sector to review the country's current position relative to standards, identify points of compliance and non-compliance, and, in an appropriate manner, suggest a prioritized action plan to improve the country's situation relative to best practice benchmarks. The private sector should offer training, technical assistance, and other forms of support to facilitate each country's progress along the desired path. The private sector should also stress that the ultimate policy decisions are the government's to make; countries must take responsibility and understand that these decisions and actions will be part of the public record that the private sector will include in their investment and lending selections.

Countries have a voluntary choice to make concerning the degree of their participation in the global economy. Participation is a path to national prosperity and requires action to prepare citizens for effective involvement. The international community can extend friendship – and express willingness to assist in building bridges to the global system – but ultimately, each country must have its own priorities, choose to be involved, and act to achieve this goal.

## Suggested Readings

Institute of International Finance, *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations*, July 2008.

Basel Committee on Banking Supervision, Bank for International Settlements, *Consultation Draft: Principles for Sound Liquidity Risk Management and Supervision*, June 2008.

The International Organization of Securities Commissions, *Final Report of the Task Force on the Subprime Crisis*, May 2008.

Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, April, 2008.

The Joint Forum, *Cross-Sectoral Review of Group-Wide Identification and Management of Risk Concentrations*, April, 2008.

Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence*, March 2008.

Basel Committee on Banking Supervision, Bank for International Settlements, *Liquidity Risk: Management and Supervisory Challenges*, February 2008.

Institute of International Finance, *Principles of Liquidity Risk Management*, March 2007.

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## Notes

<sup>1</sup> From Marc Uzan, Reinventing Bretton Wood Committee

<sup>2</sup> These cases were prominently reported in the financial press.

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*This article is adapted from an earlier version of Globalization for All: An Analysis, by George J. Vojta. Additional material is drawn from eStandardsForum, Annual Globalization Report, 2007–08. The first Annual Globalization Conference of the Financial Standards Foundation/eStandardsForum was held on July 10-11, 2008 at Emory University. The participants represented an array of private sector programs and initiatives, from systemic financial stability to microeconomic development. Participants acknowledged the need for sustained commitment to private sector-led initiatives and coherent, focused use of private-sector resources to promote development through responsible private-sector investment.*

*George J. Vojta is chairman and founder of the Financial Standards Foundation/eStandardsForum. Damon C. Morris, Ph.D., is director of policy studies. The mission of eStandardsForum is to monitor and report countries' economic, financial, and political conditions in a transparent manner. Only information that is public and authoritative is used. The resulting country profiles provide investors, policymakers, donors, and other stakeholders with a perspective on the material factors affecting country risk, such as the degree of a country's conformity with best practice standards.*

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