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PROGRESS REPORT: THE WORLD BANK GROUP'S ROLE IN STRENGTHENING THE NEW INTERNATIONAL FINANCIAL ARCHITECTURE

Attached for the September 27, 1999 meeting of the Development Committee is a Progress Report: The World Bank Group's Role in Strengthening the New International Financial Architecture, prepared by staff of the World Bank, for consideration under item 2.B of the Revised Provisional Agenda. Ministers may wish to address this topic in their prepared statements.

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September 20, 1999

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I. Introduction

1. Following the financial crisis that started in East Asia, but affected many emerging markets in the course of 1997-98, the international community has agreed to strengthen the international architecture focusing on five main areas:

- Enhancing Transparency, and Promoting Standards and Best Practices;
- Strengthening Country Policies, Financial Systems, and Institutional Foundations;
- Strengthening Policies to Mitigate the Social Costs of Crises;
- Involving the Private Sector in Crisis Prevention and Resolution; and
- Strengthening and Reforming International Fora.

2. The recent wave of financial crises have highlighted important weaknesses in the international financial system that need to be tackled at a global level. But there is also a growing recognition that the international system is made up of a series of national systems, and that the strength of each national system depends not just on one or two factors, but on the range of structural, institutional, social and human foundations needed to make a modern market economy work. Lessons drawn from the recent wave of financial crises underscore that, in addition to macroeconomic stability, good structural and social policies and their institutional underpinnings are of critical importance to enable countries to harness the benefits and avoid the pitfalls of integration with the international financial system (Box 1). Without these underpinnings, both the national systems and the global superstructure will be prone to financial crisis and sustained economic growth and poverty reduction will be challenged.

3. There is also a growing recognition of how complex these foundations need to be. In advanced countries the institutional underpinnings of a market economy took time to put into place. And even today, they need constant attention and improvement. The emerging market countries are finding that to participate in and benefit from the global economy they need to evolve similar underpinnings over a much shorter time period.

4. This paper discusses what the Bank is doing in the aftermath of the 1997-98 crisis to contribute to the efforts underway to strengthen the international financial architecture. It does not addresses systemic issues at the international level, which are being taken up in other fora. Instead it focuses primarily on the role of the Bank in helping countries adopt a more systematic approach to social and structural issues and the steps that have been taken to strengthen the Bank's capacity to assist member countries in these areas. While this work has gained momentum in the past year, it is a long-term agenda and the challenge will be to sustain it over time.

5. Three key principles are guiding the Bank's work in support of the new international financial architecture:

   - At the country level, the Bank's primary focus is to assist developing countries integrate with the global financial system, based on demand-driven country assistance strategies;

   - At the international level, the Bank is well placed to bring developing country experience and perspectives to the discussions that are underway on reform;

   - The breadth and complexity of the agenda has placed renewed emphasis on partnerships, with the Bank focussing on areas of comparative strengths and providing a supporting role in other areas.

6. Social and structural issues have always been at the core of the Bank's developmental work and its mandate of poverty reduction. More recently, they have been underscored in the systematic and holistic approach underlying the thinking of the Comprehensive Development Framework. However, sparked by the recent financial instability, social and structural issues are now also seen as critical to helping developing countries reduce their vulnerability to crisis and maximize their gains from globalization. In response, the Bank is retooling and expanding its programs in several areas emerging as particularly critical in the post-crisis period, such as social protection, corporate and financial sector reform, and institutional development and governance. The Bank has also stepped up its collaboration with other relevant international institutions on these issues, and in particular with the IMF.

II. Strengthening the Social and Structural Framework in Developing Countries

7. Recent discussions on the international financial architecture highlight three ways in which the Bank can contribute to developing good structural and social policies: (a) by supporting international standard setting bodies to develop and disseminate norms and best practices, together with the methodologies for their assessment and implementation; (b) by assisting countries to deepen their understanding of key social and structural sources of vulnerability; and (c) by assisting countries to strengthen their capacity to benefit from globalization and to achieve sustainable growth and poverty reduction. This section provides a brief summary of the Bank's work in each of these areas. A more detailed analysis of the role of the Bank can be found in the paper prepared for the Spring Meeting of the Development Committee entitled "*Strengthening the Underpinnings of a Market Economy: International Standards, Principles and Best Practices and the Role of the World Bank* (DC/99-10, April 22, 1999)", and a progress report is provided in Annex 1.

BOX 1
LESSONS LEARNED FROM THE EAST ASIAN CRISIS

The Bank has undertaken considerable analytical work on the East Asian, both to draw lessons for its operational advice and to contribute to the broader debate on strengthening the international financial architecture in three broad areas. The first body of work focused on the causes of the East Asian crisis and is aimed at distilling the main development policy lessons for managing the challenges of global financial integration. Key products are the 1998 *Global Economic Prospects* report and the regional study on *East Asia: The Road to Recovery*. The forthcoming reports on Global Economic Prospects and Global Development Finance, as well as the next regional report on East Asia will extend the Bank's thinking on these issues. Another important study currently underway is *Rethinking the East Asian Miracle*. This piece provides a post crisis perspective designed to enable policymakers to improve on past policies that delivered good results and to capitalize on the region's strengths. The study also highlights weaknesses in institutions and policies that need to be remedied if East Asia is to be resilient to further instability and to benefit from globalization.

Second, the Bank has undertaken extensive work on the impact of the crisis on households and firms. An important aspect of this work was the assessment of the poverty and social impact of the crisis, which has shown that it had a more differentiated poverty impact than initially thought. Surveys of more than 4000 firms in Indonesia, Korea, Malaysia, Philippines and Thailand have provided insights into both the causes and consequences of the crisis. This work shed light on the role of credit in changes in the financial structure as the crisis unfolded, and on characteristics of firms that better weathered the crisis. Future work will look at the impact of the crisis on competitiveness, technology diffusion, training and skills development.

Third, the Bank has initiated work on specific topics to distill best practice and strengthen our understanding of issues that are still subject to debate. For example, to identify the key elements needed to support a robust financial system, work is underway on such important issues as: (a) the links between the financial structure and growth and stability; (b) the role of market discipline in avoiding financial crises; (c) banking regulation; and (d) predicting banking crises as well as individual bank failures and banking system failures. Other important topics include: determinants and implications of economic volatility, including for financial and capital account liberalization; the design of social safety nets, including how to introduce them under differing institutional circumstances; and transparency and corruption, including the consequences of corruption, and the design of policies to combat corruption; and evolving lessons on strengthening the business environment, including corporate governance and bankruptcy regimes.

Contributing to international norms and best practices

8. There has been considerable progress in setting norms and standards and identifying good practice - in many respects, it is the area where the international community has come the farthest. The international agenda has broadened from its initial focus on transparency standards, to regulation and supervision of financial systems, and to the underpinnings of a sound market economy. However, with this broadening, some of the limitations of standards have become more apparent. There is growing recognition that it may be inappropriate in some areas to specify rigid standards; rather the focus should be on principles and good practices adapted to varying circumstances. Standards may need to be assessed according to effectiveness in the context of other policies, rather than narrowly, and must also be adapted to often very different institutional and policy-making capacities. Nevertheless, there is agreement on many important areas, and the key now is how to move on implementation.

9. The Bank is not a standard setting body. However, it can contribute to international efforts to define norms and good practices, given its long standing involvement and expertise in social and structural policies, and its experience in supporting reforms in the diverse circumstances of developing countries. For example, the Bank has supported, and continues to support, standard setting bodies such as the IMF on the Special Data Dissemination Standard, the code of good practices on fiscal transparency and the code of good practices on transparency of monetary and financial policies; the Basel Committee on Bank Supervision, IOSCO and IAIS on financial sector supervision; OECD on corporate governance; and IASC and IFAC on accounting and auditing.

10. The Bank is also catalyzing the development of principles and best practice in areas where there are gaps, such as on insolvency regimes and the social dimensions of crises. With respect to the latter, the World Bank together with other international agencies such as the UN, has a key role to play in developing practical standards and good practices for social policy. The paper, *"Managing the Social Dimensions of Crises: Good Practices in Social Policy, (DC/99-20)"* summarizes the current thinking in this area.

Understanding the role of social and structural policies

11. Analyzing the key social and structural roadblocks to poverty reduction and sustained economic growth has always been central to achieving the Bank's objectives. Well-integrated, in-depth assessments of social and structural weaknesses are key tools for governments seeking to articulate comprehensive long-term strategies to decrease their vulnerability to crises and achieve poverty reduction. The Bank has recently expanded and deepened its array of analytical tools to assist member countries in their efforts.

12. Social and Structural Reviews (SSRs), piloted over the last year, are aimed at providing a systematic evaluation of country weaknesses and vulnerabilities so as to underpin the formulation of sustained poverty reduction strategies.

13. The Bank and the Fund are also strengthening their collaboration in response to the international community's calls to assess progress and improve compliance with a wide range of standards and principles of best practice. The Bank has provided input into the first round of "transparency reports" prepared by IMF staff on implementation of standards in selected areas. We are now discussing with the IMF more systematic collaboration based on a modular approach. Under this modular approach, the Bank would take responsibility for assessing progress in public sector reform and governance, corporate governance, the business environment, social safety nets, the legal framework and insolvency regimes, and accounting and auditing, and would share responsibility with the Fund for the financial sector. The Fund would take responsibility for assessing compliance with standards in its core areas, such as, the Special Data Dissemination Standard and in fiscal and monetary policies.

14. The Bank is working in partnership with other organizations, especially the IMF (assisted by the joint Bank/Fund Financial Sector Liaison Committee (FSLC)) to carry out in-depth analyses of the financial sector. Most notably, the pilot Financial Sector Assessment Program (FSAP) examines key vulnerabilities and medium-term developmental challenges in

the financial sector, which if not addressed may lead to increasing fragility. Many of the measures emerging from these financial sector assessments also serve economic development more broadly, e.g., an improved contract enforcement system not only helps banks reduce loans losses, but can encourage them to lend to other than large industrial clients. To date, five of the proposed twelve pilot assessments have been initiated, of which one (Lebanon) has been completed and another (Colombia) is close to completion. These assessments, carried out jointly with the Fund, feed into the Bank's Country Assistance Strategies (CASs) and SSRs, as well as the IMF's Article IV consultations. Another example is the specific country assessments of compliance with the Basel Core Principles that the Bank and the IMF are conducting with the support of supervisors from G-10 countries.

15. To analyze the key developmental constraints in the corporate sector, the Bank, in collaboration with partners, is carrying out country assessments to identify the strengths and weaknesses in corporate governance and help countries establish priorities. These assessments aim to strengthen regulatory reform and enforcement while fostering private voluntary actions. (See *Corporate Governance: A Framework for Implementation, DC/99-26)*

16. In recent years, the Bank has developed new analytical and lending instruments to improve diagnosis of country level institutional constraints and to provide more effective lending to address them. For example, the Bank is currently piloting Institutional Reviews (IRs) in five countries (Armenia, Bangladesh, Bolivia, Ethiopia and Indonesia). They provide a broad-gauged assessment of the quality and accountability of policymaking and/or service delivery institutions in a country, and propose a comprehensive strategy for institutional change. Public Expenditure Reviews (PERs) have broadened their scope in recent years from an economic analysis of public spending allocations to a broader analysis of both spending patterns and the institutions of public expenditure management.

Expanding developing country capacity to implement the social and structural agenda

17. The experience gained from the recent crises has led the Bank to sharpen its support for capacity building, both to reduce vulnerability to crises and to help countries deal with the longer term consequences of crises when they occur. Two areas are of particular importance in this regard: institutional capacity and governance; and mitigating the social costs of crises;. In addition to supporting country level capacity building, we also support global initiatives through which the Bank can leverage its impact. Three examples of the latter -- the establishment of a Global Forum on Corporate Governance with the OECD; the Symposium on Bankruptcy and its follow-up; and a push for improvements in accounting and auditing practices at the global level – are currently being pursued.

18. Institutional Capacity and Governance*:* A lesson of the crisis is that countries must build institutional capacity to adjust programs rapidly, introduce new measures, and to ensure good governance. The Bank has recently introduced new lending instruments that facilitate building strong institutions. Adaptable Program Loans provide a more flexible approach to

institutional reforms in individual sectors, recognizing the time frame for reform and promoting a more programmatic rather than projectized approach to reform.

19. Mitigating the Social Costs of Crises: Recent events in the world economy have underlined the important link between economic and social issues. Effective social policy can ease the task of adjustment during times of crisis, helping to build support for necessary reforms and ensuring that the burden of adjustment does not fall disproportionately on the poorest and most vulnerable groups in society. However, effective social policies, particularly during crisis and post-crisis periods, are subject to a number of constraints. Resources available for social programs are limited, and policy makers often face particularly difficult choices between safeguarding immediately social welfare and ensuring the adjustment necessary to restore confidence and promote stable growth. Moreover, the international community has lacked an adequate understanding of what constituted good social policies to prevent and respond to economic crises.

20. The World Bank has been active in working with developing countries to address social issues as they emerge with crises and to put into place elements of the longer-term agenda to address social concerns. Some of the areas the Bank has focussed on include: (a) establishing good policy frameworks to guide social spending decisions and target the poor and other vulnerable groups; (b) putting into place effective labor market policies, including industrial relations policies; (c); pension reform; (d) developing timely operational monitoring systems to monitor the spread and impact of the crisis on households; and (e) supporting public expenditures in the social sectors, especially those sectors and programs with services targeted to the poor (see Box 2). We are also strengthening our collaboration with the IMF to ensure a consistent integration of macroeconomic, social and structural policies in country programs.

Box 2

Recent Bank Support in the Social Sector

- As part of Brazil's special international support package in 1998, the Bank lent and disbursed US$1 billion in special adjustment loans for social security reform and social protection. The social protection operation supported: (a) development of financial instruments to put a nationwide floor on funding for basic education and health services; (b) improvement of the targeting and effectiveness of federal antipoverty programs, and (c) identification of core programs in social assistance, education, health and labor whose budget will be maintained at 1998 levels.

- Early Bank sector work in Russia revealed the weaknesses of the inherited social safety net, in terms of delivery of benefits, adequacy and targeting. Through the 1997 Social Protection Adjustment Loan and the 1997 Social Protection Investment Loan, the Government of Russia and the Bank initiated regional pilot projects to test different targeting mechanisms. The effectiveness of the approaches is now being analyzed and the lessons will be incorporated into the proposed Local Social Protection Delivery Project.

- Based on a Social Sector Review (SSR), the Bank, together with the Government of Ecuador, and in close coordination with the IMF and the IDB, developed a social sector response, elements of which it is currently supporting through investment loans. The program protects key public expenditures in health and education that are targeted to the poor, supports the Government's cash transfer program, *Bono Solidario,* and initiates policy reforms to improve the efficiency and equity of health, education and social safety net programs.

- In Korea, where the impact of the crisis was severe and urban poverty more than doubled, the Bank provided a US$ 2 billion SAL, which involved labor market reforms and the development of stronger safety nets.

III. Involving the Private Sector in Crisis Prevention and Resolution

21. Unlike the debt crisis of the 1980s, the financial crises of the 1990s have entailed much greater involvement of private debt and equity flows. Accordingly there has been considerable discussion of the role of the private sector in crisis prevention and crisis resolution. The key systemic issues that need to be grappled with – such as collective action clauses, the development of principles and procedures to guide the establishment of creditor committees, orderly debt workouts, and bailing-in of the private sector – have been discussed *inter alia* by the IMF Board and will be taken up by the Interim Committee.

22. In addition to supporting the institutional underpinnings of a market economy, the Bank Group is playing a complementary role in promoting stable and sustainable private capital flows to developing countries by:

- Expanding and making more effective its broad-based partnership and outreach activities vis-à-vis the private sector.

- Investing in partnership with private investors, to broaden or restore access of developing countries and their enterprises to private finance; and
- Supporting the restructuring of insolvent banks and corporations, both to help repair the damage done by crises, and remedying underlying weaknesses in developing countries which make them prone to crises.

23. Of these, financial and corporate restructuring have required the largest incremental response. Widespread corporate and financial sector distress in the aftermath of the East Asian crisis highlighted the challenges of systemic bank and corporate restructuring that often confront countries in the aftermath of financial crises. Recent experience with crisis countries has shown that systemic bank and corporate restructuring is expensive, complex and a long-term process that proceeds in fits and starts and offers significant political challenges. Accordingly, the Bank's programs in this area are designed around individual country circumstances and aim to strengthen the policy and institutional framework needed to ensure the sound development of the corporate and financial sectors.

24. Bank financial sector restructuring programs in crisis countries are typically grouped into three elements: (a) preparing a resolution framework to establish strategies, programs and agencies for immediate crisis resolution; (b) restructuring the financial sector by closing failed institutions, restructuring weak but viable ones, and establishing procedures for bankruptcy and loan workouts; and (c) building a sound financial system through strengthening the supervisory and regulatory framework, building institutional capacity and transparency, and deepening the financial system, including through the development of capital markets. The World Bank has also expanded its programs for training, organization of consultative fora and technical assistance, including for sovereign debt management to assist countries manage risk within a sovereign asset and liability management framework.

25. Similarly, Bank programs to address corporate sector problems include: (a) identification of corporate sector weaknesses and vulnerability; (b) elimination of obstacles to restructuring (such as obstacles to debt equity swaps, mergers, elimination of tax distortions, etc.); (c) improvement of the legal and institutional framework for debt workouts including both formal bankruptcy and out of court settlement; and (d) identification and improvement of accounting standards and corporate governance.

26. IFC is complementing these efforts through direct investments, advisory mandates, and technical assistance. For example, in the Asian corporate sector IFC has taken the lead to help competitive firms restructure and rationalize their finances and operations. In the financial sector, where many countries are facing systemic crisis, IFC places priority on recapitalizing strong banks and mobilizing long-term finance through intermediaries. Creative wholesale vehicles such as Asia Opportunity Fund ($100 million in IFC's equity, $100 million in parallel debt financing facility and $50 million in equity co-investment rights) are helping mobilize international capital to support corporate restructuring.

IV. Strengthening International Fora

27. As work has proceeded over the last two years to help strengthen the global financial system, it has become increasingly clear that there is a parallel need to strengthen the global fora for discussing and handling these issues. The Bank has been, and continues to be, engaged in a number of initiatives designed to improve these fora. In particular, we attach great importance to finding new ways for developing countries to play an appropriate part in such global discussions.

28. Bank staff provided input to and participated in the work of the G22 grouping of major industrial and developing countries – subsequently the G33 – that examined a range of financial architecture issues in the course of 1998 and 1999. The Bank stands ready to play a similar support function in any comparable global grouping that meets to discuss these issues.

29. The Financial Stability Forum was established earlier this year to consider issues affecting stability in global financial markets. It now has members from the finance ministries, central banks, and regulatory bodies of the G-7, as well as members from Australia, Hong Kong, the Netherlands, and Singapore; the major international organizations (the World Bank, IMF, OECD, and BIS); and various international regulatory bodies or committees concerned with international financial issues. Andrew Crockett, General Manager of the BIS, is its current chairman. The Bank has two representatives on the Forum itself, and is represented on the Secretariat, as well. At its first meeting in April, the Forum set up three working groups to consider highly leveraged institutions, offshore financial centers, and capital flows. These groups presented status reports at the Forum's recent meeting (in Paris on September 15) and will submit final reports in the Spring.

30. The Bank together with the IMF has been discussing with shareholders a range of possible improvements in the workings of the Development and Interim Committees. Some changes have already been made. The President of the Bank has become a full participant in the work of the Interim Committee, in view of the level of the Bank's engagement and cooperation with the IMF on financial architecture issues, as described elsewhere in this note. Some practical improvements are also being made in the functioning of the Development Committee. For example, the two managements suggested, and the two Boards agreed in August, to a clear division of labor between the two committees on how HIPC would be addressed. The Development Committee Provisional Agenda states (footnote 2) that "in line with ongoing efforts to minimize duplication of work between the Development and Interim Committees, it is expected that Ministers' discussion in the Development Committee would cover the overall design of the Initiative and its connection to poverty reduction as well as general financing issues; financing issues specific to the Fund are expected to be taken up in the Interim Committee". More recently there has been considerable shareholder interest in experimenting instead with a joint meeting of the two committees on the HIPC matters scheduled for consideration by the Development Committee. Thus, the first-ever-joint session of the Interim and Development Committees will take place on September 26, 1999. The interest shown in exploring these new approaches illustrates the desire of the institutions and shareholders in finding pragmatic

ways to strengthen the work of the committees. We look forward to a review of the results of this year's experience, and will continue to work with the Fund and shareholders in developing further proposals for change.

V. Augmenting the Bank Group's Capacity

31. The Bank responded to the extra financing needs of countries affected by the 1997-99 financial crisis in a number of ways. First, there was a significant expansion in IBRD lending commitments from $14.5 billion in FY97 to $21.1 billion in FY98 and $22.2 billion in FY99, and with increases in lending of $1 billion or more to Korea, Indonesia, Thailand, Argentina, Brazil, and the Russian Federation. In two cases use was made of the newly developed Special Structural Adjustment Loan (SSAL) instrument, which gave borrowers access to larger volumes of adjustment lending than the Bank would have otherwise been able to supply. Second, the Bank provided affected countries with longer term programs of support aimed at mitigating the social costs of crisis and supporting financial and corporate sector reform. Third, the Bank developed new lending instruments to improve its capacity to provide support through long-term programmatic loans (such as the Public Expenditure Reform Loans) and policy based guarantees. Fourth, IFC reoriented its investment and advisory work towards crisis countries. For example, IFC resumed an active investment program in Korea for the first time in more than a decade, supporting 17 projects valued at $2.5 bn. Often the first investor, IFC acted as an important catalyst for private capital.

32. We are now considering what needs to be done to secure or enhance the Bank Group's capacity to provide similar support in future crises – for however successful countries are in reducing their vulnerabilities, it is clear that such crises will recur. Work is being taken forward under two headings.

33. Enhancing the Bank Group's financial capacity: Over the past two or three years, Management and Executive Directors have devoted significant time and effort to discussions about the financial structure and income dynamics of IBRD. The note Enhancing IBRD's Financial Capacity provides a an overview of the issues confronting the Bank. It reaffirms recent deliberations that the Bank meets its capital adequacy test, and evaluates the implications of various alternatives for enhancing the Bank's financial capacity. The Board discussion concluded that the current capital structure of the Bank, while sound, placed limits on the Bank's capacity to respond to new demands, including demands arising from global financial instability and to accelerate progress towards the global development targets. Consequently, Bank Management and Executive Directors propose continued attention to the issue of financial capacity, and reporting to the Development Committee on a regular basis.

- The crisis has augmented demand for IFC finance, particularly equity, in two major ways: (i) new clients, who were formerly able to access financial markets without IFC support; and (ii) new services, such as trade finance and working capital. While IFC's financial position remains robust, its capacity to increase investment volumes, particularly equity, is facing imminent constraints.

- Increasing the range of the Bank's lending products: Programmatic structural adjustment loans/credits (PSAL/PSACs) were developed in late 1998 to support medium term reform programs through a sequence of loans/credits. More recently, the Bank launched new loan and hedging products to offer its clients more flexibility in managing their financial risks and increase the borrowers financial market skills. More can be done to develop and structure these and other lending instruments to combine policy and institution building.

34. A systematic focus on the social and structural agenda as it relates to the causes, consequences and management of crises also has important implications for the organization of work and the skill mix within the Bank. Efforts to strengthen the Bank's internal capacity to deliver on the structural and social agenda include: improving risk monitoring; increasing staff skills to support financial and corporate reform; increasing capacity to deliver the social agenda; improving internal organization; and developing knowledge management and information flows for best practice.

VI. Issues for Discussion

35. Ministers may wish to comment on the following issues:

- *Do Ministers agree that the Bank's primary focus in strengthening the international financial architecture should be to assist countries assess the social and structural sources of vulnerability, and build the policy and institutional capacity to participate in, and benefit from, the global economy?*

- *Given the breadth of the agenda, what are the areas that the Bank Group should give priority to, and accordingly buttress its own capacity?*

- *Although the Bank is not a standard-setting body, do Ministers agree that the Bank can play a catalytic role in the development of international norms and good practices by bringing developing country experience and perspectives to the table?*

- *Do Ministers agree with the proposals for enhanced collaboration with the IMF to assess progress and improve implementation on key standards and principles of good practice? What other partnerships, should be underscored, for example with the OECD?*

Annex 1

Bank Support for International Standards and Principles of Best Practice

1. This Annex reports on the Bank's ongoing work on the structural and social underpinnings of market economies in developing countries. It provides a follow-up to the background paper prepared for the Spring Meetings of the Development Committee entitled *Strengthening the Underpinnings of a Market Economy: International Standards, Principles and Best Practices and the Role of the World Bank* (DC/99-10, April 22, 1999).

1. PUBLIC SECTOR REFORM AND GOVERNANCE

2. The Bank has supported the development of the IMF's *Code of Good Practices on Fiscal Transparency* and is now cooperating with its implementation. Related to this work, the Bank is developing a set of institutional principles which underpin sound public sector reform and good governance. The World Development Report 1997, *The State in a Changing World,* has charted the course: helping countries adopt the institutional option that best fits their existing limited institutional capability, and enhance capability through arrangements that foster transparency and accountability. The Bank's Public Expenditure Management Handbook, issued in 1998, illustrates a wide variety of effective institutional arrangements suitable for different levels of existing state capability, and tools for enhancing transparency and accountability such as improved reporting arrangements and client surveys. The Bank also is a repository of knowledge on effective arrangements in anti-corruption initiatives, debt management, tax policy and administration, civil service reform and decentralization.

3. A thorough analysis of the institutional realities on the ground is central to the Bank's approach to helping countries improve public sector management and governance. To that end, public expenditure reviews (PERs), of which the Bank conducts some 30 to 40 annually, have been broadened to include analysis of the institutions of public expenditure management in addition to spending allocations. The Bank also has piloted institutional reviews (IRs) in five countries as the instrument for political economy and institutional analysis of all aspects of the public sector. The IRs provide a broad-gauged assessment of the quality of accountability, policymaking and service delivery institutions and propose a comprehensive strategy for reform. In the context of PERs and IRs, the Bank is developing and testing standardized toolkits for institutional assessment in specific areas such as expenditure management, revenue mobilization and civil service, and for issues such as the balance between restraint and flexibility in public agencies. These diagnostic tools enable benchmarking and tracking of performance changes. Also, the Bank has pioneered the concept and use of anticorruption surveys as key diagnostic instruments. As such tools are applied more frequently it will become possible to distill best practices.

4. Bank support for capacity building is being strengthened through the mainstreaming of institutional concerns in country assistance strategies and the use of new long-term lending instruments. Already CASs are required to diagnose the state of governance and the risk of corruption for projects. A growing number of proposed country programs is focussed on

building public sector institutions, and this trend is expected to continue with the development of the Comprehensive Development Framework and the mainstreaming of the anticorruption agenda. Since institution building requires broad and sustained efforts, the Bank has started to make use of the new programmatic lending instruments. Already Adaptable Program Loans (APLs) support public sector reform in Bolivia, Ghana and Tanzania, Public Expenditure Reform Loans (PERLs) are being piloted in Benin and Jordan and Programmatic Structural Adjustment Loans (PSALs) are being prepared in support of institutional reforms in Thailand.

Social Protection

5. For the Spring Development Committee Meetings, the World Bank prepared a note on *Principles and Good Practices in Social Policy*, drawing on agreed United Nations declarations, and focusing on four areas: (a) achieving universal access to basic social services; (b) attainment of secure and sustainable livelihoods and decent working conditions; (c) promoting systems of social protection; and (d) fostering social integration. The Development Committee proposed further review and refinement of these principles in conjunction with the preparation of the next Social Summit in June 2000. The Committee also asked the Bank to follow-up in translating the broad principles into country-specific results, and to report back to the Committee on policies and practices that support national and international actions, especially to assist countries be better prepared for crisis situations. Accordingly, the Bank has prepared a follow-up paper on *Preventing and Managing the Social Dimensions of Crises: Good Practices in Social Policy* that reports on the findings from existing knowledge on good practices and on the plans for continued work.

6. Bank lending support for social protection – comprising labor market interventions, social insurance and social safety nets including social funds – has increased nearly six-fold since the first half of the 1990s to more than US$3 billion in FY98, amounting to over 13 percent of total Bank lending. Much of the recent increase reflects crisis support for the poor during the global financial crisis. But non-crisis lending also has increased more than three-fold. The expansion in technical and financial support is associated with a broadening of the approach to providing security for the poor, in addition to providing support for the incapacitated poor. Providing risk management instruments to the poor– by assisting them to build-up assets to mitigate shocks to their earning capacity, opening-up trading possibilities to allow diversification, and helping them cope with adverse events through labor based public schemes – reduces their need to take risk averse decisions that tend to exclude them from the benefits of the open and integrated economy.

Strengthening Financial Systems

7. International standards for regulation and supervision of the financial system have been developed for the three main components: banking, securities markets and insurance. The World Bank and the IMF participate in the Basle Committee’s Core Principles Liaison Group, which developed and is charged with following up on the implementation of the Core Principles for Effective Banking Supervision. Both contributed to the working group on Core Principles Methodology, and have in particular recommended the handbook for assessing compliance with the Core Principles. Other activities include participation in the working

group on a New Capital Adequacy Framework to replace the 1998 Capital Accord and the preparation of a best practice paper on loan classification and provisioning. The Bank participated in the process of consultation leading to the formulation of the IOSCO Principles of Securities Regulation, and is strengthening its collaboration with IOSCO on developing implementation and assessment methodologies. In the insurance sector, Bank staff have provided input to IAIS on the development of standards relating to licensing and on-site supervision, and continues to participate in selective meetings of the IAIS, especially those of the technical and education committees.

8. The Bank's work on financial systems is closely coordinated with that of the IMF, with the help of the joint Financial Sector Liaison Committee. Bank and Fund have launched a joint Financial Sector Assessment Program, on which a separate joint progress report to the Development Committee has been prepared. The joint assessments focus on identifying financial system strengths and vulnerabilities so as to reduce the potential for crises. They will feed into the IMF's Art. IV consultation, and into the Bank's Social and Structural Reviews and the Country Assistance Strategies.

9. The Bank has established a specialist crisis-management capacity, led since early 1998 by the new Special Financial Operations Unit and financed by the "New Spending Authority". The intensive work of the SFO in Korea and Thailand has contributed to their rapid pace of recovery, and in Indonesia has helped regaining a measure of stability. In the three crisis countries, the SFO has first helped the authorities establish a crisis resolution framework and then assisted in restructuring the financial sector – identifying and closing failed institutions, restructuring weak but viable institutions and establishing procedures to work out defaulted loans. Increasingly assistance has moved to building a sound financial system, including strengthening the regulatory framework and the supervisory institutions, improving transparency, promoting adoption of international standards, and deepening the financial system through development of capital markets and non-bank inter-mediation.

10. The Bank also has intensified its efforts in countries vulnerable to financial crisis. Main activities include an intensified level of dialogue with the authorities, assessment of financial sector vulnerability, wherever possible development with the authorities and the IMF of so-called standby policy matrices that can form the basis for rapid response in the event of crisis, and technical and financial support to remedy underlying sources of vulnerability. This support is being provided in addition to the Bank's financial sector adjustment lending and investment lending in many countries on the order of some US$2 billion annually. In response to the Asian financial crisis, such lending increased three-fold in FY1998.

Corporate Governance and Business Environment

11. The central role of the corporate sector in recent financial crises has put the spotlight on corporate governance and more generally the legal, policy and institutional framework, which sets the business environment. The Bank's new comprehensive policy framework paper complements the OECD's Principles of Corporate Governance in whose preparation the Bank has participated and which it continues to endorse. (See *Corporate Governance: A Framework for Implementation,* DC/99-26.) The paper focuses on the specific issues and

challenges in developing countries while also providing a systematic comparison of best practices in developing and emerging markets. The emphasis of the Bank's work, and that of its partners, increasingly is on raising awareness of the need for reform, helping countries assess their strengths and weaknesses on corporate governance and the wider framework for business, assist with systemic corporate restructuring and with policy, legal and regulatory reforms crucial for improving the business environment.

12. The Bank has worked closely with the OECD and other partners on raising awareness for the need for reform, including sponsoring conferences and roundtables to involve public and private practitioners and policy makers. To help countries establish priorities, the Bank and its partners have supported country self-assessments, for which the Bank has developed templates with the cooperation of institutional investors and the IFC. Complementing these assessments are investor surveys that establish how markets perceive the same issues. To catalyze the growing international work on corporate governance reform, the Bank and the OECD, in a Memorandum of Understanding dated June 21, 1999, have agreed to sponsor the Global Corporate Governance Forum, which brings together multilateral development banks, bilateral and international organizations, the IMF, the Commonwealth Association, APEC, standard-setting bodies (IASC,IOSCO), and the private sector. The forum will provide a rapid-response mechanism for coordinating and channeling practical technical assistance to help design and implement reforms. Above all, the forum will mobilize local and international public and private sector expertise and resources to champion and advance corporate governance issues in a short period of time. Initiatives include task forces on investor responsibility and on accounting and auditing, training of directors, scaling up the watchdog role of the financial media, and establishing regional private sector advisory groups.

13. The Bank has responded to the short-term need for systemic corporate restructuring. A rapid response team, the Private Sector Development Corporate Restructuring team, is creating analytical tools, designs preventative measures, policy options and technical assistance, and provides advice to governments as well as to Bank and Fund operational departments. The team has conducted some 11 corporate governance assessments; and has developed a new framework for assessing corporate sector vulnerability which will be used in coordination with the Bank-Fund Financial Sector Assessment Program. Numerous papers, seminars and conferences on corporate restructuring best practice also have been prepared. The team also has helped prepare technical assistance loans for corporate restructuring in Indonesia, Korea and Thailand; and has prepared corporate restructuring components in more than 12 Bank adjustment loans in these countries as well as Malaysia, Philippines, China and Vietnam. Similar work is ongoing in the Bank's other geographical regions.

14. The Bank has long supported, and continues to support, structural reforms that strengthen the business environment including the liberalization of trade and foreign investment, legal and regulatory reform, and the acquisition of technical know-how. In this context, the Bank is strengthening its long-standing engagement in the area of competition policy, to help countries reduce excessive profits and rent-seeking behavior which often lie at the root of corruption and cronyism. In collaboration with other multilateral organizations (APEC,OECD,UNCTAD,WTO), national competition offices, NGOs, professional associations and academic institutions, the World Bank Group has been working with

governments to develop competition law, establish the institutional basis for its enforcement, upgrade the skills and understanding of key private and public sector officials on competition issues, and integrate competition policy with the broader range of government economic policies and practices impacting on the business environment.

Financial Disclosure, Reporting, Accounting and Auditing

15. International standards for accounting and auditing, developed and promulgated by the International Accounting Standards Committee (IASC) and the International Federation of Accountants (IFAC), are being increasingly used as a benchmark by countries to develop their own requirements, by stock exchanges and regulatory authorities, and by a growing number of companies. IASC and IFAC are working with IOSCO to develop core standards that could be used for cross-border offerings, listings and reporting in global markets.

16. The Bank supports the work of the standard setting bodies. In recent years the Bank has provided over US$2 million in grants to IASC (development of an IAS for agriculture), IFAC (development of international public accounting standards), the International Organization of Supreme Audit Institutions (INTOSAI Development Initiative for training government auditors from developing countries), and the Intergovernmental Group of Experts in Standards of Accounting and Reporting (the ISAR Group, managed by UNCTAD, for developing approaches to environmental financial accounting and reporting.) The Bank's collaboration with these professional bodies includes identifying key issues encountered by member countries, serving as observer on standard-setting committees and providing comments and inputs for the development of new standards.

17. In addition, the Bank has long played an active leadership role in fostering the use of international standards by the accounting and auditing profession, particularly the international firms. The Bank met with the 'Big 5' audit firms in 1996 and in 1997, the latter occasion coincident with James Wolfensohn's Keynote Address to 4,000 leaders of the world accountancy profession stressing the need for global accounting and auditing principles and standards as a vehicle for transparency and in the fight against corruption. In response, IFAC, the Bank and other multilateral agencies initiated discussions on achieving a more concerted approach to improve financial accountability in developing countries. The International Forum for Accounting Development (IFAD) held several exploratory meetings and will move forward on the agenda for a trial two years. The Bank met again with the "Big Five" firms in 1998 to discuss the role of audit firms in the East Asian crisis, arguing that they had a responsibility to flag non-compliance of financial statements with international standards even if they may have complied with the national requirements. There was broad agreement on the need to improve transparency and quality of accounting. Later, publicity for these discussions in the international news media provided a very positive reinforcement for all parties to move forward.

18. Developing diagnostic tools for evaluating countries' institutional and regulatory frameworks is an important task of the Bank, helping countries to detect weaknesses in the field of financial accountability. In this context, the Bank is developing and testing *Country Financial Accountability Assessments* (CFAAs). Such assessments have been conducted in Angola, Armenia, Egypt, Kazakhstan, Latvia, Moldova, Mozambique, South Africa, Turkey and Yemen. The Bank also promotes adoption of international standards by encouraging

borrowers to use them in reporting for revenue earning enterprises under Bank projects. (About a quarter of the Bank's 1800 on-going projects involve such revenue earning enterprises.)

19. The accounting and auditing component of Bank projects is being strengthened as part of the institution building agenda for development of each country's regulatory framework. The scope of CFAAs is being enhanced to include deeper evaluations of regulatory aspects, including banking, and compliance with standards. A significant additional number of such assessments are to be conducted in major countries during the next two years. Their results will be more systematically reflected in the Bank's Country Assistance Strategies.

20. The Bank continues to provide technical and financial support to many countries as part of its country assistance programs. To provide an impression of the extent of such support, the following lists support recently provided to countries in Europe and Central Asia, one of the Bank's six geographical regions: Bosnia-Hercegovina (government accounting), Croatia (government accounting), Kazakhstan (government accounting and accounting/auditing standards), Kyrgyz Republic (accounting and auditing workshop), Moldova (progressing standards using IASs and ISAs), Russian Federation (professional development and accounting/auditing standards), Turkey (government accounting system), and Ukraine (accounting development).

Legal Systems and Insolvency Regimes

21. Legal and judicial systems are increasingly recognized as fundamental building blocks of social and market development. There is considerable potential for the development of internationally-accepted principles in many areas of legal endeavor, such as anti-corruption, insolvency and the administration of justice. Other areas remain so closely connected to the social fabric that the question of what is a good law or appropriate dispute resolution mechanism necessarily varies widely across countries and legal systems. Two areas of immediate focus for the Bank are anti-corruption and insolvency regimes. A number of global and regional initiatives are underway to combat corruption through establishing standards to define and prosecute corruption and establish mechanisms for mutual cooperation. The Bank is actively supporting these efforts, which complement its own and provide recognized international standards on which action at the country level can be based. The Bank participates in the meetings of many of the organizations concerned as observer, and in other meetings to publicize these conventions. The Bank will also take these international agreements into account in the assistance on corruption it gives to the borrowing countries parties to them. Widespread corporate and financial sector distress in East Asia and other regions has underlined the importance of effective insolvency systems in providing both a framework for the rehabilitation of viable firms and the reallocation of the assets of those which cannot survive. The Bank has accordingly launched an initiative that will undertake a comprehensive review of those elements that comprise an effective insolvency system for developing countries, beginning with a major insolvency symposium will be held at the Bank on September 14-15 this year. Participants at the Symposium will include insolvency experts, bankruptcy judges, representatives of law and accountancy firms, business and banking representatives, academics, and Bank and Fund staff. Following the Symposium, a team of insolvency experts will prepare a set of principles and guidelines for

effective insolvency systems. The Bank will host several regional workshops later this year and early next year to review the principles and guidelines. The completion of the principles and guidelines following the consultation process is targeted for May 2000.

22. The development and application of diagnostic tools for the assessment of judicial and court performance is an important focus of the Bank's work on judicial and legal reform. One study published by the Bank tests the use of statistical indicators to measure the results of courts handling commercial matters in eleven countries. Areas of comparison include the number of cases filed, resolved and pending per judge, the clearance and congestion rates, time to resolve a case, the number of judges, and the cost of a case. The study shows that comparative court statistics can be used as a means for longer range planning within the judiciary. Another Bank study covering four countries offers insights into the factors determining success of the innovation and learning model of pilot court reforms, a mechanism of increasing interest for countries seeking to build the capacity of their court systems. The Bank also has carried out a number of full-scale judicial assessments in transition economies seeking to strengthen the independence and capacity of their judicial systems, including Armenia, Georgia and Bulgaria. They have proven invaluable in establishing a baseline for reform programs and building consensus around reform priorities. These and more limited assessments have provided the diagnostic for free-standing legal and judicial reform operations in Georgia, Guatemala and Kazakhstan, which were approved for Bank financing in FY99.

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