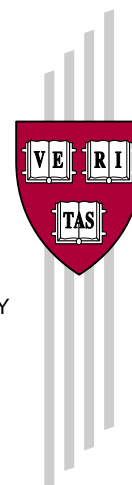


UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT



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CENTER FOR  
INTERNATIONAL  
DEVELOPMENT  
HARVARD UNIVERSITY



## **G-24 Discussion Paper Series**

# **Recasting the International Financial Agenda**

**José Antonio Ocampo**

*No. 13, July 2001*

**UNITED NATIONS CONFERENCE ON  
TRADE AND DEVELOPMENT**

**CENTER FOR INTERNATIONAL DEVELOPMENT  
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***G-24 Discussion Paper Series***

**Research papers for the Intergovernmental Group of Twenty-Four  
on International Monetary Affairs**



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## PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s*. Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series*.

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Governments of Denmark and the Netherlands, as well as contributions from the countries participating in the meetings of the G-24.

# **RECASTING THE INTERNATIONAL FINANCIAL AGENDA**

**José Antonio Ocampo**

*Executive Secretary, United Nations Economic Commission for  
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**G-24 Discussion Paper No. 13**

July 2001

## *Abstract*

*This paper argues that the agenda for international financial reform must be broadened in at least two senses. First of all, it should go beyond the issues of financial prevention and resolution to those associated with development finance for poor and small countries, and to the “ownership” of economic and development policies by countries. Secondly, it should consider, in a systematic fashion, not only the role of world institutions but also of regional arrangements and the explicit definition of areas where national autonomy should be maintained. These issues should be tabled in a representative, balanced negotiation process.*

*In the area of financial crisis prevention and resolution, a balance must be struck between the need to improve the institutional framework in which financial markets operate and the still insufficient attention to the design of appropriate schemes to guarantee the coherence of macroeconomic policies worldwide, the enhanced provision of emergency financing during crises, and the creation of adequate debt standstill and orderly debt workout procedures. In the area of development finance, emphasis should be given to the need to increase funding to low-income countries. The role of multilateral development banks in counter-cyclical financing – including support to social safety nets during crises – must also be emphasized. The enhanced provision of emergency and development financing should be accompanied by a renewed international agreement on the limits of conditionality and a recognition of the central role of the “ownership” of development and macroeconomic policies by developing countries.*

*Regional and subregional institutions should play an essential role in the supply of “global public goods” and other services in international finance. The required financial architecture should in some cases have the nature of a network of institutions that provide the services required in a complementary fashion (in the areas of emergency financing, surveillance of macroeconomic policies, prudential regulation and supervision of domestic financial systems, etc.), and in others (particularly in development finance) should exhibit the characteristics of a system of competitive organizations. The fact that any new order would continue to have the characteristics of an incomplete “financial safety net” implies both that national policies would continue to play a disproportionate role in crisis prevention and that certain areas should continue to be realms of national autonomy, particularly capital account regulations and the choice of exchange rate regimes.*

## ***Abbreviations***

BIS	Bank for International Settlements
CCL	Contingency Credit Line
ECLAC	Economic Commission for Latin America and the Caribbean
ESAF	Enhanced Structural Adjustment Facility
GDP	gross domestic product
FDI	foreign direct investment
HIPC	heavily indebted poor countries
IAIS	International Association of Insurance Supervisors
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
SDR	special drawing right
SRF	Supplemental Reserve Facility
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

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# RECASTING THE INTERNATIONAL FINANCIAL AGENDA

**José Antonio Ocampo\***

## **I. Introduction**

The recent phase of financial turmoil that started in Asia, crossed through the Russian Federation and then reached Latin America, generated a deep sense that fundamental reforms were required in the international financial architecture to prevent and improve the management of financial crises. The crisis led, indeed, to a recognition that there is an enormous discrepancy between the sophisticated and dynamic financial world and the institutions regulating it, and that “existing institutions are inadequate to deal with financial globalization” (UN, 1999, sect. 1).

The crisis set in motion positive responses: a concerted expansionary effort in the midst of the crisis, led by the United States, which was probably the crucial step that facilitated the fairly rapid though incomplete normalization of capital markets; the approval of new credit lines and the expansion of IMF resources; the recognition that incentives must be created to induce adequate debt profiles in developing countries, and that some capital account regulations may serve this purpose and provide a breathing space for corrective macroeconomic poli-

cies; the parallel recognition that financial liberalization in developing countries should be carefully managed and sequenced; a special impetus to international efforts to establish minimum standards of prudential regulation and supervision, as well as of information; the acceptance that no exchange rate regime is appropriate for all countries under all circumstances; the partial acceptance by IMF that fiscal overkill is inappropriate in adjustment programmes; the improvement of the HIPC Initiative; and the greater emphasis given to the design of adequate social safety nets in developing countries.<sup>1</sup>

Some responses were positive but do not seem to have been leading in any clear direction (or even in a wrong one). This is the case of the adoption of collective action clauses in debt issues as an essential step to facilitate internationally agreed debt standstills and orderly workout procedures. In some cases, the responses were insufficient or were clearly inadequate: IMF conditionality was overextended; the need for stable arrangements to guarantee the coherence of the macroeconomic policies of industrialized countries did not receive sufficient scrutiny; the Japanese proposal to create an Asian Monetary Fund gave rise to strong unwarranted opposition, that

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\* The paper partly draws on parallel work by the author, as coordinator of the Task Force of the United Nations Executive Committee on Economic and Social Affairs (UN, 1999), as well as on Ocampo (1999, 2000a) and on joint work with Stephany Griffith-Jones (Griffith-Jones and Ocampo, 1999), supported by the Swedish Ministry of Foreign Affairs.

led to its rapid dismissal (though there has been a recent revival of this idea); more generally, the role which regional institutions could play in an appropriate international financial arrangement was not given adequate attention; and no (or only very partial) steps were taken to ensure a fair representation of developing countries in the discussions on reform or in a revised international architecture.

The partial recovery of capital markets since 1999 gave way to a sense of complacency that slowed down the reform effort. Moreover, it could lead efforts in the wrong direction. One such step would be to give new impetus to discussions on capital account convertibility. The calmer environment could be taken, on the other hand, as an opportunity to broaden the agenda and to set in motion a representative, balanced negotiation process. The ongoing process for a United Nations Consultation on Financing for Development in 2001 constitutes an important opportunity in this regard. The agenda should be broadened in at least two senses: first of all, it should go beyond the issues of financial crisis prevention and resolution – which may be termed the “narrow” financial architecture (Ocampo, 2000a) – to include those associated with development finance and the “ownership” of economic and, particularly, development policies; secondly, it should consider, in a systematic fashion, not only the role of world institutions, but also of regional arrangements and the areas where national autonomy should be maintained. Such is the focus of this paper. As a background, section II presents brief reflections on the nature of the problems that the system faces and the political economy of the reform effort. The paper then deals with crisis prevention and management, development finance, the issue of conditionality versus “ownership” (which concerns both of them), the role of regional institutions, and national regulations and autonomy. The last section draws some conclusions.

## II. The nature of the problems that the system faces

International capital flows to developing countries exhibited four outstanding features in the 1990s.<sup>2</sup> First of all, official and private flows displayed opposite patterns: whereas the former tended to decline, private capital flows experienced rapid medium-term growth. Secondly, different private flows showed striking differences in terms of stability. Thirdly, private flows were concentrated in middle-income countries, with official flows playing only a very

partial redistributive role at the global level. Finally, the instability of private financial flows required the design of major emergency rescue packages, of unprecedented size, which concentrated funds in a few large “emerging” economies.

The first two patterns are shown in table 1. Both FDI and all types of private financial flows have experienced strong medium-term growth. However, these flows have shown striking differences in terms of stability: whereas FDI has been resilient in the face of crises, private financial flows have experienced strong volatility and “contagion” effects. Although access to markets has tended to be restored faster than in the past, credit conditions – spreads, maturities and special options to reduce investors’ risks – have deteriorated, and significant instability in capital flows has been the rule since the eruption of the Asian crisis.<sup>3</sup>

In contrast to the growth of private flows, official development finance and particularly its largest component, bilateral aid, have lagged behind. Indeed, bilateral aid has fallen in real terms and currently stands at one third of the internationally agreed target of 7 per cent of the GDP of industrialized countries (World Bank, 2000: 58). The reduction in bilateral aid has been strongest in the case of the largest industrialized countries. This trend has been partly offset, in terms of effective resource transfers, by the increasing share of grants in official development assistance. Also, contrary to private flows, official finance has been stable and some components of it – particularly balance-of-payments support, but also multilateral development finance – have displayed an anti-cyclical behaviour.

The third pattern is shown in table 2. Private flows have been strongly concentrated in middle-income countries. The share of low-income nations in private financing has been lower than their share in the total population of developing countries, a fact that may be expected, but it is also lower than their share in developing countries’ GDP. This fact is particularly evident in bond financing, commercial bank lending and portfolio flows (excluding India in the latter). In all these cases, private financing to poor countries is minimal. The share of low-income countries in FDI is also smaller than their contribution to developing countries’ GDP. Moreover, a striking feature of FDI is its high concentration in China, which captures, on the contrary, a smaller proportion of financial flows. The high concentration of the most volatile flows in middle-income countries, excluding China, in turn implies that issues of financial

Table 1

NET LONG-TERM FLOWS TO DEVELOPING COUNTRIES,<sup>a</sup> 1990–1999

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999 <sup>b</sup>
<b>Total</b>	<b>98.5</b>	<b>124.0</b>	<b>153.7</b>	<b>219.2</b>	<b>220.4</b>	<b>257.2</b>	<b>313.1</b>	<b>343.7</b>	<b>318.3</b>	<b>290.7</b>
Official flows	55.9	62.3	54.0	53.4	45.9	53.9	31.0	39.9	50.6	52.0
Private flows	42.6	61.6	99.7	165.8	174.5	203.3	282.1	303.9	267.7	238.7
From international capital markets	18.5	26.4	52.2	99.8	85.7	98.3	151.3	133.6	96.8	46.7
Private debt flows	15.7	18.8	38.1	48.8	50.5	62.2	102.1	103.4	81.2	19.1
Commercial bank loans	3.2	5.0	16.4	3.5	8.8	30.4	37.5	51.6	44.6	-11.4
Bonds	1.2	10.9	11.1	36.6	38.2	30.8	62.4	48.9	39.7	25.0
Others	11.3	2.8	10.7	8.7	3.5	1.0	2.2	3.0	-3.1	5.5
Portfolio equity flows	2.8	7.6	14.1	51.0	35.2	36.1	49.2	30.2	15.6	27.6
Foreign direct investment	24.1	35.3	47.5	66.0	88.8	105.0	130.8	170.3	170.9	192.0

*Source:* World Bank, *Global Development Finance 2000*, 4 April 2000 (<http://www.worldbank.org/prospects/gdf2000/vol1.htm>).

*a* Net long-term resource flows are defined as net liability transactions of original maturity greater than one year. Although the Republic of Korea is a high-income country, it is included in the developing country aggregate since it is a borrower from the World Bank.

*b* Preliminary.

volatility and contagion are particularly relevant to them.

Low-income countries have thus been marginalized from private flows and have continued to depend on declining official resource flows. They have, indeed, been strongly dependent on official development assistance, particularly grants, coming mostly in the form of bilateral aid. If we again exclude India, this is the only component of the net resource flows to developing countries that is highly progressive, in the sense that the share of low-income countries exceeds not only their share in developing countries' GDP but also in population. This is also marginally true of multilateral financing, excluding IMF.

The volatility of private financial flows, on the one hand, and its strong concentration in middle-income countries, on the other, have jointly generated the need for exceptional financing on an unprecedented scale, which has been concentrated in a few "emerging" countries. As a result, IMF (including

ESAF) financing has shown both strong anti-cyclical behaviour in relation to private flows and a concentration in a few countries. As the figure below indicates, both patterns are closely associated, as cyclical borrowing by a few countries is the major determinant of the overall cyclical pattern. The latter feature has become even more marked in recent years. Thus, whereas India and the three largest Latin American borrowers received less than half of net real flows from the Fund during the period 1980–1984, net real flows to only four large borrowers (Indonesia, Mexico, Republic of Korea, and Russian Federation) accumulated close to 90 per cent of total net real flows from the Fund in 1995–1998. As a result of this feature, the share of IMF financing going to large borrowers<sup>4</sup> has displayed a strong upward trend over the past two decades. Indeed, in recent years, IMF financing has underestimated the magnitude of emergency financing to large borrowers, as the bilateral contributions to the rescue packages of six nations (Brazil, Indonesia, Mexico, Republic of Korea, Russian Federation, and Thailand) are not included in the data.<sup>5</sup>

Table 2

NET FLOW OF RESOURCES, 1992–1998										
<i>(Annual averages, billion dollars and percentages)</i>										
	Foreign direct investment		Portfolio equity flows		Grants		Bilateral financing		Multilateral financing <sup>a</sup>	
	A	P	A	P	A	P	A	P	A	P
<b>Developing countries</b>	<b>109.4</b>	<b>100.0</b>	<b>33.0</b>	<b>100.0</b>	<b>28.0</b>	<b>100.0</b>	<b>2.3</b>	<b>100.0</b>	<b>15.3</b>	<b>100.0</b>
Excluding China	75.4	68.9	29.4	89.2	27.7	99.0	0.3	13.1	13.1	86.0
<b>Low-income countries</b>	<b>7.4</b>	<b>6.8</b>	<b>3.0</b>	<b>9.0</b>	<b>16.2</b>	<b>58.0</b>	<b>0.8</b>	<b>36.7</b>	<b>5.8</b>	<b>37.8</b>
India	1.8	1.6	2.2	6.6	0.5	2.0	-0.3	-11.2	1.0	6.4
Other countries	5.6	5.1	0.8	2.4	15.7	56.1	1.1	48.0	4.8	31.5
<b>China<sup>b</sup></b>	<b>34.0</b>	<b>31.1</b>	<b>3.6</b>	<b>10.8</b>	<b>0.3</b>	<b>1.0</b>	<b>2.0</b>	<b>86.9</b>	<b>2.1</b>	<b>14.0</b>
<b>Middle-income countries</b>	<b>68.0</b>	<b>62.1</b>	<b>26.4</b>	<b>80.2</b>	<b>11.4</b>	<b>40.9</b>	<b>-0.5</b>	<b>-23.6</b>	<b>7.4</b>	<b>48.2</b>
Argentina	5.2	4.7	1.5	4.5	0.0	0.1	-0.2	-10.1	1.0	6.5
Brazil	9.8	8.9	3.6	10.9	0.1	0.2	-1.1	-49.6	0.7	4.9
Indonesia	3.0	2.7	2.1	6.4	0.2	0.8	1.2	52.8	0.3	2.0
Mexico	8.8	8.0	4.5	13.6	0.0	0.1	-0.7	-28.8	0.3	2.0
Republic of Korea <sup>c</sup>	2.0	1.9	3.5	10.5	0.0	0.0	0.1	3.1	1.1	7.4
Russian Federation	1.9	1.8	1.0	3.0	1.0	3.5	0.5	21.6	0.9	5.9
Other countries	37.3	34.1	10.3	31.3	10.1	36.2	-0.3	-12.6	3.0	19.6
	Bonds		Commercial bank loans		Other loans		Total		Memo	
	A	P	A	P	A	P	A	P	GDP	Population
<b>Developing countries</b>	<b>38.2</b>	<b>100.0</b>	<b>27.5</b>	<b>100.0</b>	<b>3.7</b>	<b>100.0</b>	<b>257.4</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Excluding China	36.6	95.7	26.7	97.0	0.3	8.7	209.5	81.4	89.3	74.8
<b>Low-income countries</b>	<b>1.0</b>	<b>2.7</b>	<b>0.7</b>	<b>2.6</b>	<b>1.1</b>	<b>29.5</b>	<b>36.0</b>	<b>14.0</b>	<b>11.3</b>	<b>40.7</b>
India	0.9	2.4	0.5	1.6	0.2	5.9	6.8	2.6	5.3	19.4
Other countries	0.1	0.3	0.3	0.9	0.9	23.5	29.2	11.4	6.0	21.3
<b>China<sup>b</sup></b>	<b>1.6</b>	<b>4.3</b>	<b>0.8</b>	<b>3.0</b>	<b>3.4</b>	<b>91.3</b>	<b>47.9</b>	<b>18.6</b>	<b>10.7</b>	<b>25.2</b>
<b>Middle-income countries</b>	<b>35.6</b>	<b>93.0</b>	<b>26.0</b>	<b>94.4</b>	<b>-0.8</b>	<b>-20.8</b>	<b>173.5</b>	<b>67.4</b>	<b>78.0</b>	<b>34.1</b>
Argentina	5.9	15.4	1.2	4.5	0.0	-1.3	14.5	5.6	4.7	0.7
Brazil	3.1	8.0	9.6	34.7	-0.5	-13.3	25.2	9.8	10.3	3.3
Indonesia	1.4	3.6	0.3	1.2	0.1	2.9	8.6	3.4	3.1	4.0
Mexico	4.8	12.6	1.6	5.8	-0.4	-10.9	19.0	7.4	6.1	1.9
Republic of Korea <sup>c</sup>	6.8	17.7	0.7	2.5	-0.4	-10.4	13.8	5.3	6.8	0.9
Russian Federation	2.3	6.0	1.1	4.0	1.1	29.0	9.8	3.8	6.6	3.1
Other countries	11.4	29.7	11.5	41.7	-0.6	-16.8	82.7	32.1	40.4	20.1

**Source:** World Bank, *Global Development Finance 2000*, CD-ROM (advance release), Washington, DC (2000); and *World Economic Indicators 1999*, Washington, DC (1999) for GDP and population data.

**Note:** A = amount; P = percentage.

**a** Excluding IMF.

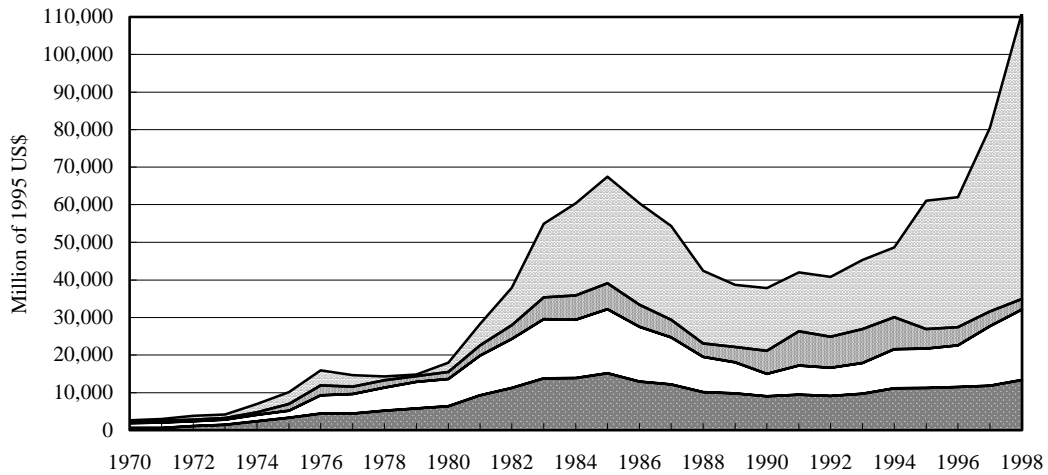
**b** The World Bank considered China as a low-income country until 1998. Since 1999 it has been classified as a middle-income country. In this table it is considered as a specific category.

**c** The World Bank classifies it as a high-income country, but it is included as a middle-income country in *Global Development Finance 2000*.

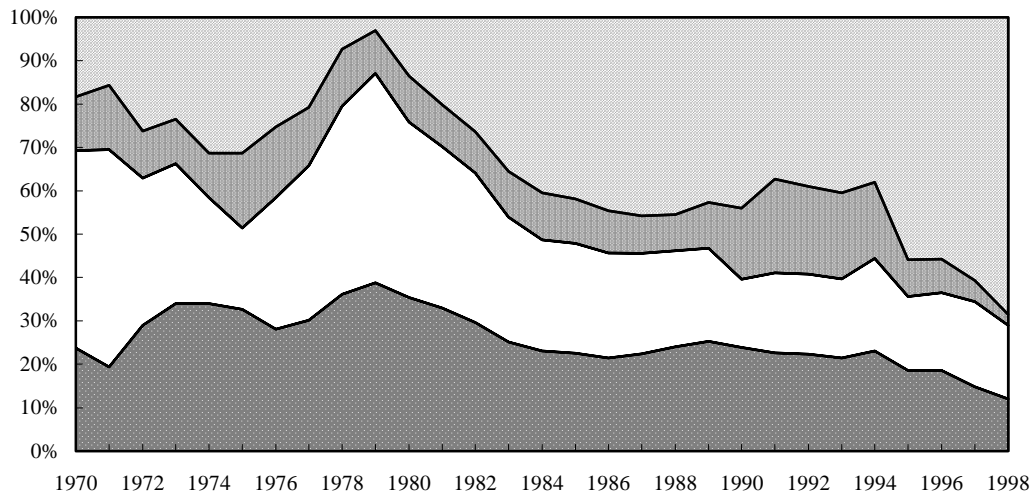
Figure 1

## USE OF IMF CREDIT

## AMOUNTS



## COMPOSITION



- Large borrowers
- High middle-income countries, excluding Argentina, Brazil and Mexico
- Low middle-income countries, excluding China, Indonesia and Russian Federation
- Low-income countries, excluding India

Strictly speaking, however, “crowding out” by the largest borrowers does not seem to have taken place, as overall Fund support has responded elastically to the needs of these large borrowers, with financing to other poorer or smaller middle-income countries remaining stagnant or even increasing mar-

ginally when they also required additional balance-of-payments resources. This was the case in the 1980s for much of the developing world and has also been true of the supply of financing to the smaller East Asian and Pacific nations in recent years. In any case, Fund and counterpart bilateral emergency financing

have complemented private funds through the business cycle. Given the high concentration of private capital flows in middle-income countries, this has led to a similar pattern of concentration in the case of official emergency financing. In the context of a significant scarcity of official funds for low-income countries, the high concentration of balance-of-payments support in a few large “emerging” economies raises significant concerns as to the global rationality with which global capital, and even official flows, are distributed. It certainly raises question about whether the problems of the largest developing countries generate specific biases in the response of the international community.

Thus, although the volatility and contagion exhibited by private capital flows – the centre of attention in recent debates – are certainly problematic, no less important are the problems of the marginalization of the poorest countries from private capital flows and the decline in the bilateral aid on which they largely depend. International financial reforms must thus be focused also on guaranteeing solutions to all these problems. Moreover, the debt overhang of many developing countries, particularly poor ones, continues to weigh heavily on their development possibilities.

### **III. Financial crisis prevention and resolution**

#### **A. *Improving the institutional frameworks in which financial markets operate***

The issues associated with financial crisis prevention and resolution have received extensive attention in recent discussions.<sup>6</sup> The most important area of agreement relates to the need to improve the institutional framework in which financial markets operate: to strengthen prudential regulation, supervision and accounting practices of financial systems worldwide; to adopt minimum international standards in these areas, codes of conduct of fiscal, monetary and financial policies, and sound principles of corporate governance; and to improve the information provided to financial markets. From the point of view of industrialized countries, the central issues are stricter regulation and supervision of highly leveraged institutions and operations, controls on offshore centres, and the greater weight that should be given to the risks associated with operations with countries engaging in large-scale net borrowing, par-

ticularly of a short-term character, to discourage risky financing at the source. In this regard, it should be emphasized that, despite the recognition of the central role of the strengthening of regulations of highly leveraged institutions, moves in this direction have been rather timid and biased towards indirect rather than direct regulations.

From the point of view of borrowing economies, greater weight should be given by domestic regulators to the accumulation of short-term liabilities in foreign currencies, to risks associated with the rapid growth of credit, to currency mismatches of assets and liabilities, and to the valuation of fixed assets as collateral during episodes of asset inflation. Most importantly, due account should be taken of the links between domestic financial risks and changes in key macroeconomic policy instruments, notably exchange and interest rates. This indicates that prudential standards should be stricter in developing countries, where such links are more important, and that they should be strengthened during periods of financial euphoria to take into account the increasing risks being incurred by financial intermediaries. Due account should also be taken of the important externalities which large non-financial firms could generate for the domestic financial sector, which implies that the external liabilities exposure of these firms should also be regulated. We shall return to these issues below.

Nonetheless, a substantial divergence of opinion remains. Firstly, there is no consensus as to which institutions should be entrusted with enhanced responsibilities in this field. The BIS should certainly play the leading role, but this requires a significant expansion of developing country membership in this organization. The more ambitious proposal to create a World Financial Authority on the basis of BIS, IOSCO and IAIS should also be considered (Eatwell and Taylor, 2000).

Secondly, the lack of adequate representation of developing countries in the definition of all sorts of international standards and codes of conduct is a basic deficiency of current arrangements<sup>7</sup> – which the launching of the Group of Twenty only partly solves – and violates the central principle formulated by Helleiner (2000a): “No harmonization without representation”. It also works against the necessary adaptation of rules to developing country conditions (Ahluwalia, 1999).

Thirdly, although the essential role of regulation and supervision is to make financial intermediaries

more risk-conscious, there are clear limits to the appropriateness of discouraging private risk-taking. Stronger prudential regulation in developing countries increases the costs of domestic financial intermediation and thus encourages the use of more external borrowing in the absence of adequate regulation of the latter. Fourthly, differences exist as to the relative merits of prudential regulations and supervision versus alternative instruments in key areas. One particularly relevant issue in this regard, as will be seen in section VII, relates to capital account regulations. Moreover, there are significant differences of opinion as to what may be expected from enhanced prudential regulation and supervision, given their inherent limitations. Regulations will tend to lag behind financial innovations, supervisors are likely to face significant information problems, and macroeconomic events may overwhelm even well-regulated systems. Finally, traditional prudential regulation and supervision tend to have pro-cyclical macroeconomic effects (they may be unable to avoid excessive risk-taking during the booms but may accelerate the credit crunch during crises, when bad loans become evident and the effects of provisioning standards are thus felt), a fact which may increase rather than decrease credit risks through the business cycle.

Equally important, there is some doubt as to what can be expected from better information. Indeed, although improved information enhances microeconomic efficiency, it may not improve macroeconomic stability, which is dominated by the evolution of opinions and expectations rather than information, in the correct sense of that term (i.e. factual information). Indeed, the tendency to equate opinions and expectations with “information” is a source of confusion in the recent literature. Well-informed agents (rating agencies and institutional investors, for example) are equally subject to the whims of opinion and expectations, a fact that accounts for their inability to stabilize markets and, indeed, under certain conditions, for the additional instability which they may generate.<sup>8</sup> To use modern terminology, more than “information cascades”, what characterizes macroeconomic financial instability are “opinion and expectation cascades”, i.e. the alternate “contagion” of both optimism and pessimism through the business cycle. The best information system will be unable to correct this “market failure”, as the whims of expectations involve “information” about the future which will never be available.<sup>9</sup> Developing countries have also strongly argued for “a symmetrical application of transparency criteria between public institutions and the private sector” (Group of Twenty-Four, 1999a), and thus against the

tendency to emphasize the former over the latter in current proposals. Heated debates still surround the advantages versus the disadvantages of the disclosure of IMF surveillance reports, which reflect the relative virtues of greater information and transparency versus “the importance of maintaining the Fund’s role as confidential and trusted advisor”.<sup>10</sup>

### ***B. The need for coherent macroeconomic policies worldwide***

The consensus on the need to strengthen the institutional framework in which financial markets operate has not been matched by a similar emphasis on the role played by the coherence of macroeconomic policies worldwide, i.e. on appropriate mechanisms to internalize the externalities generated by national macroeconomic policies.<sup>11</sup> A particularly crucial area, which the Group of Twenty-Four and other analysts have emphasized, are the high costs that fluctuations among major currencies have for developing countries.<sup>12</sup>

The need for coherent macroeconomic policies is crucial in relation to both booms and crises, but the need to strengthen the extremely weak existing arrangements is particularly crucial during booms, when IMF surveillance is perceived by national authorities as an academic exercise, consultative mechanisms seem less necessary and “market discipline” has perverse effects, as it does not constrain excessive private risk-taking or the adoption of national pro-cyclical policies. Indeed, the focus of current institutions, both national and international, on crises rather than booms is a serious deficiency of existing arrangements, as they underplay the preventive role that they should perform. Obviously, concerted expansionary action during crises is also essential and, as was pointed out in the introduction to this paper, moves in that direction since the Russian crisis were probably the single most important reason for the relative, although incomplete, normalization of capital markets in 1999.

The lack of adequate representation of developing countries in existing organs is another deficiency of current arrangements, as the composition of the IMF International Monetary and Financial Committee reflects. Given the more adequate balance in the representation of developing and developed countries, the United Nations could play an enhanced role in the normative area, through either an improved Economic and Social Council or an Economic Security Council.

### C. *Emergency financing*

The enhanced provision of emergency financing during crises is the third pillar of the system to prevent and manage financial crises. This principle may be called the principle of the “emergency financier”, to differentiate it from the role that central banks play at the national level as “lenders of last resort”, which is not exactly matched by IMF. More specifically, the Fund provides exceptional financing but certainly not *liquidity*, a fact that is reflected in the lack of automaticity in the availability of financing during crises.<sup>13</sup> The access to emergency financing raises, in any case, “moral hazard” issues that give rise, on the side of borrowers, to the need to define access rules and, on the side of private lenders, to the need for orderly debt workouts that guarantee that they assume a fair share of the costs of adjustment.

The main lessons from recent crises are that:

- (i) as a preventive measure, wider use should be made of private contingency credit lines that are agreed during periods of adequate access to capital market, following the (partly successful) pioneering experiences of some “emerging” economies;
- (ii) large-scale official emergency funding may be required, though not all of it needs to be disbursed if support programmes rapidly restore market confidence;
- (iii) funds should be made available before, rather than after, international reserves reach critically low levels; and
- (iv) due to strong contagion effects, contingency financing may be required even by countries that do not display fundamental disequilibria.

At least the last two lessons imply significant differences with respect to the traditional IMF approach, which is based on the principle of correcting fundamental balance-of-payments disequilibria once they have become evident. Positive measures have been adopted in this area, including a significant expansion of IMF resources through a quota increase and the New Arrangements to Borrow, which entered into effect in late 1998; the launching of SRF in December 1997 to finance exceptional borrowing requirements during crises; and the creation of CCL in April 1999 to provide financing to countries facing contagion and its redesign in September 2000.

The major controversies relate to inadequate funding, conditions for access and credit terms. With respect to the first point, bilateral financing and contributions to IMF will continue to be scarce during crises. This is a crucial issue, as the stabilizing effects of rescue packages will be absent if the market deems that the intervening authorities (IMF plus additional bilateral support) are unable or unwilling to supply funds in the quantities required. As bilateral financing and contributions to IMF will continue to be scarce and unreliable during crises, the best solution, according to several recent proposals, is to allow additional issues of SDRs during episodes of global financial stress; these funds could be destroyed once financial conditions normalize.<sup>14</sup> This procedure would create an anti-cyclical element in global liquidity management and would give SDRs an enhanced role in world finance, a principle that developing countries have advocated in the past and should continue to endorse in the future. Second-best alternatives are to make more active use of Central Bank swap arrangements under IMF or BIS leadership, and to allow IMF to raise the resources needed in the market.

The broad issues raised by conditionality will be discussed in section V below. However, the adequate mix of conditionality and other credit conditions deserves some attention here. In this regard, the idea that conditionality cum the provision of limited funding should be mixed with harder terms for exceptional financing – both shorter maturities and higher spreads – is controversial. This has been the pattern established in new IMF facilities (both SRF and CCL) and was introduced as a general principle of IMF financing in September 2000, which will only be applied, however, after a transitional period. It has eliminated the “credit union” character of IMF but still does not reflect “market conditions”. It should be recalled, in this regard, that the classical Bagehot criteria for lending of last resort relies on short-term financing at penalty interest rates, but on the basis that financing is unconditional and unlimited (or, to be precise, limited by good collaterals only). Thus, contrary to current IMF practice, Bagehot criteria consider more onerous credit terms (with unlimited funding) as a substitute rather than a complement for conditionality (cum limited funding).

Indeed, following ideas closer to these classical criteria, some of the more radical proposals in this area involve reducing conditionality significantly and moving towards short-term credit lines, at penalty interest rates.<sup>15</sup> These alternatives are equally controversial. First of all, they also violate one of



Bahegot's criteria: unlimited funding; indeed, these proposals would restrict financing severely when compared to recent IMF credit lines. Secondly, in some of these proposals, conditionality is maintained, and even includes conditions that have been absent in traditional IMF financing.<sup>16</sup> Moreover, a basic assumption of these proposals is that recent crises have been severe but short (see Council on Foreign Relations, 1999, chap. III) – a fact that, as argued in section II, has not been confirmed by events since the Asian crisis.<sup>17</sup> More importantly, the characteristics of recent crises – including their duration – is certainly not independent of the rapid response of the international community in the form of larger and faster rescue packages than in the past (along the “lessons” previously inferred). During the Asian crisis, it was also associated, as indicated, with the rapid, concerted macroeconomic response of industrialized countries.

The recent CCL designed to deal with contagion has introduced similar but also some additional problems. Again, following traditional “lending of last resort” criteria, critics have argued that such a credit line should have more onerous credit terms, but should also be automatic, based on whether countries fulfil certain *ex ante* criteria, and thus be detached from traditional conditionality. Even after its redesign, the CCL does not fully meet these criteria: although the “activation” process made access more automatic, and monitoring arrangements were made less intensive, the “post-activation” review still kept the character of traditional IMF financing subject to conditionality (though now subject to lower initial charges). A more important difficulty is that *ex ante* signalling transforms, in effect, IMF into a credit-rating agency, a fact that could generate severe destabilizing effects on countries when downgraded. It also transforms the nature of Article IV consultations, eroding its character of a dialogue with a “trusted advisor”.

This discussion highlights how complex it is for an “emergency financier” (rather than a true “lender of last resort”) to find the appropriate mix of conditionality, limited funding and more onerous credit terms. The adequate solution would require: (i) large up-front financing; (ii) no prequalifications, but a fast review process during periods of crisis and, in particular, strong contagion; and (iii) reduced conditionality in general, but particularly for those credit lines subject to harsher terms.<sup>18</sup>

#### ***D. Debt standstills and orderly workout procedures***

Debt standstills and orderly workouts procedures are an essential mechanism to avoid the coordination problems implicit in chaotic capital flight, to guarantee an appropriate sharing of adjustments by private lenders, and thus avoid “moral hazard” issues associated with emergency financing. Broad consensus on the need to create arrangements of this sort exists,<sup>19</sup> but little action has followed. This reflects both private sector opposition to non-voluntary arrangements in industrialized countries and also the practical difficulties involved in designing a mechanism of this nature.<sup>20</sup> As recently summarized by the IMF International Monetary and Financial Committee, these difficulties are associated with the need to strike a balance between broad principles, required to guide market expectations, and the operational flexibility, which calls for elements of a “case-by-case” approach (IMF, 2000c; Köhler, 2000). It is clear, however, that there is no substitute to the declaration of a debt standstill by the borrowing country, followed by voluntary negotiations with lenders, subject to some internationally agreed principles.

Due to the effects that the use of this mechanism could have on their credit standing, borrowing countries are unlikely to abuse it. Nonetheless, to avoid “moral hazard” issues on the side of borrowers, it must be subject to international control by allowing countries to call a standstill unilaterally, but then requiring that they submit it for approval by an independent international panel or an agreed international authority whose authorization would give it legitimacy (UNCTAD, 1998, Part I, chap. IV; UN, 1999). An alternative could be to draft *ex ante* rules under which debt service could be automatically suspended or reduced if certain macroeconomic shocks were experienced; such rules have sometimes been incorporated into debt renegotiation agreements.

On the other hand, debt issues and negotiations must be subject to five basic rules. Firstly, to avoid both free riding and discrimination against countries or a group of countries adopting them, they require the *universal* adoption by borrowing countries of “collective action clauses”, as indeed British rules already require. The G-7 countries must actually lead the process, as they suggested in October 1998 (Group of Seven, 1998), for otherwise these clauses would become an additional source of discrimination against “emerging markets”. Secondly, “bailing in” should be encouraged by giving seniority to lend-

ing that is extended to countries during the period in which the standstill is in effect and during a later phase of “normalization” of capital flows. Thirdly, IMF “lending into arrears” should continue to be considered a normal practice so long as countries seek to work cooperatively with private creditors. Fourthly, the phase of voluntary debt renegotiations under this framework must have a short, strictly defined, time horizon, beyond which the country in arrears could request the independent panel or international authority to intervene in the negotiations or even to determine the terms of rescheduling. Indeed, the basic deficiency of voluntary case-by-case solutions is that the negotiation periods can become extremely long, generating large costs to developing countries, as the experience of Latin America in the 1980s indicates. Finally, to avoid repeated renegotiations – another troublesome feature of voluntary arrangements in recent decades – aside from the portion that is written off (or refinanced in highly concessional terms), the service of another portion should be subject to the fulfilment of certain contingent macroeconomic conditions that determine debt service capacity (e.g. terms of trade, normalization of lending, domestic economic activity, etc.).

It must be emphasized, finally, that private sector involvement in crisis resolution should be seen as a complement, rather than as a substitute or prerequisite, for emergency financing (even if only above a certain threshold level). This implies that the international agency with authority in this area could be given the role of advising countries on the desirability of the standstill but not the capacity to force it on debtor countries. An alternative system would significantly increase market instability and/or “solve” moral hazard issues by increasing spreads or severely rationing financing to developing countries. The recent experience indicates, indeed, that the large rescue packages of the 1990s were served normally. This indicates that the problems faced by the emerging economies that led to large-scale emergency financing had a significant element of illiquidity rather than insolvency, a fact that argues for more rather than less emergency financing. The conditions that such financing carried are, obviously, more debatable. We shall return to this issue below.

The definition of international rules on capital account regulations and exchange rate regimes has been left out of this discussion. The reason is that, under the current, incomplete, international arrangements, national autonomy should continue to prevail in these areas. They are therefore considered in section VII of this paper.

## IV. Development finance

As the discussion presented in section II indicates, although IMF financing is certainly important to low-income countries, the major issues for them are associated with the need to guarantee adequate development finance, through ODA and multilateral lending, and to generate mechanisms that will allow them to participate more actively in private capital markets. Given the relative magnitude of financing to low-income countries (see table 2), the reversal of ODA flows – particularly those originating in the largest industrialized economies – is certainly the most important issue. Thus, it is important that efforts to accelerate the HIPC Initiative should not crowd out new ODA financing. Actually, beyond a more ambitious HIPC Initiative, the world requires an even more ambitious and permanent “ODA Initiative” aimed at effectively meeting internationally agreed targets. An essential characteristic of this process, as is emphasized in the following sections, should be an effective “ownership” of policies by developing countries, a fact that requires less direction from abroad and more emphasis on national institution building. The latter requires, in turn, respect for the central role that parliaments and governments in aid-receiving nations should have in the global allocation of aid through their budgetary processes, and for the central role that governments in those countries should have in directing traditional areas of public policy (for example, social policy and infrastructure), even when civil society is given a central role in execution.

Equally important, however, is the acceleration of the growth of multilateral development finance. Such lending will continue to play a central role in at least four “function” areas:

- (i) channelling funds to low-income countries;
- (ii) correcting market failures associated with the overpricing of risks, which may lead to inadequate access to long-term financing by middle income countries with insufficiently high credit rating;
- (iii) acting as a counter-cyclical balance to fluctuations in private capital market financing; and
- (iv) facilitating the transition to private markets by supporting some innovations in long-term financing to developing countries and signalling creditworthiness.

Table 3

DEVELOPING COUNTRIES: AVERAGE TERMS OF NEW COMMITMENTS									
	1990	1991	1992	1993	1994	1995	1996	1997	1998
<i>Average maturity (years)</i>									
Official									
All developing countries	22.2	20.9	21.1	21.4	22.1	19.2	21.2	20.1	18.5
Income groups									
Low income	27.0	25.9	26.8	25.4	26.2	24.4	26.8	26.2	26.6
Middle income	18.8	17.8	17.0	18.1	18.4	15.8	17.2	17.2	14.2
Private									
All developing countries	13.9	10.2	10.0	9.4	8.9	7.4	8.3	10.0	8.8
Income groups									
Low income	13.7	11.5	12.3	11.3	11.2	8.0	7.5	7.0	7.0
Middle income	13.9	9.9	9.0	8.4	8.1	7.2	8.6	10.8	9.0
<i>Average interest (per cent)</i>									
Official									
All developing countries	5.5	5.5	5.3	4.8	4.9	5.8	4.8	5.4	5.2
Income groups									
Low income	4.0	4.5	3.8	3.8	3.9	4.5	3.9	4.2	3.7
Middle income	6.6	6.1	6.4	5.6	5.8	6.7	5.6	6.0	6.0
Private									
All developing countries	8.5	7.8	6.8	6.3	6.3	6.4	7.3	7.3	7.9
Income groups									
Low income	7.9	7.5	6.7	6.0	5.7	6.4	6.6	6.4	6.9
Middle income	8.8	7.8	6.9	6.4	6.5	6.4	7.5	7.5	8.0

Source: World Bank (2000).

To these we should add the traditional “value added” of multilateral financing: lending-associated technical assistance.<sup>21</sup>

The first of these functions underscores the central role that financing from IBRD-IDA and the regional and subregional development banks will continue to play in the immediate future. It has received widespread support in recent debates. The second and third functions emphasize the role that official development financing will continue to play even for middle-income countries. Some authors reject, nonetheless, the validity of these arguments.<sup>22</sup> The high interest rates that have characterized private lending to developing countries in the 1990s, and the much shorter maturities of private versus

official financing to middle-income countries, may indicate that, on average, risk may have been overestimated (see table 3).<sup>23</sup>

It must be stressed, however, that the anti-cyclical provision of funds should not be confused with the provision of emergency balance-of-payments financing, which is essentially a task of IMF. However, to the extent that anti-cyclical fiscal policies are a necessary element in counter-cyclical macroeconomic management in general, there may be an argument for development financing during crises as a counterpart to pure balance-of-payments financing.<sup>24</sup> An alternative would be to allow IMF financing – or the latitude it offers for domestic credit creation – for fiscal purposes, but this step would be subopti-

mal. In any case, the large-scale requirements for counter-cyclical financing to middle-income countries during crises may crowd out financing to poor countries – a point which has been made by the President of the World Bank (Wolfensohn, 1998). Thus, if multilateral development financing is not significantly expanded, its role as a counter-cyclical device will necessarily be very limited, and it would certainly be of secondary importance relative to its first two roles, particularly the provision of long-term development financing to poor countries. This is underscored by the data from table 2, which indicate that multilateral financing in 1992–1998 represented only 15 per cent of that provided by the private sector, excluding FDI, and only 8 per cent in the case of middle-income countries. Thus, a useful counter-cyclical function would certainly require a significant increase in resources available to multilateral development banks or a more active use of cofinancing and credit guarantees by these institutions (see below).

The role of development banks in supporting social safety nets, which has received correct emphasis in recent discussions, should be seen as part of the counter-cyclical role that multilateral institutions should play. Strong social safety nets are, indeed, essential to manage the social repercussions of financial vulnerability in the developing world. The concept itself is subject to some confusion, as it has been used to refer both to the design of long-term social policies and to specific mechanisms to protect vulnerable groups during crises. The term should probably be used to refer specifically to the latter, although, as will be discussed below, these arrangements should be part of stable mechanisms of social protection. Multilateral banks have been involved in the former for a long time and have also accumulated some experience with the latter.

Recent analyses have come to some basic conclusions about these programmes. Firstly, safety nets must be part of *permanent* social protection schemes, as only a permanent scheme can guarantee that the programme coverage will respond without lags to the demand for protection of vulnerable sectors during crises (Cornia, 1999). Secondly, given the heterogeneity of labour markets in developing countries,

a combination of several programmes, with different target groups, is necessary.<sup>25</sup> Thirdly, these programmes must be adequately financed and should not crowd out resources from long-term investment in human capital. This, it must be said, leads to a fourth conclusion: that the effective functioning of social safety nets requires that public-sector expenditure include anti-cyclical components. This would be impossible, without generating inefficiencies in the rest of public-sector expenditure, if fiscal policy as a whole is not counter-cyclical. In the absence of this anti-cyclical fiscal pattern, external financing from development banks to safety nets during crises will be unnecessary, as overall net fiscal financing requirements will actually decrease, despite the increased spending associated with such safety nets.

The fourth function is of fairly recent origin but has been rapidly gaining in importance in the 1990s and should become one of the primary focuses of multilateral financing in the future. This function has been associated in the recent past with direct financing or cofinancing with the private sector (by banks or associated financial corporations) or with the design of guarantee schemes to support private infrastructure projects in developing countries. It has also been recently used to support developing countries' efforts to return to markets after crises, and could be used to support initial bond issues by developing (particularly poor) countries seeking to position themselves in private capital markets. It must be emphasized, however, that the full development of these guarantee schemes would require a radical change in the management of guarantees by development banks as, under current practices, guarantees are treated as equivalent to lending – a fact which severely restricts the banks' ability to extend them. Such an expansion of the role of development banks in guaranteeing private financing has been criticized on the grounds that it could involve excessive risk-taking by these institutions. Nonetheless, in a world dominated by private financing, it may be absolutely essential to prevent low-income countries from being left out of major developments in capital markets and to facilitate a more active anti-cyclical role for development banks. It should thus receive priority attention in current discussions.

## V. Conditionality versus “ownership”

The most controversial issue behind international emergency and development financing is certainly conditionality. In the case of IMF, this issue has long been a central area of contention. However, in recent years, and even decades, the issue has become increasingly troublesome for three different reasons. Firstly, the scope of conditionality has been gradually expanded to include not only the realms of other international organizations (quite often, for example, that of the WTO and the development banks) but also of domestic economic and social development strategies and institutions which, as the United Nations Task Force has indicated, “by their very nature should be decided by legitimate national authorities, based on broad social consensus” (UN, 1999, sect. 5). The broadening of conditionality to social policy, governance issues and private sector involvement in crisis resolution has been criticized by developing countries in the Group of Twenty-Four (1999b). The need to restrict conditionality to macroeconomic policy and financial sector issues is shared by a broad group of analysts with quite different persuasions as to the future role of IMF.<sup>26</sup> A similar view was expressed in the external evaluation of surveillance activities of the Fund (Crow et al., 1999). This led to the recent agreement that IMF conditionality should be streamlined, though its agreed focus is still very broad.<sup>27</sup>

Secondly, whereas the legitimacy of conditionality is indisputable when domestic policies are the source of macroeconomic disequilibria that lead to financial difficulties, as well as being necessary to avert “moral hazard” issues, it is unclear how this principle applies when such difficulties are generated by international crises and, particularly, by contagion effects. Thirdly, as has already been pointed out, it is even less clear why conditionality should be mixed with adverse credit terms. Finally, many observers have criticized overkill in some IMF programmes, a fact that has led the Fund to allow some room for anti-cyclical fiscal policies in its adjustment programmes (Fischer, 1998).

Even if the legitimacy of the principle of conditionality – or, as it is sometimes stated, “support in exchange for reforms” – is accepted, there are thus reasons to review the characteristics of such conditionality. Indeed, the perception that conditionality has been carried beyond what may actually be necessary in order for the Fund to perform its functions properly may be helping to undermine its legitimacy.

Thus, a strong argument can be made that the way to restore full confidence in the principle of conditionality is by reaching a renewed international agreement on how it should be used.

Several principles can be advanced in this regard. Firstly, as noted, IMF conditionality should be restricted to the macroeconomic policies that were its purview in the past. Reforms of domestic financial regulation and supervision may also be required, but in this case parallel agreements should be made with the corresponding international authorities (a still unresolved issue, as we have seen). Secondly, low-conditionality facilities should be available in adequate quantities when the source of the imbalance is an international shock or a country faces contagion. Nonetheless, beyond and above the pre-established level of the low conditionality facilities, access to Fund resources could be subject to macroeconomic conditionality on traditional terms. Thirdly, as we have also noted, more stringent credit terms should not be used as a complement to conditionality. Fourthly, automatic rules should be agreed upon when signing an agreement with the Fund under which the restrictiveness of the adjustment programme would be eased should evidence of overkill become clear. Finally, regular official evaluation of IMF programmes by an autonomous division of the Fund (a decision already adopted in 2000) and by outside analysts should be the basis for a regular revision of the nature of conditionality.

It must be emphasized that similar issues have been raised in relation to development finance. With respect to this issue, a World Bank report that analyses the success of structural lending, according to its own evaluation, comes to the conclusion that conditionality does not influence the success or failure of such programmes at all.<sup>28</sup> However, according to the same report, aid effectiveness is not independent of countries’ economic policies. In particular, the effects of aid on growth are higher for economies that adopt “good” policies, which, according to their definition, include stable macroeconomic environments, open trade regimes, adequate protection of property rights and efficient public bureaucracies that can deliver good-quality social services. In the context of good policies, there is an additional positive effect of aid that is manifested through the “crowding in” of private financing. Neither of these effects are present, however, in countries following “wrong” policies. In terms that are now familiar in the aid literature, the ownership of adequate economic policies – i.e. the commitment of national authorities to them – is what really matters. Conditionality has no

additional contribution to make in such cases, and it is obviously ineffective in the case of countries that do not follow good policies.

Curiously enough, on the basis of this study the World Bank draws the conclusion that conditionality is good after all. Hence, it claims that “Conditional lending is worthwhile where reforms have serious domestic support” (World Bank, 1998a: 48) and, in particular, that it “still has a role ... to allow governments to commit to reform and to signal the seriousness of reform ... but to be effective in this it must focus on a small number of truly important measures” (World Bank, 1998a: 19). This statement is certainly paradoxical if the conclusions of the report are taken at face value. Rather, this study raises serious doubts about the rationality of conditionality itself, a fact that is, indeed, implicit in the idea that policies are only effective when they are rooted in broad national consensus, the essential idea that has been captured in the concept of “ownership”.<sup>29</sup> Indeed, the President of the World Bank has made the strongest statement in this regard: “We must never stop reminding ourselves that it is up to the governments and its people to decide what their priorities should be. We must never stop reminding ourselves that we cannot and should not impose development by fiat from above – or from abroad” (Wolfensohn, 1998).

Rodrik has come to complementary conclusions, which extend to short-term macroeconomic policies (Rodrik, 1999b). Aside from arguing that international arrangements should allow for diversity in national development strategies (different “brands of capitalism”), this author makes a strong argument that adequate institutions of conflict management, which can only be guaranteed by national democratic processes, are crucial for macroeconomic stability and that this, in turn, is vital for economic growth. To borrow the term, the “ownership” of adjustment programmes is also essential to guarantee their political sustainability.

The issue of conditionality versus ownership is, indeed, essential to the broader objectives of democracy at the world level. There is clearly no sense in promoting democracy if the representative and participatory processes at the national level are given no role in determining economic and social development strategies, as well as the particular policy mix by which macroeconomic stability is obtained. Both of them may not only be relatively ineffective but will also lack political sustainability if international institutions or the aid agencies of the industrialized countries play this role.

## VI. The role of regional institutions

There are three basic arguments in support of a strong role for regional institutions in the new financial order. The first one is that globalization also entails open regionalism. The growth of intraregional trade and direct investment flows are, indeed, striking features of the ongoing globalization process. This factor increases macroeconomic linkages and thus the demands for certain services provided by the international financial system which we have analysed in previous sections: macroeconomic surveillance and internalization of the externalities that national macroeconomic policies have on neighbouring countries, and mutual surveillance of each other’s mechanisms for the prudential regulation and supervision of the financial system.

Secondly, some of these services may be subject to diseconomies of scale, and it is unclear whether others have strong scale economies to justify single international institutions in specific areas (i.e. natural monopolies). Traditional issues of subsidiarity are thus raised. For example, macroeconomic consultation and surveillance at the world level may be necessary to guarantee policy coherence among major industrialized countries but would certainly be insufficient to manage the externalities generated by macroeconomic policies on neighbours in the developing world (or even within Europe). Due to differences in legal traditions and the sheer scale of the diseconomies involved, surveillance of national systems for the prudential regulation and supervision of financial sectors, and even the definition of specific minimum standards in this area, may be dealt with more appropriately with the support of regional institutions. Development finance can operate effectively at different scales and can perform certain functions at regional and subregional levels that could not be performed at the international level. Also, although regional and international contagion implies that management of the largest balance-of-payments crises should be assigned to a single world institution, it is unclear how far we should push this assertion. Strong regional institutions can serve as regional buffers, as indicated by post-war western European experience. Regional reserve funds or swap arrangements can also play a useful role in the developing world and, if expanded, could even provide full support to the small- and medium-sized countries within some regions. Also, as the rising concentration of balance-of-payments support in some countries indicates (see section II), there may be biases in the response of the international community according

to the size of the country, a fact which would argue for a division of labour in the provision of services in this area between global and regional organizations.

Thirdly, for smaller countries, access to a broader menu of alternatives to manage a crisis or to finance development is relatively more important than the “global public goods” that the larger international organizations provide (e.g. global macroeconomic stability) and upon which they will assume they have little or no influence (i.e. they have the attitude of “free riders”). Due to their small size, their negotiation power vis-à-vis large organizations may be very limited, and their most important defence is therefore competition in the provision of financial services from such institutions.

The current discussion has underscored the fact that some services provided by international financial institutions, including various “global public goods”, are being undersupplied. However, according to previous remarks, it would be wrong to conclude from this statement that an increasing supply should come from a few of the world organizations. Rather, the organizational structure should have, in some cases, the nature of networks of institutions that provide the services required on a complementary basis and, in others, should function as a system of competitive organizations. The provision of the services required for financial crisis prevention and management should be closer to the first model, whereas, in the realm of development finance, competition should be the basic rule (and, in fact, should also include competition with private agents). But purity in the model’s structure is probably not the best characteristic: it is desirable for parts of networks to compete against each other (e.g. regional reserve funds or swap arrangements versus IMF in the provision of emergency financing) and for competitive organizations to cooperate sometimes.

This implies that the International Monetary Fund of the future should not be viewed as a single, global institution, but rather as the apex of a network of regional and subregional reserve funds and swap arrangements. To encourage the development of the latter, incentives could be created to enable common reserve funds to have automatic access to IMF financing and/or a share in the allocation of SDRs proportional to their paid-in resources; in other words, contributions to common reserve funds could be treated as equivalent to IMF quotas (UN, 1999, sect. 9; Ocampo, 2000a). Regional reserve funds or swap arrangements could provide not only most of

the exceptional financing for smaller countries within a region but part of the financing for larger countries as well, and they could also serve to deter, at least partly, would-be speculators from attacking the currencies of individual countries.

This model should be extended to the provision of macroeconomic consultation and surveillance, as well as to coordination and surveillance of national systems of prudential regulation and supervision. Thus, regional and subregional systems, including peer review mechanisms, should be designed to internalize the externalities that macroeconomic policies generate on neighbours. This would complement, rather than substitute for, regular IMF surveillance. In the area of prudential regulation and supervision, more elaborate systems of regional information and consultation, including the design of specific regional “minimum standards”, could also play a positive role. Again, peer reviews should be part of this system. Aside from other functions considered in section IV, subregional development banks can play a significant role as a mechanism to pool the risks of groups of developing countries, thus allowing them to make a more aggressive use of opportunities provided by private capital markets.

As is well known, western Europe provides the best example of regional financial cooperation in the post-war period. The United States, through the Marshall Plan, catalyzed the initial phases of this process, which underwent a dynamic deepening from the design of the European Payments Union to a series of arrangements for macroeconomic coordination and cooperation that eventually led to the current monetary union of most of its members. No similar schemes have been devised in the rest of the world, although some proposals have been made, the most ambitious of which was the Japanese suggestion to create an Asian Monetary Fund. The most interesting development in recent years has been the swap arrangement among 13 Asian countries agreed in May 2000 (Park and Wang, 2000) and initiatives to strengthen the Latin American (previously Andean) Reserve Fund (Agosin, 2000; ECLAC, 2000a, chap. 2).

Such an institutional framework would have two positive features. First of all, it might help to bring more stability to the global economy by providing essential services that could hardly be provided by a few international institutions, particularly in the face of a dynamic process of open regionalism. Secondly, from the point of view of the equilibrium of global relations, it would be more balanced than a system

based on a few world organizations. This would increase the commitment of less powerful players to abide by rules that contribute to global and regional stability.

## VII. The realms of national autonomy

Whatever international system is developed, it is clear that it will continue to be a very imperfect “financial safety net”. Consequently, a degree of “self-insurance” by countries will continue to be essential to avoid financial crises, as well as to avoid “moral hazard” issues intrinsic to any support scheme. This raises two issues as to the national policies necessary to guarantee financial stability and the areas where national autonomy should be maintained. We shall argue that the international system should continue to maintain national autonomy in two crucial areas: the management of the capital account and the choice of the exchange rate regime. The choice of development strategies is obviously an additional, essential realm in which national autonomy should prevail, as the analysis in section V emphasizes.

The experience of developing countries indicates that the management of capital account volatility requires: (i) consistent and flexible macroeconomic management; (ii) strong prudential regulation and supervision of domestic financial systems; and (iii) equally strong “liability policies”, aimed at inducing good public and private external and domestic debt profiles.<sup>30</sup> Despite the traditional emphasis on crisis management, the focus of the authorities instead should be the management of “booms”, since it is in the periods of euphoria of capital inflows, trade expansion and terms-of-trade improvements that crises are incubated. Crisis prevention is thus, essentially, an issue of the adequate management of boom periods.

In this regard, regulations on capital inflows may be essential to avoid unsustainable exchange rate appreciation during booms. Although some appreciation may be inevitable and even an efficient way to absorb the increased supply of foreign exchange, an excessive revaluation may also generate irreversible “Dutch disease” effects. The regulation of capital inflows thus plays an essential role in open developing economies as a mechanism for monetary and domestic credit restraint and for the avoidance of unsustainable exchange rate appreciation during booms. The nature of such regulations will be con-

sidered below. Regulations governing outflows may also play a role as a way to avoid overshooting interest or exchange rates during crises, which may have adverse macroeconomic dynamics, including the greater risk of domestic financial crises; they are also essential to put in place debt standstill and orderly debt workout procedures. It is essential, of course, that capital account regulations be used as a complement, and not a substitute, for fundamental macroeconomic adjustment.

As pointed out in section III, prudential regulation and supervision must take into account not only the micro but also the macroeconomic risks typical of developing countries. In particular, due account should be taken of the links between domestic financial risk and changes in key macroeconomic policy instruments, notably exchange and interest rates. The risks associated with the rapid growth of domestic credit, currency mismatches between assets and liabilities, the accumulation of short-term liabilities in foreign currencies by financial intermediaries and the valuation of fixed assets used as collateral during episodes of asset inflation must also be adequately taken into account. Depending on the operation, higher capital adequacy requirements, matching liquidity requirements, higher provisioning standards for due loans, precautionary provisioning rules or caps on the valuation of assets should be established. Moreover, given these macroeconomic links, prudential regulations should be strengthened during years of financial euphoria to take into account the increasing risks being incurred by financial intermediaries. These links also imply that the application of contractionary monetary or credit policies during booms (e.g. higher reserve requirements or ceilings on the growth of domestic credit) may be highly complementary to stricter prudential regulation and supervision. Moreover, due to the important externalities which large non-financial firms could generate for the domestic financial sector, particularly in the context of exchange rate depreciation, the external liability exposure of these firms should also be subject to some regulation. Tax incentives (e.g. tax on external liabilities or new borrowing, or limits on the deductibility of external interest costs or exchange-rate losses) and rules that force non-financial firms to disclose information on their external liabilities may thus be relevant complements to appropriate prudential regulation and supervision of financial intermediaries.

The experience of many developing countries indicates that crises are associated not only with high debt ratios but also with inadequate debt profiles.<sup>31</sup>



The basic reason for this is that under uncertainty financial markets respond to gross, rather than only to net, financing requirements, or, in other words, the rollover of short-run debts is not neutral in financial terms. This gives an essential role to “liability policies” aimed at improving debt profiles. Although improving the external debt profile should be the central role of such policies, there is a strong complementarity between good external and internal debt profiles. Hence, excessive short-term domestic borrowing may force a government that is trying to roll over debt during a crisis to raise interest rates in order to avoid capital flight by investors in government bonds. Also, excessively high short-term private liabilities increase the risks perceived by foreign lenders during crises – a fact that may induce a stronger contraction of external lending.

In the case of the public sector, direct controls by the Ministry of Finance are an appropriate instrument of a liability policy. Exchange rate flexibility may deter some short-term private flows and thus partly operate as a “liability policy”, but its effects are limited in this regard, as it is unlikely to smooth out medium-term financial cycles, which will be reflected in a parallel cycle of nominal and real exchange rates. Direct controls on inflows may also be an appropriate instrument to achieve a better private debt profile. An interesting, indirect price-based policy tool is reserve requirements on capital inflows, such as those used by Chile and Colombia in the 1990s. These requirements are a particular type of Tobin tax, but the equivalent tax rate (3 per cent in the case of Chile for one-year loans, and 10 per cent or more in Colombia during the boom) is much higher than that proposed for an international Tobin tax. A flat tax has positive effects on the debt profile, as it induces longer-run borrowing, for which the tax can be spread over a longer-term period, and is easier to administer. The effects of this system on the magnitude of flows have been the subject of heated controversy. In any case, since tax avoidance is costly and short- and long-term borrowing are not perfect substitutes, the magnitude of flows – or, what is equivalent interest arbitrage conditions – should also be affected.<sup>32</sup> A basic advantage of this instrument is that it is targeted at capital inflows and is thus a preventive policy tool. It also has specific advantages over prudential regulations that could have similar effects: it affects both financial and non-financial agents, and it uses a non-discriminatory price instrument, whereas prudential regulations affect only financial intermediaries, are usually quantitative in nature, and supervision is essentially discretionary in its operation.<sup>33</sup>

Simple rules are preferable to complex ones, particularly in underdeveloped regulatory systems. In this sense, quantitative controls (e.g. flat prohibitions on certain activities or operations) may be preferable to sophisticated price-based signals, but simple price rules such as the Chilean-Colombian system can also play a role. Any regulatory system must also meet an additional requirement: it must have adequate institutional backing. A *permanent* system of capital account regulations, which can be strengthened or loosened throughout the business cycles, is thus preferable to the alternation of free capital movements during booms and quantitative controls during crises. Indeed, the latter system may be totally ineffective if improvised during a crisis, simply because the administrative machinery to make it effective is not operative, and it may thus lead to massive evasion or avoidance of controls. Such a system is also pro-cyclical and leaves aside the most important lesson learned about crisis prevention: avoid overborrowing during booms and thus target primarily capital inflows rather than outflows.

Obviously, capital account regulations are not foolproof, and some developing countries may prefer to use policy mixes that avoid their use (e.g. more active use of fiscal and exchange rate policies, as well as alternative prudential regulations) or may prefer a less interventionist environment even at the cost of greater GDP volatility. Thus, the most compelling argument that can be derived from this analysis is the need to maintain the autonomy of developing countries to manage their capital accounts (UN, 1999; Group of Twenty-Four, 2000b).

There are actually no strong arguments in favour of moving towards capital account convertibility.<sup>34</sup> There is no evidence that capital mobility leads to an efficient smoothing of expenditures in developing countries through the business cycle and, on the contrary, strong evidence that in these countries the volatility of capital flows is an additional source of instability. There is also no evidence of an association between capital account liberalization and economic growth, and there are some indications that point in the opposite direction.<sup>35</sup> A simple way to pose the issue is to argue that, even if it were true that freer capital flows, through their effects on a more efficient savings-investment allocation process, have positive effects on growth, the additional volatility associated with freer capital markets has the opposite effect. The absence of an adequate international financial safety net is an equally important argument in this connection. Why should developing countries give up this degree of freedom if they

do not have access to adequate amount of contingency financing with well-defined conditionality rules, and no internationally agreed standstills and debt workout procedures? This is a crucial issue for countries without significant power in the international arena, for whom renouncing any possible means of crisis management is a costly alternative. Indeed, there are strong similarities between today's international financial world and the era of "free banking" at the national level: in the absence of central banks as lenders of last resort and officially managed bank rescue schemes, the inconvertibility of private bank notes was a necessary legal alternative in the face of bank runs.

Similar arguments could be used to claim that there are no grounds for limiting the autonomy of developing countries to choose their exchange rate regime. There are certainly virtues to the argument that, in the current globalized world, only convertibility regimes or totally free-floating exchange rate regimes can generate sufficient credibility in the eyes of private agents. However, any international rules in this area would be unfortunate. The advantages and disadvantages of these extremes, as well as of interventionist regimes in between the two, have been subject to extensive historical debate (and, of course, experience).<sup>36</sup> In practice, countries almost invariably choose intermediate regimes – a fact that can probably be traced back not only to the deficiencies of the extremes, but also to the many additional demands that authorities face.<sup>37</sup> The choice of the exchange rate regime has, nonetheless, major implications for economic policy that must be recognized in macroeconomic surveillance. Particularly, as we have noticed, domestic prudential regulations must take into account the specific macroeconomic risks that financial intermediaries face under each particular regime.

## VIII. Conclusions

This paper has argued that the agenda for international financial reform must be broadened in at least two senses. First of all, it should go beyond the issues of financial prevention and resolution, on which the recent debate has focused, to those associated with development finance for poor and small countries, to overcome the strong concentration of private and even official financing in a few large "emerging" economies, and to the "ownership" of economic and development policies by countries.

Secondly, it should consider, in a systematic fashion, not only the role of world institutions but also of regional arrangements and the explicit definition of areas where national autonomy should be maintained. These issues should be tabled in a representative, balanced negotiation process.

In the area of financial crisis prevention and resolution, a balance must be struck between the current emphasis on the need to improve the institutional framework in which financial markets operate and the still insufficient attention to, or action on, the design of appropriate schemes to guarantee the coherence of macroeconomic policies worldwide, the enhanced provision of emergency financing during crises, and the creation of adequate debt standstill and orderly debt workout procedures. In the area of development finance, emphasis should be given to the need to increase funding to low-income countries, including the use of multilateral development finance to support increased participation of low-income and small middle-income countries in private capital markets. The role of multilateral development banks in counter-cyclical financing, particularly to support social safety nets during crises, must also be emphasized. The enhanced provision of emergency and development financing should be accompanied by a renewed international agreement on the limits of conditionality and a full recognition of the central role of the "ownership" of development and macroeconomic policies by developing countries.

It has also been argued that regional and subregional institutions should play an essential role in increasing the supply of "global public goods" and other services in the area of international finance. The required financial architecture should in some cases have the nature of a network of institutions that provide the services required in a complementary fashion (in the areas of emergency financing, surveillance of macroeconomic policies, prudential regulation and supervision of domestic financial systems, etc.), and in others (particularly in development finance) should exhibit the characteristics of a system of competitive organizations. The fact that any new order would continue to have the characteristics of an incomplete "financial safety net" implies both that national policies would continue to play a disproportionate role in crisis prevention and that certain areas should continue to be realms of national autonomy, particularly capital account regulations and the choice of exchange rate regimes. Regional institutions and national autonomy are especially important for the smaller players in the international arena, which will gain significantly from competi-

tion in the services provided to them and from the maintenance of freedom of action in a context of imperfect supply of global public goods.

## Notes

- 1 See on some of these issues the regular reports of the IMF Managing Director to the Interim Committee, now the International Monetary and Financial Committee (IMF, 1999, 2000a and b).
- 2 For a full evaluation of trends, see UNCTAD (1999, chaps. III and V), and World Bank (1999, 2000).
- 3 This was recognized by IMF (2000c) in its September 2000 Communiqué: "... flows remain below pre-crisis levels, at higher spreads, and continue to show significant volatility, and market access remains extremely limited for some emerging markets".
- 4 This group includes Argentina, Brazil, China, India, Indonesia, Mexico, Republic of Korea, and Russian Federation.
- 5 It must be emphasized, however, that pledged bilateral financing tends to be disbursed in smaller proportions than the multilateral shares in rescue packages.
- 6 See, among others, IMF (1998a and b, 1999, 2000a and b); Group of Seven (1998); UNCTAD (1998, Part One, chap. IV); UN (1999); ECLAC (2000a); Miyazawa (1998); Rubin (1999); Summers (1999); Camdessus (1998, 2000); Fischer (1999); Akyüz and Cornford (1999); Eatwell and Taylor (2000); Eichengreen (1999); Griffith-Jones (1998); Griffith-Jones and Ocampo (1999); Ocampo (1999, 2000a); White (2000a, b); Wyplosz (1999).
- 7 A very strong statement in this regard was made by the Governor of the People's Bank of China: "The monopoly by a handful of developed countries on the rule-making in the international financial field must be changed" (Dai, 2000).
- 8 On the former, see Larraín et al. (1997); on the latter, Calvo (1998).
- 9 For a more extensive analysis, see Ocampo (2000a). Keynes' concept of a "beauty contest" is thus much more appropriate to analyse the volatility of expectations, as Eatwell (1996) and Eatwell and Taylor (2000) have emphasized.
- 10 Group of Twenty-Four (1999b). See a more extensive discussion of this issue in IMF (1999, 2000a and b).
- 11 See, in this regard, the emphasis of the Group of Twenty-Four (2000b) on the "imperative need for better coordination, coherence, and mutual reinforcement of macroeconomic and structural policies among the three major economies in order to reduce the risks and uncertainties in the global economy", and the absence of this topic in the parallel Communiqué of the IMF International Monetary and Committee or in IMF (1999, 2000a, b and c) reports on reforms of the international financial architecture.
- 12 See Group of Twenty-Four (1999b, 2000a). See also the different points of view on this issue in Council on Foreign Relations (1999).
- 13 This important distinction is made by Helleiner (1999) and Eatwell and Taylor (2000). For a fuller discussion of this issue and its relation to IMF access to adequate resources, see Mohammed (1999).
- 14 See UN (1999); Council on Foreign Relations (1999); Group of Twenty-Four (2000b); Meltzer et al. (2000); Camdessus (2000).
- 15 See, in particular, Meltzer et al. (2000), and also Council on Foreign Relations (1999).
- 16 Thus, Meltzer et al. (2000) would require borrowing countries, as conditions for access, fiscal soundness, minimum prudential regulation, transparent data on debt and its structure, and freedom of operation for foreign financial institutions. The latter is absent, not only in current conditionality but in other proposals related to IMF financing.
- 17 It must be added that commercial bank lending did not normalize in Latin America in the 1990s, despite the boom in such financing to East and South-East Asia.
- 18 See a discussion along these lines in Ahluwalia (1999).
- 19 See the references quoted in footnote 6.
- 20 See a review of some of the controversies involved in IMF (1999, 2000a and b), Boorman and Allen (2000) and Fischer (1999).
- 21 See Gilbert et al. (1999), who, nonetheless, reject the idea that market failures are an argument for development lending to middle-income countries. The idea suggested by these authors that there is some kind of "natural monopoly" in some types of development economics research is not a sensible defence of the World Bank. The parallel idea that global public goods should be provided is certainly valid, but it justifies the existence of many types of international institutions, not development banks per se.
- 22 The strongest argument in this regard is that of Meltzer et al. (2000) but a weaker version can be found in Gilbert et al. (1999), who argue, however, that the World Bank should be allowed to lend to middle-income countries to improve its portfolio.
- 23 Indeed, it is peculiar that Meltzer et al. (2000) estimate the subsidies of development financing in the 1990s by assuming that it is equivalent to only half of spreads in capital markets.
- 24 Such financing could be tied to broader forms of anti-cyclical management, on the basis of counterpart savings in fiscal stabilization funds during the previous boom, or repayment conditions that would require acceleration of amortizations if fiscal revenues experienced a strong recovery during the subsequent boom.
- 25 Márquez (1999). Different groups would be supported by unemployment insurance, emergency employment or emergency labour-intensive public works programmes, income-support schemes in conjunction with training, and special targeted subsidies (such as some nutrition programmes, subsidies to households with school-age children that are tied to school attendance, and various support programmes aimed at ensuring that households with an unemployed head of household do not lose their home during crises, etc.).
- 26 See Council on Foreign Relations (1999); Meltzer et al. (2000); Collier and Gunning (1999); Feldstein (1998); Helleiner (2000b); Rodrik (1999a).
- 27 See IMF (2000c) and Köhler (2000). The difficulties are associated with the fact that, although IMF is expected to focus on macroeconomic and financial issues, it should also look at "their associated institutional and structural aspects". Such a broad definition led to the increasing scope of conditionality over the past two decades.
- 28 See World Bank (1998a, chap. 2 and Appendix 2). See also Gilbert et al. (1999), and Stiglitz (1999).
- 29 See a full discussion of these issues in Helleiner (1999).
- 30 The literature on national policies is extensive. See, among recent contributions, ECLAC (2000b, chap. 8); World Bank (1998b, chap. 3); Ffrench-Davis (1999); Helleiner (1997); Ocampo (1999, 2000b).

- 31 See an excellent recent treatment of this issue in Rodrik and Velasco (1999).
- 32 See Agosin (1998); Agosin and Ffrench-Davis (2000); Le Fort and Lehman (2000); Ocampo and Tovar (1998, 1999); Villar and Rincón (2000).
- 33 Ocampo (2000a). Indeed, this instrument is similar to practices used by private agents, such as the sales fees imposed by mutual funds on investments held for a short period in order to discourage short-term holdings. See JP Morgan (1998: 23).
- 34 For a more extensive analysis of this subject, see UN (1999); UNCTAD (1998, Part One, chap. IV); ECLAC (1998, Part III); IMF (1999); Eichengreen (1999); Griffith-Jones (1998); Grilli and Milesi-Ferreti (1995); Ocampo (1998a, b); Ocampo (2000a); Rodrik (1998).
- 35 See, in particular, Eatwell (1996); Eatwell and Taylor (2000); Rodrik (1998); and, for Latin America, Ocampo (1999).
- 36 Velasco (2000) provides a recent survey of the issues involved.
- 37 The best conclusion on this subject, thus, is that reached by IMF (2000a): "No single regime is appropriate for all countries or in all circumstances". See also ECLAC (2000a, chap. 2), and, for a recent defence of intermediate regimes, Williamson (2000).

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