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FOREWORD

International economic issues touch the lives of people everywhere. Whether grappling with the challenges posed by new information technologies, seeking to draw policy lessons from financial crises in emerging markets, or assessing the possible impact of China's entry into the World Trade Organization, we look to economics as a guide in our rapidly changing world. The poorest nations especially require a clear economic road map if they are to make progress against the persistent problems of hunger, ill health and social insecurity.

Over the past 20 years, UNCTAD's *Trade and Development Report* has established itself as an authoritative voice on key international economic issues. This year's *Report* offers an assessment of recent trends and prospects in the world economy, with particular focus on the impact that developments and policies in the industrial economies are likely to have on prospects in the developing world. With policy makers everywhere concerned about the effect of the economic slowdown in the United States, the *Report*'s call for greater coordination and cooperation on economic issues deserves careful consideration.

In the past decade, there has been growing concern about the ability of multilateral rules and regulations to meet the challenges posed by global financial markets. This year's *Report* examines in depth the ongoing discussions about reforming the multilateral financial system. It looks at key areas such as codes and standards, the contributions of private institutions in managing financial crises, and the workings of the exchange rate system. On each subject, it offers challenging recommendations on how to move the reform process forward. Many of these issues are expected to be discussed at next year's high-level event on financing for development. I hope this *Report* will make a useful contribution to those discussions.

Kofi A. Annan
Secretary-General of the United Nations

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Explanatory notes

Classification by country or commodity group

The classification of countries in this Report has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area.

The major country groupings distinguished are:

» Developed or industrial(ized) countries: in general the countries members of OECD (other than the Czech Republic, Hungary, Mexico, the Republic of Korea and Turkey).

» Transition economies: the countries of Central and Eastern Europe (including the States formerly constituent republics of Yugoslavia), the Commonwealth of Independent States (CIS) and the Baltic States.

» Developing countries: all countries, territories or areas not specified above.

The term "country" refers, as appropriate, also to territories or areas.

References to "Latin America" in the text or tables include the Caribbean countries unless otherwise indicated.

Unless otherwise stated, the classification by commodity group used in this Report follows generally that employed in the UNCTAD *Handbook of Statistics 2000* (United Nations publication, sales no. E/F.00.II.D.30).

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 2000* refers to *Trade and Development Report, 2000* (United Nations publication, sales no. E.00.II.D.19).

The term "dollar" ($) refers to United States dollars, unless otherwise stated.

The term "billion" signifies 1,000 million.

The term "tons" refers to metric tons.

Annual rates of growth and change refer to compound rates.

Exports are valued FOB and imports CIF, unless otherwise specified.

Use of a dash (–) between dates representing years, e.g. 1988–1990, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 1990/91, signifies a fiscal or crop year.

Two dots (..) indicate that the data are not available, or are not separately reported.

A dash (-) or a zero (0) indicates that the amount is nil or negligible.

A dot (.) indicates that the item is not applicable.

A plus sign (+) before a figure indicates an increase; a minus sign (-) before a figure indicates a decrease.

Details and percentages do not necessarily add to totals because of rounding.

Abbreviations

APG	Asia/Pacific Group on Money Laundering
ASA	ASEAN Swap Arrangement
ASEAN	Association of South-East Asian Nations
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
bpd	barrels per day
CAC	collective action clause
CCL	Contingency Credit Line (IMF)
CFA	Communauté financière africaine
CFATF	Caribbean Financial Action Task Force
CFR	(United States) Council on Foreign Relations
CFRTF	(United States) Council on Foreign Relations Task Force
CIS	Commonwealth of Independent States
CPLG	Core Principles Liaison Group (of BCBS)
CPSS	Committee on Payment Settlement Systems (of BIS)
DAC	Development Assistance Committee (of OECD)
EC	European Commission
ECB	European Central Bank
ECE	Economic Commission for Europe
ECLAC	Economic Commission for Latin America and the Caribbean
EMI	European Monetary Institute
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
EU	European Union
FASB	Financial Accounting Standards Board (United States)
FATF	Financial Action Task Force on Money Laundering
FDI	foreign direct investment
FLAR	Fondo Latinoamericano de Reservas
FSAP	Financial Sector Assessment Programme (IMF-World Bank)
FSF	Financial Stability Forum
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDDS	General Data Dissemination System
GDP	gross domestic product
HIPC	heavily indebted poor country
HLI	highly leveraged institution
IAIS	International Association of Insurance Supervisors
IASC	International Accounting Standards Committee
ICT	information and communication technology
IDB	Inter-American Development Bank
IFAC	International Federation of Accountants
IFAD	International Fund for Agricultural Development

IFI	international financial institution
IFIC	International Financial Institutions Commission
IIF	Institute for International Finance
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
IOSCO	International Organization of Securities Commissions
IPO	initial public offering
M&A	merger and acquisition
NCVA	National Venture Capital Association
NIE	newly industrializing economy
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OFC	offshore financial centre
OPEC	Organization of the Petroleum Exporting Countries
SDDS	Special Data Dissemination Standard
SDR	special drawing right
SRF	Supplemental Reserve Facility (of IMF)
SWIFT	Society for Worldwide Inter-Bank Financial Telecommunications
UDROP	universal debt rollover option with a penalty
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNCTC	United Nations Centre on Transnational Corporations
UN/DESA	United Nations Department of Economic and Social Affairs
WTO	World Trade Organization

OVERVIEW

A quarter is a long time in economics. At the annual meetings of the Fund and Bank in Prague last September the mood was upbeat. The world economy had shrugged off a series of financial shocks in emerging markets, the United States economy was continuing to forge ahead, driven by the "new economy", Europe was at last showing signs of a robust recovery and Japan was beginning to emerge from a prolonged recession. Growth figures were being marked upwards. The only cloud on the horizon was rising oil prices.

The mood is different today. There are concerns about just how far and how fast the United States economy will slow down and whether traditional macroeconomic instruments can manage a rapid recovery; how vulnerable the dollar is; whether the nascent recovery in Japan will once again be nipped in the bud; whether the European locomotive can pick up sufficient speed to keep the world economy on track, and if not what a global downturn might mean for the still fragile recovery in Asia. On a more optimistic note, the oil cloud on the horizon has dissipated; prices had already peaked at the time of the Prague meetings. Conventional economic analysis is not, it seems, adapting very well to the gyrations of a globalizing world.

The UNCTAD secretariat has for some time been warning that excessive financial liberalization is creating a world of systemic instability and recurrent crises. A common response has been to blame such crises on misguided policies and crony investment practices in emerging markets. Whether similar accusations will surface as financial excesses and wasteful investments are exposed in the United States by economic slowdown remains to be seen, but they would be no more helpful than they were in the aftermath of the Asian crisis. Markets can and do get it wrong, and for developing and developed countries alike. The onus is still on policy makers to find preventive measures and appropriate remedies.

Certainly that task is difficult in a highly integrated world economy. But multilateral financial rules and institutions were established precisely to prevent a repetition of the inter-war economic chaos linked to persistent payments and currency disorders and excessive reliance on short-term capital flows. Sadly, since the break-up of the Bretton Woods system the world has been ill-prepared to deal with the re-emergence of such problems. Talk of far-reaching reform of the international financial architecture after the Asian crisis has proved to be no more than that. However, if a strong wind does pick up from the North, the consequences for the world economy will be much more chilling than those of the wind that blew in from the South. It is to be hoped that this threat will suffice to breathe new life into the reform efforts.

Global economic downturn and prospects

The performance of the world economy in 2000 was the best in over a decade. In every region growth edged upwards, with recoveries in Latin America and the transition economies that were stronger than expected. Moreover, this performance was achieved against the backdrop of sharply rising oil prices. While positive impulses from the previous year, notably the large liquidity injection to stave off the Y2K bug and to support the introduction of the euro, helped maintain the momentum, it was the continued strength of the United States economy that underpinned the 4 per cent growth in global output. To some observers, the combination of deregulated markets and new information technologies was putting pay to old-fashioned ideas about how economies worked, and many were looking forward eagerly to an unprecedented era of global prosperity.

Things changed dramatically over the last quarter of 2000 and into the new year. The United States economy began to slow sharply and the landing could well be harder than optimists had expected. The unwinding of its high-tech boom has produced a drop in investment spending, which has been aggravated by weaker consumer confidence and the threat of sizeable job losses in new and old economic sectors alike. The Federal Reserve reacted swiftly by cutting interest rates twice in January, with further cuts expected. The question that remains is whether the United States economy is experiencing the kind of cyclical downturn which will respond positively to such moves, and so ensure a quick rebound from two or three quarters of flat or negative growth back to a potential growth rate above 3 per cent. If the answer is in the negative, is the United States in for a longer period of disinvestment and debt restructuring with resemblances to those which occurred in Japan and parts of Europe in the early 1990s?

Expectations remain quite high that a short Keynesian downturn in the United States can be corrected by appropriate monetary and fiscal action. Some indicators at the beginning of the year provided grounds for guarded optimism: oil prices had dropped from their earlier peak; equity prices appeared to be stabilizing; and the trade balance had started to improve. The quick and decisive action taken by the Federal Reserve is also encouraging. The tax cuts that are under consideration, if appropriately timed and targeted, could further stabilize the situation.

But, even if the steady policy hand of recent years is maintained, there are doubts that traditional macroeconomic policies will carry the day, given the high level of private indebtedness, the surfeit of investment during the technology boom, and uncertainties surrounding the dollar. While the public sector prepares to pay off its outstanding debt, the private sector has attained record debt levels. As households see their income growth decline, they will have to borrow more in order to maintain current spending, at precisely the time when it is becoming more difficult for them to keep up with payments on their outstanding debt. At the same time, much of the high-tech Schumpeterian investment sustained by the venture capital boom and the stock market bubble may be destroyed with a return to normal financing conditions. If households and the business sector were to simultaneously limit their spending to current earnings, there could be a significant decline in GDP.

The fact that such a long period of expansion has no recent precedent should make for cautious assessment of the current slowdown. However, on balance, the various conflicting pressures point to an uncertain future; any abrupt shifts in sentiment or policy could still make for a deeper downturn than many are expecting and prejudice a swift recovery.

In view of its pivotal role in bolstering global demand in recent years, the prospects for the United States economy are a matter of worldwide concern. The increasing integration of the global economy certainly means that both real and financial shocks are transmitted much more rapidly across regions, countries and sectors. At the same time, because of the intertwining of finance and production, such shocks can have unexpected consequences, as has been demonstrated by the financial crises which began in Asia in 1997.

Whatever the immediate future holds in store for the United States, the long-term fate of the global economy cannot be left to be determined by policies and events in a single country. In the context of growing interdependence, all the major industrial economies need to harmonize their forces, if the gains from globalization are to be widely distributed and, in particular, to reach down to developing countries. Accordingly, "business as usual" is not the right mantra for policy makers anywhere.

Growth in Europe in 2000 broke through the 3 per cent barrier for the first time in over a decade, but leading indicators point to a slowdown in 2001. Now that budget deficits have been brought under control, the current account is healthy and there are few signs of inflationary pressure, the way is clear for a shift to expansionary macroeconomic policy. With interest rates falling in the United States and the prospect of a recovery of the euro which should further ease the pressure on monetary policy, Europe seems well placed to take on global economic responsibilities and boost global demand, thus offsetting the effects of slowdown in the United States. However, the EU appears reluctant to test the limits of its potential growth, as the United States did in the second half of the 1990s. Yet such action is also necessary in order to overcome its persistent and high unemployment. The European Central Bank maintains that it sees no signs of the potential growth rate in the euro area rising above a modest 2.0–2.5 per cent, implying that it sees no immediate scope for relaxing monetary policy without inflationary consequences. This stance may need to be reconsidered if, as seems likely, the EU is hit harder by a slowdown in the United States than might be suggested by its limited trade ties with that country.

Japan is unlikely to fill the breach, given its fragile recovery and the importance to it of the United States market. Its nascent expansion, which looked healthy in the first half of 2000, was built on rising net exports, but negative growth was resumed in the third quarter of the year. A lower dollar and weaker demand in the United States market place the burden of recovery on strong domestic demand. But since domestic investment is still closely tied to exports, and unemployment is again edging upwards, it is not at all clear from where the impulse will come.

Governments in Japan have repeatedly responded to sluggish growth with more active fiscal measures, but now that public debt is at an unprecedently high level pressure for fiscal consolidation is starting to impact on macroeconomic policy. Considerable uncertainty also surrounds the future direction of monetary policy; the Central Bank no longer seems willing to hold itself to a zero interest-rate policy, which it views as an impediment to financial structuring. With liquidity and fiscal traps snapping shut and export prospects darkening, recovery may once more be cut off just as it gathers momentum.

* * *

Much still depends on the readings and actions of policy makers in Washington and it is premature to give the global economy a clean bill of health. Even if Europe in 2001 were to match the earlier United States growth performance, that would not have the same effect on the developing world, since

it has a lower propensity to import from those countries. The downside risks for developing countries are thus considerable.

Trade flows are one channel for contagion from a United States slowdown. The danger is apparent from the Asian experience, when slower growth in high-tech exports played an important role in the build-up of external fragility and the impact of the subsequent financial shock was amplified through intraregional trade. Just as significantly, strong export growth has played a key role in the Asian recovery. In 2000 the growth of United States imports reached double-digit figures for the third year running. The benefits to developing countries and transition economies were particularly marked, their total export volumes being estimated to have risen by over 10 and 15 per cent, respectively. A further factor in their favour was an improvement in their terms of trade on account of sustained oil price rises. The prospects for this year are much less favourable.

Financial and currency markets are another channel for contagion. Falling United States interest rates will certainly benefit countries with large stocks of dollar debt. Capital flows could also be redirected to emerging markets as smaller profits in the United States discourage inflows of capital seeking to join in the high-tech revolution and falling interest rates dampen short-term arbitrage inflows. However, it is equally possible that the United States slowdown will accentuate the bearish sentiment in global financial markets, raising the liquidity premium on dollar assets and the risk spread on emerging-market borrowing, thereby wiping out the benefits of lower United States interest rates. In that event, capital flows to developing countries would scarcely exceed their disappointing levels of 2000.

The presence of different channels of transmission suggests that the United States slowdown will be felt very differently in different regions of the developing world. East Asia was the fastest-growing region last year. After strong recoveries in 1999 in most of the economies damaged by the financial turmoil of 1997–1998, growth accelerated further in 2000. Exports to the United States, which amount to more than 20 per cent of GDP in Malaysia, 10 per cent in Thailand, and 7 per cent in the Republic of Korea, played a key role, especially exports from high-tech sectors. The current combination of declining sales in the United States and falling semiconductor prices has resulted in terms-of-trade losses and declining export earnings for all these countries. Growth is consequently expected to fall throughout the region this year. Intraregional trade linkages could once again amplify the negative impact of these shocks, triggering a further round of destabilizing exchange rate swings across the region. Moreover, the economies are slowing down at a time when financial and corporate restructuring is running into difficulties in a number of countries.

The economy of China is also sensitive to developments in the United States, which absorbs over 20 per cent of its exports. While robust growth last year gives grounds for hope that China can weather the downturn in the United States as well as it did the Asian crisis, the task of striking the right policy balance is being complicated by protracted, and as yet unfinished, negotiations over accession to WTO. The prospect of Chinese accession in the near future is also a matter of concern among some of the smaller labour-intensive exporters in Asia, who fear losing competitiveness at the very time when their export prospects are blackened by weakening import demand in the United States.

The impact of a United States slowdown on Latin America is more difficult to gauge. Recovery in that region was stronger than expected in 2000, when growth reached close to 4 per cent, after stagnation in the previous year. However, the aggregate picture hides much variation among countries. Mexico, which accounts for one fifth of regional output, witnessed growth of around 7 per cent, reflecting its close economic ties to the United States (which takes some 85–90 per cent of Mexican exports), as well as the rise in the export prices of its oil. It seems unlikely that the Mexican economy will be able to escape the consequences of the slowdown in the United States, although lower interest rates could be helpful. In addition, there is concern, shared with some other Central American and Caribbean countries, over the prospect of greater competition from China after its accession to WTO.

The impact on the rest of Latin America is likely to be different. In view of the weaker trade links with the United States and the heavy dependence on capital inflows, improved external financial conditions may more than offset the effect on their exports of reduced demand in the United States. In the absence of a significant increase in risk spreads, lower interest rates in that country should mean reduced borrowing costs and debt servicing, easing the pressure on balances of payments and budgets. Furthermore, for countries which have opted for a currency board or outright dollarization a weaker dollar improves competitiveness vis-à-vis third parties. Argentina may turn out to be a big winner on both counts, emerging from the vicious circle of stagnation and deflationary adjustment to the external shocks of 1998–1999. Brazil should also benefit from improved financial conditions, though to a lesser extent.

Despite some grounds for optimism, the real danger facing Latin America is one of diminished expectations. Policy makers throughout the region appear content to target growth in the 3–4 per cent range, well below what is required to promote graduation to the next level of development. Moreover, with more countries choosing dollarization, dependence on conditions and policy decisions in the United States is increasing. A deeper downturn there, bringing with it a new round of financial uncertainty and reassessment of risks, could well wipe out the potential benefits of a weaker dollar and lower interest rates and, together with a slowdown in exports, could produce a further setback to growth prospects.

As regards Africa, there is a certain degree of asymmetry in the impact of fluctuations in global economic activity. Because of supply-side rigidities, African LDCs that rely on exports of only one or two primary commodities cannot take full advantage of global expansion by increasing their export volumes, while they often bear the full brunt of commodity price declines. Prices of many of the commodities exported from Africa were falling in the 1990s. The rise in oil prices benefited some countries in 1999, and again in 2000, but for others, particularly the many that depend on oil imports, the consequence was a further widening of the resource gap.

Thus, despite the strong growth in the world economy in 2000, Africa's growth rate rose only modestly, to 3.5 per cent, which is below the rate reached before the Asian financial crisis and well below what is needed to tackle the problems of rising poverty and declining health. Even before the slowdown in the United States, growth forecasts were being revised downwards because of the continued sluggishness of some of the larger economies, severe weather conditions and disruptions caused by civil and political unrest.

In these circumstances, any global shock could be particularly damaging for African countries. Not surprisingly, aid and debt relief remain high on their political agendas. The region should benefit from bilateral debt reduction accorded by some industrialized countries to the poorest economies, as well as from recent European and United States initiatives to open up their markets to the poorest economies in Africa. However, with progress on the HIPC Initiative still much too slow, and a growing acknowledgement that the financial benefits are much smaller than expected, there is an urgent need for a bolder approach to multilateral debt relief.

The transition economies benefited considerably from favourable trading conditions in 2000. For the first time since the Berlin Wall fell, GDP increased in all countries. Growth in the Russian Federation rose sharply, thanks to strong demand for its primary exports, particularly oil. Elsewhere, it was the industrial sector that underpinned improvements, notably those of Eastern European countries, which benefited from strong export growth of manufactures to the EU. Even so, the fact that the recovery is from a low base, and occurred in favourable global demand conditions, means that a slowdown in the world economy will be felt by many of the transition economies and that any further recovery will have to come largely from a stimulus originating in domestic demand.

* * *

The downturn in the United States, unresolved structural difficulties and sluggish growth in Japan, and undue emphasis that monetary policy continues to place on inflation in Europe have the consequence that the major industrial countries will be converging towards a slower pace of economic activity. Despite decisive policy action, rapid recovery in the United States economy is jeopardized by the financial excesses associated with its unprecedented period of expansion. Furthermore, an orderly transition to a world where all the leading economies are pulling in the same direction is further complicated by the uncertainty surrounding exchange rate adjustments to the trade imbalances which have built up over the past few years. A rapid weakening of the dollar would not only compromise the ability of monetary policy in the United States to respond vigorously to a deepening of the downturn, but could also expose financial fragilities elsewhere. For all these reasons the downturn and instability in the world economy could be more pronounced than under normal cyclical conditions. Consequently, cooperation among, and responsible action by, all major players in the world economy becomes all the more necessary.

Reforming the international financial architecture

Between the myopia of global markets and the myth of global government, multilateral rules and institutions can help reduce market volatility and prevent mutually incompatible policy responses to economic shocks. For the architects of the post-war multilateral system who gathered at Bretton Woods, history had taught that financial markets were a particularly fecund source of instability and shocks, and that control over international capital flows was a precondition for currency stability, the revival of trade and economic growth and the achievement of full employment.

The breakdown of the Bretton Woods system in the early 1970s initiated a period of financial and economic uncertainty and instability that shares at least some of the characteristics of the inter-war period. Various initiatives have been pursued in different forums in the hope of finding a system of governance compatible with flexible exchange rates and large-scale private capital flows. The history of these initiatives can point to some successes but has, by and large, proved unsatisfactory, in part because they have been premised on keeping separate the problems facing developed and developing countries within the multilateral financial arrangements.

When the Asian financial crisis erupted, it seemed that all that would change. The virulence of the economic forces unleashed after the collapse of the Thai baht in July 1997, and among countries with track records of good governance and macroeconomic discipline, seemed to confirm the systemic nature and global reach of currency and financial crises. But despite the initial emphasis of some policy makers in the leading industrial economies on the need for systemic reform, moves in that direction have subsequently stalled. Instead of establishing institutions and mechanisms at the international level to reduce the likelihood of such crises and better manage them when they do occur, there has been a very one-sided emphasis on reforming domestic institutions and policies in developing countries.

Efforts in the past few years have focused on measures designed to discipline debtors and provide costly self-defence mechanisms. Countries have been urged to better manage risk by adopting strict financial standards, improving transparency, adopting appropriate exchange rate regimes, carrying large amounts of reserves, and making voluntary arrangements with private creditors to involve them in crisis resolution. While some of these reforms undoubtedly have their merits, they presume that the cause of crises rests primarily with policy and institutional weaknesses in the debtor countries and accordingly place the onus of responsibility for reform firmly on their shoulders. By contrast, little attention is given to the role played by institutions and policies in creditor countries in triggering international financial crises.

* * *

Proposals for new international institutions explicitly designed to regulate and stabilize international capital flows have been summarily dismissed by critics as the work of mavericks lacking in political sense and technical judgement. The preferred line of reform has sought to establish various codes and standards to help strengthen domestic financial systems in debtor countries, enhance their macroeconomic and financial policy formulation, and improve the collection and disclosure of information. The Bretton Woods institutions, the Basel-based bodies and the Financial Stability Forum have already made a series of proposals along these lines.

Such measures can bring self-evident benefits, but they can be properly assessed only as part of an evolutionary process of stabilizing global financial markets. Of more immediate concern to developing countries is the fact that what has been proposed so far under the heading of codes and standards embodies the view that the main problems lie in countries receiving capital flows, but entails neither a fundamental change in policies and practices in the source countries nor improvement in the transparency and regulation of currently unregulated cross-border financial operations. And despite the emphasis on their voluntary adoption, there is the danger that incentives and sanctions linked to standard-setting will become features of IMF surveillance and conditionality, compliance with which would place a further heavy burden on the administrative capacities of many countries.

Because much of the impetus to improve codes and standards assumes their introduction into a stable and predictable global financial system, such measures offer little in the way of immediate protection for developing countries against supply-driven fluctuations in international capital flows, which are strongly influenced by policies and monetary conditions in the major industrial countries. Almost all major crises in emerging markets have been connected with shifts in exchange rates and monetary policy in those countries. The root of this problem lies, in large part, in the failure to establish a stable system of exchange rates after the breakdown of the Bretton Woods arrangements. The expectation then was that floating among the main reserve currencies would automatically bring about orderly balance-of-payments adjustments, increased exchange-rate stability and greater macroeconomic policy autonomy. This has not happened. But while the damage inflicted by disorderly exchange-rate behaviour has been limited for the G-3 economies this has not been the case for debtor developing countries, which depend more heavily on trade and whose borrowing profile exposes them to greater currency risk.

Despite the broad consensus that the Bretton Woods institutions should get back to what they do best, the discussion on reforming the international financial and monetary system has so far avoided serious mention of how the Fund might help rebuild a stable exchange rate system among the G-3 currencies. Proposals for securing greater stability through coordinated intervention and macroeconomic policy action, including formally established target zones, have been brushed aside, and discussions have concentrated on the pros and cons for developing countries of fixed or floating exchange-rate regimes and the macroeconomic policies consistent with one or other of these “corner

solutions". This ignores the mounting evidence that developing countries cannot unilaterally ensure appropriate alignment and stability of their exchange rates as long as major reserve currencies are subject to frequent gyrations and misalignments and international capital flows to large swings beyond the control of recipient countries.

* * *

With little progress on how best to prevent financial crises, attention has increasingly turned to how best to limit their damage through faster and more effective responses once they do occur. So far, large bailout packages have been the preferred option, in most creditor and debtor countries alike, but they are becoming increasingly problematic. Not only do they create moral hazard for lenders but also they shift the burden of the crisis firmly onto taxpayers in debtor countries. Moreover, the approach is running into political opposition in creditor countries as crises become more frequent and extensive and the funds required get larger.

Thus, ways and means have been sought to redress the balance of burden-sharing between official and private creditors, as well as between debtors and creditors, by involving private creditors in crisis management and resolution. The issue is a contentious one. While the international community has come to recognize that market discipline will only work if creditors bear the consequences of the risks they take, it has been unable to reach agreement on how to bring this about.

For some time now the UNCTAD secretariat has been advocating a temporary standstill on debt payments during crisis situations to prevent asset grabbing by creditors, combined with lending into arrears to ensure that debtors have access to working capital. Although such procedures do not need full-fledged international bankruptcy procedures, they do need effective mandatory backing at the international level. Such backing has met with strong opposition from some of the major economic powers and market participants, who favour voluntary arrangements between debtors and creditors. Governments in some debtor countries have also been reluctant to back this proposal for fear of impairing their access to international capital markets. However, voluntary arrangements, while potentially helpful in debt restructuring, are unlikely to halt asset grab races. Again, the evidence from recent settlements suggests that without statutory protection for debtors the balance of power will continue to weigh heavily in favour of creditors.

A credible strategy for involving the private sector in crisis management and resolution should combine mandatory temporary standstills with strict limits on access to Fund resources. A first step in this direction would be the design of explicit guidelines under the IMF's Articles of Agreement allowing a stay on creditor litigation in order to provide statutory protection for debtors imposing temporary standstills. On the other hand, since the main objective of large-scale crisis or contingency lending would be to keep debtors current on their obligations to creditors, it would be difficult to ensure private sector involvement without limiting access to IMF financing. There is indeed growing agreement on the need to limit crisis lending. In setting such limits, it must be recognized that current IMF quotas have lagged far behind the growth of global output, trade and financial flows, and may not provide appropriate yardsticks to evaluate the desirable limits to normal access. However, the current approach still appears to favour large-scale packages for countries considered to present systemic risks, while other countries would face access limits and be encouraged to default in order to involve their private lenders in the resolution of their financial difficulties.

* * *

The above are not the only changes needed in the mandates and policies of the Bretton Woods institutions. Over the past two decades, the unwillingness of the advanced countries to defer to IMF on contentious monetary and financial matters which directly affect their own interests has meant that the Fund's surveillance of the policies of the most important players in the global system has lost any real purpose. Instead, there has been an intensification of surveillance of developing countries, which has now been extended to include financial sector issues, consistent with the diagnosis that the main flaws are to be found in debtor countries.

One result has been the expansion of conditionalities attached to IMF lending to countries facing actual or potential crisis. This has given rise to serious concerns about undermining sovereign responsibility, even as the effectiveness of IMF surveillance is increasingly questioned. These concerns increased in the aftermath of the East Asian crisis, when excessive conditionalities led to policy responses which intensified the crisis. As a result, there have been calls, including within the International Monetary and Financial Committee, for the streamlining and refocusing of surveillance in line with the Fund's core competence in macroeconomic policy and related reforms. However, the recent financial difficulties in Turkey and Argentina illustrate the reluctance to break with the past practice of attaching wide-ranging policy recommendations to any IMF-negotiated loan package.

With swings in exchange rates and monetary policies in the major industrial economies acting as a catalyst for crises elsewhere in the world economy, a priority of the reform process must be strengthening surveillance mechanisms to achieve a minimum degree of coherence among the macroeconomic policies of those countries. In view of the asymmetries in existing practices, one way forward might be to link surveillance procedures to a mechanism analogous to that used for settling disputes in international trade, where disagreements over the impact of macroeconomic and financial policies could be taken up and their resolution sought.

More radical reform proposals put forward so far have sought to build on the consensus that the Fund should provide international liquidity not only to countries facing current-account difficulties but also to those facing capital-account crises. According to the Meltzer Commission, the time has come to make the Fund an international lender of last resort for any economy able to meet a series of *ex ante* conditions for solvency. This proposal raises two major concerns. On the one hand, it is likely to result in much larger packages than existing crisis lending, with attendant moral hazard problems for lenders and no incentive for bailing in the private sector. On the other hand, a radical shift in IMF lending to short-term capital-account financing would deny access to multilateral financing to all those developing countries considered systemically unimportant. These proposals place inordinate faith in market forces both to resolve financial crises and to provide finance for development.

One of the original objectives of IMF was to provide short-term financing to countries facing current-account problems due to temporary shocks and disturbances so as to ensure an orderly adjustment process. Experience continues to show that financial markets often fail to meet such needs, as they tend to be pro-cyclical. Given the increased instability of the external trading and financial environment of developing countries, an effective reform of the Bretton Woods institutions should seek to improve, not eliminate, counter-cyclical and emergency financing for trade and other current transactions.

* * *

There are certainly a number of conceptual and technical difficulties in designing reasonably effective global mechanisms for achieving currency and financial stability. Such difficulties are familiar from the design of national systems. At the international level, there are additional political problems associated with striking the right balance between multilateral disciplines and national sovereignty.

Indeed, political constraints and conflicts appear to be the main reason why the international community has not been able to achieve significant progress in setting up effective global arrangements for the prevention and management of financial crises. In particular, the process has been driven by the interests of the major creditor countries, which hold most of the power in the multilateral financial institutions, as well as in bodies set up more recently with the explicit intention of reforming the international financial architecture. As a result, many of the issues of crucial importance to developing countries have been excluded from the reform agenda.

If reforms to the existing financial structures are to be credible, they must provide for much greater collective influence from developing countries and embody a genuine spirit of cooperation among all countries. This will require a major reformulation of the reform agenda. It will also require careful examination of the representation in the existing multilateral financial institutions and of their decision-making practices.

But it is equally important that developing countries themselves reach a consensus on how they want the reform process to move forward. While this consensus is lacking on several issues of the reform agenda, there are many commonly shared objectives, including: more balanced and symmetrical treatment of debtors and creditors regarding standards, codes, transparency and regulation; more stable exchange rates; more symmetrical surveillance; less intrusive conditionality; and above all, multilateral institutions and processes that are more democratic and participatory. Effective reform of the international monetary and financial system will ultimately depend on the willingness of developing countries to organize their efforts around such common objectives, and on acceptance by developed countries that accommodating these objectives will be an essential part of building a more inclusive system of global economic governance.

In the absence of collective arrangements for a stable international financial system, developing countries should avoid commitments which restrict their policy autonomy with respect to dealing with financial instability. Interest is now growing in regional arrangements to provide collective defence mechanisms against systemic failures and instability, and regional currencies are increasingly seen as viable alternatives to dollarization. The European experience has also been held up as a model for regional arrangements, including in areas such as intraregional currency bands, intervention mechanisms, regimes for capital movements, payments support and regional lender-of-last-resort facilities. Such arrangements among developing countries probably require the inclusion of a major reserve-currency country willing and able to assume a key role for this purpose. In this respect, recent initiatives in Asia, involving developing countries and Japan, could constitute an important step towards closer regional monetary integration.

Rubens Ricupero
Secretary-General of UNCTAD

GLOBAL TRENDS AND PROSPECTS

Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Global outlook

Prospects for the world economy dimmed towards the end of 2000. After an unprecedented period of expansion, growth in the United States decelerated sharply in the third and fourth quarters of the year in response, inter alia, to a series of interest rate hikes, falling equity prices and rising oil prices. Lower investment spending in the last quarter snuffed out growth altogether at the beginning of 2001, raising concerns that a harder landing than expected might send recessionary shockwaves throughout the world economy. The fact that the slowdown, with its potential consequences, has caught many observers by surprise is a further confirmation that policy makers everywhere are ill-prepared to cope with the changes brought about by the increasing integration of the world economy.[1]

As a result of growing global interdependence both real and financial shocks are transmitted much more rapidly across regions, countries and sectors. At the same time, given the intertwining of the real and financial sides of the economy, such shocks have unexpected consequences. The Asian financial crisis was initially expected to plunge the global economy into recession; instead, it provided a stimulus to the United States economy, prolonging growth there, which in turn supported a rapid recovery in Asia through higher exports (*TDR 1999* and *TDR 2000*). On the other hand, the adverse impact of the Asian crisis on commodity and petroleum prices, which helped keep prices in the United States under control, created balance-of-payments and fiscal difficulties for a number of developing countries. These eventually produced another series of financial shocks, ignited by bond default in the Russian Federation, which triggered a global rush for liquidity that threatened even United States financial markets during the late summer of 1998. The reduction in United States interest rates in response to that threat, followed by substantial injections of liquidity to counter the Y2K computer problem and to support the introduction of the euro, steadied confidence, particularly in the United States, and brought about a global recovery of growth in 1999 and at the beginning of 2000.

However, the global recovery also aggravated domestic and global imbalances in a manner simi-

lar to that of previous major cyclical disruptions and periods of financial instability. As was suggested in *TDR 2000*, an end to the expansion in the United States economy was unavoidable and imminent. Monetary tightening by the Federal Reserve, which began in mid-1999 and had pushed interest rates to 6.5 per cent by May 2000, took longer than expected to affect business and household expenditures, but the squeeze was clearly visible in the last quarter of the year. The current slowdown is expected to reduce the burgeoning current-account deficit, which stands at over 4 per cent of GDP, thereby helping to correct a major global imbalance, but without faster growth elsewhere it will lead to a significant decline in global demand.

Unlike the Asian crisis, the United States downturn is not expected to generate significant expansionary impulses elsewhere in the world economy.

A broad body of opinion expects the slowdown to be brief, although more pronounced than had earlier been predicted; once equity prices, excess capacity and inventories return to normal levels, the economy is expected to see robust growth consistent with the spread and further development of new telecommunications and information technologies. On this view, therefore, global growth should be little affected by what, at worst, would amount to a short recession, followed by recovery in the second half of 2001.

However, the current United States slowdown cannot be described simply in terms of previous experience, when booms were ended by a combination of monetary tightening in response to wage and price pressures and fiscal tightening to reign in public debt. Critics of the view that the introduction of new telecommunications and information technology has produced a structural change in the productive potential of the economy and in its cyclical behaviour point to the large increase in debt and the reduction in savings ratios that have been incurred by households and the business sector in the presence of large fiscal surpluses (Godley, 2000). If the private sector were to attempt to repay its excessive debt and restore its savings rates to historical levels, the shortfall in demand could produce a prolonged recession, since it would far exceed any fiscal stimulus that could be expected from planned tax cuts.[2] In this scenario, no region of the world could expect to escape the effects of a United States downturn.

The crucial question is consequently whether a new locomotive of global growth will emerge to compensate for the at least temporary abandonment of this role by the United States. Unlike the Asian crisis, this downturn is not expected to generate significant expansionary impulses elsewhere in the world economy. Japan's nascent expansion, based on rising net exports and higher corporate profits leading to a recovery in investment, is vulnerable to a slowdown in the United States. Moreover, output growth was already negative in the third quarter of 2000, after a strong performance in the first half. In addition, with interest rates close to zero and a large public-sector deficit, there appears to be little room for a policy stimulus without the help of a major adjustment in exchange rates. Most analysts are looking instead to the EU to help sustain global growth and offset declining import demand in the United States.

Growth in EU last year broke through the 3 per cent barrier for the first time in over a decade (table 1.1), and there is confidence that it will outperform the United States in 2001, given that exports to that country amount to less than 3 per cent of regional output. However, despite the fact that the EU countries have successfully reduced their budget deficits, have kept their current accounts in balance and are showing little sign of inflationary pressures, last year's growth recovery continued to rely on net exports, accounting for as much as half of the increase in output, even in larger economies such as Germany. As net exports are expected to make a smaller contribution in 2001, a sustained expansion in private domestic demand will be needed to meet even the modest growth ambitions expressed at the Lisbon summit. Perhaps not surprisingly, and despite the moderate stimulus that has resulted from structural reforms in the fiscal regimes in a number of countries, there has as yet been no policy commitment to the kind of domestic demand-led growth enjoyed by the United States in recent

Table 1.1

WORLD OUTPUT, 1990–2000

(Percentage change over previous year)

Region/country	1990–1995[a]	1995–2000[a]	1990–2000[a]	1998	1999	2000[b]
World	2.0	3.1	2.6	1.9	2.7	4.0
Developed market-economy countries	1.8	2.9	2.3	2.1	2.6	3.5
of which:						
United States	2.4	4.3	3.4	4.4	4.2	5.1
Japan	1.4	1.1	1.3	-2.5	0.2	1.3
European Union	1.5	2.5	2.0	2.7	2.4	3.3
of which:						
Euro area	1.6	2.4	2.0	2.8	2.4	3.4
Germany	2.0	1.8	1.9	2.1	1.6	3.1
France	1.0	2.4	1.7	3.2	2.9	3.1
Italy	1.3	1.7	1.5	1.5	1.4	2.9
United Kingdom	1.6	2.8	2.2	2.6	2.2	3.1
Transition economies	-6.9	1.9	-2.6	-0.6	2.3	5.6
Developing economies	5.0	4.3	4.6	1.5	3.3	5.5
of which:						
Africa	1.5	3.6	2.5	3.2	2.9	3.5
Latin America	3.6	2.9	3.3	1.9	0.1	3.7
Asia	6.2	5.0	5.6	1.1	4.9	6.6
of which:						
China	12.0	8.3	10.1	7.8	7.1	8.0
Other economies	4.9	4.1	4.5	-0.8	4.2	6.2
Memo item:						
Developing economies, excluding China	4.1	3.7	3.9	0.5	2.7	5.1

Source: UNCTAD secretariat calculations, based on data in 1995 dollars.
a Annual average.
b Estimates.

years. Indeed, even as overall macroeconomic conditions suggest that Europe should at last be ready to test the limits of its potential growth rate – as the United States did in the second half of the 1990s – the European Central Bank (ECB) sees no signs that the euro zone's non-inflationary growth potential has risen above its current estimates of 2.0–2.5 per cent,[3] implying that it also sees no immediate scope for relaxing monetary policy.

This reluctance to make a more concerted policy move to bolster recent performance is a matter of concern, since Europe will, in all likelihood, be more affected by the slowdown in the United States than official views, based on the limited trade ties to the United States, suggest. Euro-zone exports to the rest of the world still account for more than 15 per cent of the area's output, which is considerably higher than for either the United States or Japan, and the reliance on exports over the past year of some of the larger European countries suggests that they could still be hit quite hard by a global slowdown. Furthermore, the integration of global production means that corporate profitability and investment plans can be quickly disrupted by changes in a country

which plays host to a large number of foreign affiliates. This is particularly true for European high-tech firms that have made very large acquisitions in the United States in recent years. Knock-on difficulties in European equity markets created by reduced corporate earnings in United States affiliates could be further aggravated by a lower dollar, making it even more difficult for these countries to offset the decline in their exports to the United States through higher domestic investment expenditures.

Consequently, without a determined change in economic policy, growth in the EU is unlikely to reach 3 per cent in the current year, and it may be much lower. Moreover, given the current propensity to import, its growth rate would have to be higher than that achieved in the United States in recent years if it is to generate an external deficit similar in size to that of the United States and act as a global buyer of last resort for the recovering economies of Asia and Latin America.

An orderly transition to a world where the leading economies all pull in the same direction is further complicated by the uncertainty surrounding exchange rate adjustments to current imbalances. The recent strength of the dollar has been due to relatively high United States growth and profit levels, the large inflows of capital seeking to join the information and communication technology (ICT) revolution, positive interest rate differentials and the high liquidity premium attached to dollar assets in the aftermath of the global liquidity crisis that followed the Russian default in 1998. If the United States economy were to slow down sufficiently to induce the Federal Reserve to further relax monetary policy, this would eliminate two factors that underpin the dollar's strength. Moreover, the large-scale acquisition of United States companies during the period of boom in high-tech stocks[4] appears to be running out of steam, as European firms move to consolidate existing operations rather than expand into what is an increasingly uncertain market.[5] However, the likely impact on the dollar is not clearcut since not all merger and acquisition (M&A) activity is financed by cash payments requiring the sale of currency for dollars.[6]

In any event, with widespread expectations of slower growth, falling interest rates and lower profitability of high-tech companies in the United States, the liquidity premium on United States assets remains the major support for the dollar. Recent experience teaches that this is not a reliable foundation. The way global imbalances are corrected and, in particular, the behaviour of the United States current-account deficit, may be crucial in determining whether slower inflows into dollar assets leads to a major weakening of the currency and widespread disruption in global financial markets.

While a sharp depreciation of the dollar would increase global financial fragility, a measured decline from its recent highs would be beneficial to global growth.

While a sharp depreciation of the dollar would increase global financial fragility, a measured decline from its recent highs would be beneficial to global growth. The benefits to European growth of a stronger euro, which would allow interest rates to fall, are likely to outweigh the disadvantages of reduced competitiveness and earnings of European companies with affiliates operating in the United States. In addition, a stronger euro would further reduce the dependence of growth on external demand and encourage a more positive role for Europe in sustaining global growth.

The United States slowdown is likely to have a damaging impact on the developing world, particularly if it is not offset by strong growth in other OECD economies, even assuming a measured decline of the dollar. However, the impact on individual countries and regions will depend on the relative importance of their trade and financial linkages with the United States. In Asia, where rising net exports have financed a post-crisis expansion, a weaker dollar, coupled with a sharp United States downturn, will quickly reduce current-account surpluses and could threaten bank and corporate restructuring.[7] Linkages to United States firms are particularly strong in high-tech sectors, such as semiconductors and personal computers, where declining sales and difficulties in financing production translates directly into lower

component imports from Asia. While a substantial depreciation of the dollar would help exports of countries such as China and Malaysia with pegs to that currency, it could create difficulties for the stability of regional exchange rates. It might also trigger currency depreciations across the region, which, together with the fall in semiconductor prices, could result in terms of trade losses and declining demand in countries affected. Japan's recovery would not be helped either by a weaker dollar or by a depreciation of Asian currencies. On the other hand, if the Japanese economy weakens further, the yen/dollar exchange rate might come under pressure. This could lead to similar pressures for depreciation against the dollar across East Asia rather than to a strengthening of regional currencies against the yen.

By contrast, a weaker dollar, accompanied by lower interest rates, could benefit many Latin American countries that have linked their currencies either directly or indirectly to the dollar. With the exception of Mexico and some smaller Caribbean economies, dependence on exports to the United States is lower than in Asia and financial links are more important. Brazil and, in particular, Argentina could stand to gain from a weaker dollar and lower United States interest rates through the effects on the public finances and the services account of the balance of payments. Since the major Latin American economies still have large external financing gaps, they should benefit from lower international interest rates more than they lose from declining exports. However, even in these countries, trade flows would probably decline. Furthermore, if the United States slowdown leads to an overall perception of increased risks and, hence, higher yield spreads for emerging-market borrowers, the final outcome might still involve considerable costs for the region.

B. Developed economies

1. The slowdown in the United States economy

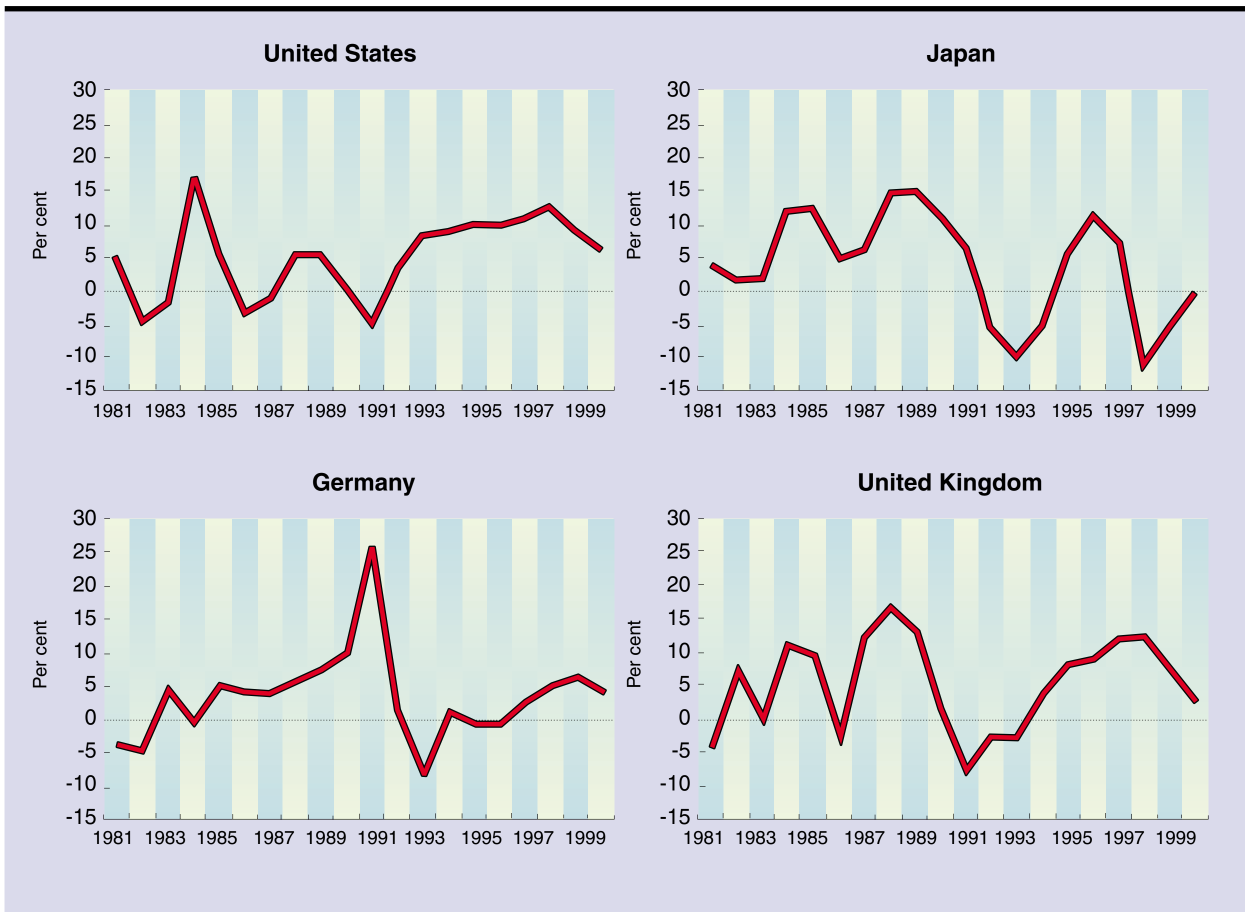
The recent expansion in the United States has been driven by domestic demand and supported by a Schumpeterian process of creative destruction that increased investments in new technologies and raised productivity performance. A series of international events kept the lid on prices, even as the economy grew at around 5 per cent and unemployment dropped below 4 per cent. Although the increase in petroleum prices in 2000 pushed the rate of increase in the consumer price index close to 4 per cent for the first three quarters of 2000, underlying price pressures remain benign.

However, with growth over the past two years exceeding most estimates, the Federal Reserve raised the Federal Funds rate in several steps to 6.5 per cent in mid-2000.[8] While the strong economic activity appeared resistant to tighter monetary conditions until mid-2000, the slowdown in the third and fourth quarters of 2000 was much more pronounced than expected and growth stalled in the first quarter of 2001, suggesting that the risk of recession is by no means negligible. With hindsight, it seems clear that the last increase in the Federal Funds rate of 50 basis points was unnecessary, as was perhaps also the previous increase from 5.75 per cent to 6 per cent, given the lagging effect of changes in monetary policy. In response to falling equity prices and sharply lower

Chart 1.1

INVESTMENT CYCLES IN MAJOR INDUSTRIAL COUNTRIES, 1981–2000

(Real gross fixed capital formation of the business sector, per cent change over previous year)



Source: OECD, *Economic Outlook*, various issues.

indicators of consumer confidence, the Federal Funds rate was reduced by 50 basis points twice during January 2001.

Two mutually reinforcing developments accounted for the faster than expected slowdown: the decline in investment spending on information technologies; and the sharp drop in consumer confidence, resulting in a slowdown in consumer spending.

One of the most striking characteristics of the United States expansion has been the sustained boom in gross domestic fixed investment which lasted much longer than in other major industrial countries and in previous investment cycles in the United States itself (chart 1.1). By the first half of 2000, gross fixed investments in the business sector had risen to over 18 per cent of GDP (chart 1.2) and business investment in equipment and software to over 10 per cent. Spending on investments in ICT has contributed to about a quarter of real GDP growth over the past six years.[9] Much of the investment was in the formation of new start-up companies which needed structures, equipment, and a full range of more traditional services such as legal support and advertising. A good deal of this new investment has been financed by venture capital funds in preparation for raising equity in these companies through initial public offerings

(IPOs). In 1999, new IPOs raised close to $60 billion, a figure matched in 2000 (most of it being raised in the first half of the year) (NVCA, 2001). Such IPOs originated from companies that had benefited from the high-tech bubble in the NASDAQ index, which produced triple-digit price-earnings ratios and extremely easy financing conditions.

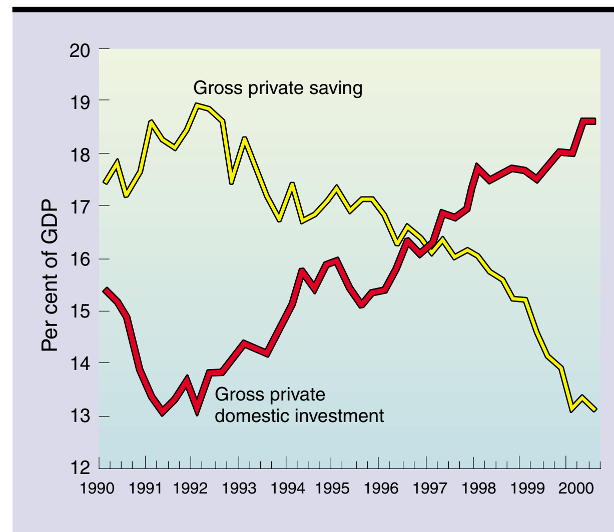
It is now clear that many of the new technology companies could never have developed without the easy financial conditions made possible by the boom in venture capital funding and the stock market bubble. It is also clear that as a result more capacity was created in the sector than if the financing had been made available under normal conditions by bank lending or retained earnings. A sharp reversal of expectations concerning the future earnings capacity of these companies led to a collapse in their share prices in the first quarter of 2000. The NASDAQ index, which contains a high proportion of ICT-based companies, finished the year down nearly 40 per cent. The resulting loss in stocks initially issued in 1999 and 2000 has been estimated at nearly $300 billion, and new issues were halted at the end of 2000 and the beginning of 2001. Thus, in the second half of 2000, the new borrowing that these companies needed to cover their negative cash flows came to an end and many had to close down or default. As a result, investment and related expenditures came to a halt; in the fourth quarter, real non-residential fixed investment in equipment and software decreased by 4.7 per cent on an annualized basis.

All this bears more than a passing resemblance to the Asian experience[10] of easy access to cheap credit and excessively optimistic expectations of higher future earnings, leading to investments that could not possibly be profitable. The Asian boom was followed by a stock market bust and recession, and a similar result appears to be in prospect for the United States. The decline in equity prices has reduced household wealth and dampened consumer spending, which already appears to have been affected by rising domestic prices for energy. In particular, the deregulation and liberalization of electricity and natural gas prices – which in some states have increased fivefold along with the return to more normal cold winter – have resulted in sharply increased heating costs for many households. The decline in consumer confidence and outlays is likely to be further reinforced as the effects of layoffs due to corporate restructuring and inventory adjustment spread throughout the economy.[11] Growth in consumer expenditure fell from an annual rate of 4.5 per cent in the third quarter to 2.9 per cent in the fourth quarter.

Chart 1.2

UNITED STATES: PRIVATE INVESTMENT AND SAVINGS, 1990–2000

(Per cent of GDP)



Source: United States Department of Commerce, Bureau of Economic Analysis.

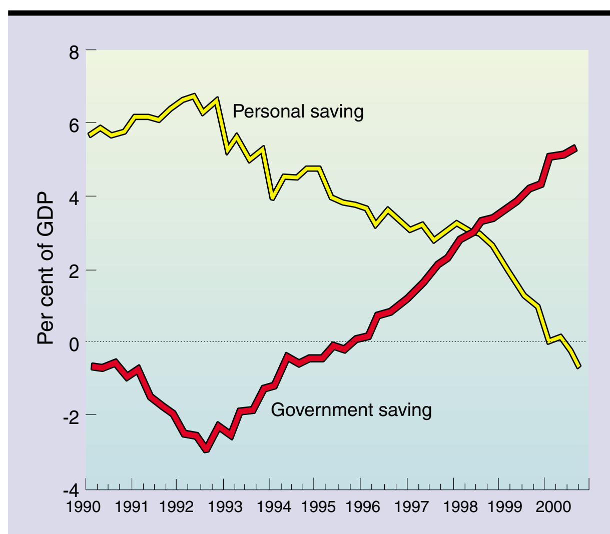
Basically two scenarios are envisaged for the United States economy: a normal cyclical downturn which will quickly bring about adjustments to productive capacity and inventories through a short deceleration in growth during two or three quarters, to be followed by a rapid recovery; or, alternatively, a sustained period of disinvestment, producing recessions similar to those in Japan or Europe in the early 1990s.

At the beginning of 2001 certain developments suggested there might be a quick recovery: petroleum prices were in the range of $20–25 a barrel, inventory accumulation appeared to have come to a halt, equity prices seemed to be stabi-

Chart 1.3

UNITED STATES: PERSONAL SAVINGS AND GOVERNMENT SAVINGS, 1990–2000

(Per cent of GDP)



Source: United States Department of Commerce, Bureau of Economic Analysis.

lizing and the trade balance had started to improve. Furthermore, the dollar had depreciated by over 10 per cent against the euro from its earlier highs, and prospects for increased dollar earnings provided support for equity prices of companies with large international operations. The Federal Reserve moved aggressively to lower rates and announced that it had changed its policy bias from fighting inflation to fighting a rapid slowdown.

Despite these positive developments the risk of a sustained recession cannot be overlooked, since the late stages of the boom were underpinned by historically large increases in private-sector indebtedness, which is the counterpart of the historically large fiscal surplus (chart 1.3). Since 1997, total private expenditure has exceeded disposable income, reversing the normal relation that has held since 1952; by the third quarter of 2000 the private-sector financing gap had reached 8 per cent of GDP, the personal savings ratio had become negative, and household debt had reached 110 per cent of annual disposable income. Thus, while the Government prepares to pay off its outstanding debts, the private sector has been accumulating record amounts of debt relative to its ability to service that debt. Just as start-up companies in the ICT sector needed to borrow to stay in business, households need to borrow in order to sustain their current rate of consumption. A decline in income growth associated with a recession would mean that households would have to increase borrowing just when their ability to meet the payments on their outstanding debt is declining.

The fact that such a long period of expansion is unprecedented should make for a cautious assessment of the current slowdown. However, if, as already noted, the investment boom does share some resemblance to that in Asia in the early 1990s, the conflicting pressures on the economy from expansionary macroeconomic and stagnationary structural impulses point to a more uncertain future than either the V-shaped cyclical downturn and recovery or sustained recession scenarios suggest (box 1.1). Moreover, although the United States economy is in a much stronger position than in the past to make appropriate fiscal and monetary adjustments to avoid a prolonged recession, it seems unlikely that the economy will return smoothly to its growth path of the past decade, and certainly not to the nearly 5 per cent growth it had reached after the Asian crisis.

2. European Union

In 2000, the European Union experienced one of its best growth performances since the 1990–1991 recession (table 1.1). Growth finally exceeded 3 per cent and unemployment dropped to below 9 per cent. The growth disparities between the larger and smaller economies that had created difficulties in formulating a uniform monetary policy also narrowed. France, Germany and Italy grew at about 3 per cent in 2000, while the Spanish economy grew by more than 4 per cent. Among the smaller economies, Ireland continued to surge ahead of the pack, achieving a remarkable 11 per cent growth rate. With investment and consumer spending leading the recovery, the euro area appeared to be emulating the kind of private-sector-led growth enjoyed by the United

States. Indeed, the growth differential of about one and three-quarter percentage points between the United States and the euro area over the last three years was reversed in the second half of 2000.

The failure of Europe to achieve a strong and sustained recovery after 1991 reflects, in part, the responsiveness of European interest rates to those of the United States because of increased integration of financial markets. Furthermore, attempts by the ECB to establish credibility resulted in rising rates in response to United States monetary tightening, regardless of whether that was consistent with European growth and employment trends. The tight fiscal policies to meet the convergence requirements for the single currency and the Stability and Growth Pact meant that the main source of demand expansion had to come from net exports. The stimulus from this source after 1999 reflected increased competitiveness created by the depreciation of the euro, which went unchecked until the third quarter of 2000 when joint intervention by G-7 central banks seemed to halt any further slide. Growth appears to have peaked in mid-2000, around the same time as in the United States. France has continued to grow vigorously on the basis of domestic demand and managed to reduce its unemployment rate, but the German economy registered an unexpectedly sharp downturn in the last quarter of 2000, and most leading indicators of economic activity point to a slowdown in the euro zone in 2001.[12] Net exports are expected to drag down growth and the important question is whether Europe can continue to build on last year's growth performance in the face of the United States slowdown.

The United States slowdown will have an impact not only through trade. Sales of German and United Kingdom affiliates in the United States were roughly five times their exports to the United States in 1998, a figure which is roughly double that for smaller European economies such as the Netherlands. Lower sales will hit profitability, which could make it more difficult to carry out the restructuring necessary to introduce the high-tech production and organizational methods required to compete with United States companies. Economic integration between these two industrial blocs appears to be more significant than a casual discussion of trade ratios might suggest. According to recent estimates, the elasticity of euro-area growth with respect to the United States is as high as 0.4.[13] This suggests that the recent decline in the United States growth rate of more than 3 percentage points from its average over the last five years, could cause a decline of around 1.5 percentage points in European growth, bringing it below 2 per cent, irrespective of any further impact from a loss of export competitiveness due to the strengthening of the exchange rate.

Europe seems well placed to build on last year's growth performance and bolster global demand in the face of a United States slowdown. To that end a departure is necessary from an undue reliance of the largest economies on exports for growth.

Nevertheless, Europe seems better placed than ever to decouple from the United States. Since European companies are not as highly leveraged as their United States counterparts, investment should be less influenced by liquidity shortages, increasing spreads in high-yield and corporate capital markets, or difficulties in the ICT sector. The lower share of equity in personal wealth also suggests that consumption expenditures should be less constrained by declining global equity prices. In addition, the macroeconomic picture is broadly favourable. A necessary degree of convergence has been achieved across the region and the launch of the euro has been successful; its initial weakness reflected cyclical rather than structural factors. Moreover, the fall in United States interest rates eases pressure on the ECB, and the fiscal situation is healthy; changes in the fiscal regime of the major economies (Italy, France and Germany) will provide a stimulus of between 35 and 50 billion euros in 2001, adding as much as 1 per cent of GDP. The reversal in the upward trend of petroleum prices should also have a greater positive impact on Europe, since it is a larger net importer of oil than the United States, and this will be reinforced by a stronger euro, creating further increases in purchasing power for households and lower costs for European firms.

Box 1.1

DISSECTING THE UNITED STATES DOWNTURN

Many observers expect that the United States economy will experience a short Keynesian-type downturn, associated with overinvestment and excessive inventories accumulation, followed by a relatively rapid recovery. Such an outcome places considerable faith in discretionary fiscal and monetary adjustments. However, there are a number of factors suggesting that the current downturn is quite different from that which is typical of the Keynesian cycle.

While the sustained high rate of expansion in business investment has played an important part in the unprecedented period of expansion, even more striking has been the increase in investment in new computer and peripheral equipment, with average annual increases close to or above 50 per cent during 1995–2000. Total investment in information-processing equipment and software rose more slowly, at rates of around 25 per cent per annum. Although such spending represented less than 10 per cent of GDP in 2000, it accounted for almost one third of all output growth during 1995–1999.

This exceptionally rapid increase in investment was driven primarily by new business ventures attempting to exploit in full the benefits of a Schumpeterian wave of technological innovation in information processing and telecommunications. The boom in venture capital funding and the bubble in the IPO market allowed the financing of new start-ups with no current earnings and highly uncertain expectations of future earnings.[1] The sharp rise in equity prices after initial public offerings lowered the cost of finance. Venture capital funds were thus able to recover their investments and explore new business plans. As long as the equity market remained bullish, even unsuccessful and never profitable technology firms were able to continue to count on low-cost funding to meet ongoing losses. However, such firms represent excess capacity that will not be absorbed even by an increase in aggregate demand on the cyclical upswing. In a downturn, they are likely to be eliminated by bankruptcy.

This process now seems to be under way. It started with the collapse of the NASDAQ index in the first quarter of 2000, when investors began to distinguish the new start-up companies that were making their way and held out good profit prospects from those that were being kept alive only by continuous cash infusions, with little hope of future earnings to justify their elevated share prices. It is possible to look at the cyclical downturn as the market finally exercising its role selecting from the wide range of information technology innovations those that will be viable in the long run. The kind of excess capacity that is present in the economy may thus be rather different from the excess capacity in steel or automobile plants that had been associated with typical post-war cycles.

But even successful high-tech companies with positive earnings may not be immune from the current process of market selection. Many of them have acquired smaller start-up companies. Others have created their own venture capital funds to invest in start-ups, or financed new start-ups via reduced prices and the provision of credit through vendor financing. Some have accepted stock options in lieu of payment. Thus, sharp declines in stock prices, liquidity difficulties or bankruptcies of the weaker companies will adversely affect the earnings prospects of the more successful ones.

Box 1.1 (concluded)

Although the formal banking system has largely shunned the financing of new technology companies, the share of business lending in bank portfolios rose during the second half of the 1990s. Much of this lending has been to the so-called “old economy” or “blue chip” companies with high credit ratings, either in term lending, in back-up credit lines for commercial paper issues, or in underwriting and supporting bond financing. However, the survival of these companies is threatened by the process of Schumpeterian creative destruction that occurs as successful high-tech companies adopt new, more profitable technological approaches. The performance of these “old economy” companies will suffer from the overall slowdown in activity, which may also entail problems for banks that have substantial exposure to them. Recent weakness in high-yield bond markets, and difficulties in the issuance of commercial paper experienced by many such companies suggest that this is indeed happening (Silverman and Hill, 2001).

A lack of precedent in the current United States economic situation calls for a cautionary assessment. However, there are good reasons to view the current cycle as an interruption in a wave of Schumpeterian innovation rather than as a simple Keynesian problem of insufficient aggregate demand.[2] If that is so, the confidence that has been placed in monetary and fiscal policy in ensuring that the downturn is short may be misplaced. Only a wave of bankruptcies, the extent of which is uncertain, can eliminate the excess capacity in much of the ICT sector and allow more promising investment to resume. The length of the downturn will depend on how rapidly non-viable businesses can be wound up, on the extent to which successful companies elsewhere in the economy will face financial difficulties as a result of this process, and on the impact of possible macroeconomic stimuli on the rest of the economy.

It does not follow from the above that monetary and fiscal stimuli would be inappropriate. However, they would have a much smaller impact than in the past because they can do little to recreate the investment momentum and liquidity conditions that allowed the recent rapid experimentation with new technologies. The improvement that many observers expect from a rapid easing of monetary conditions may be slow to appear unless financial institutions, venture capitalists and households are again willing to return to their exuberant support of new businesses that have no current earnings and highly uncertain expected future earnings. But this is where the problem originated in the first place.

1 Venture capital funds usually expect a success ratio of 1 to 10 on their investments.

2 Some aspects of the current cycle resemble that described by von Hayek, who argued that an excessively low cost of capital would create investments in techniques that were excessively capital-intensive; the subsequent return to a more normal level of capital costs would show that these investments are unprofitable, and the surplus capacity generated would have to be eliminated by a sharp downturn and widespread bankruptcies. However, while many companies have invested without achieving their expected sales, and the capital-output ratios may have increased, the problem is not one of excess capital intensity, but rather the fact that overgenerous financing conditions allowed unprofitable investments to come on stream.

For all these reasons Europe seems well placed to build on last year's growth performance and bolster global demand in the face of a United States slowdown. A rapid expansion in Europe of domestic demand is also essential to deal with its legacy of high unemployment. To that end a departure is necessary from an undue reliance of the largest economies on exports for growth.[14] The creation of an internal momentum for growth in Europe and its contribution to an expansion of demand are likely to depend in large part on the willingness and ability of governments to use economic policy to anticipate, rather than react to, worsening conditions.

The structural changes that have been made in fiscal policy should boost real incomes and partly offset the adverse impact of higher energy and heating costs. Nonetheless, consumer confidence in Europe does not appear to be improving, and growth in real compensation, which peaked in 1999 at around 3 per cent, had fallen to below 2.5 per cent by the end of 2000. Current wage agreements in some of the larger economies were negotiated under less advantageous conditions and will not be renewed during 2001. For example, the very moderate wage settlements reached in Germany in 2000 still have a year to run. Where wage agreements have been linked to an expected inflation rate that in the event has been exceeded on account of petroleum prices and the weakness of the euro, there should be some recovery of real incomes.

The appreciation of the euro towards the end of 2000 has produced a de facto tightening of monetary policy, with real interest rates reaching cyclical highs – up from around 2 per cent in 1999 to around 3.75 per cent[15] in early 2001. With lower petroleum prices, the strengthening of the euro and monetary growth moving towards ECB targets, there should be ample scope for discretionary monetary easing to accompany any expansive fiscal policy. However, recent pronouncements from the ECB indicate that it will continue to be solely concerned with internal price stability. This sits ill with the spirit of the preparatory discussion of the EMU, when there was a broad consensus that monetary policy could be used to counter symmetric external shocks, such as an oil price hike or a fall in global demand. Failure to counter these influences could result in global imbalances producing disruptive movements in exchange rates similar to those between the yen and the dollar that helped precipitate the Asian crisis.

The United Kingdom economy, which remains outside EMU, has had a consistently better growth performance than that of the euro area since the 1990–1991 recession and was one of the first economies to lead the global recovery. However, during 2000 growth was slightly below the EMU average and appeared to have peaked by mid-year. With industrial production falling sharply in the last quarter of 2000, performance looks set to mirror that in the United States, unless electoral or other considerations result in provision of a more direct stimulus.

3. Japan

Growth in Japan – led by exports – picked up in the first half of 2000 and fed through to increased corporate profits, investment, industrial production and output, suggesting that the foundation for recovery might be in place. The impression of an accelerating recovery was reinforced when the Bank of Japan raised its interest rate to 0.25 per cent in August, since the Bank had maintained that policy would not be tightened until there were clear signs that the threat of a deflationary spiral had subsided. However, growth slipped to an annual rate of -2.4 per cent in the third quarter, and unemployment continued to rise, reaching 4.9 per cent by December despite the rise in employment. Figures for output and private consumption in the second half were also disappointing and, with the decline in exports, inventories began rising. As a result, subsequent Government estimates for growth in the fiscal year ending in March 2001 were lowered to below 0.5 per cent, measured in current prices.[16] Final data for the fourth quarter may well show a new decline in output, returning Japan to recession.

Although weaker markets in the United States and in developing Asia have sharply dampened the export-led recovery, it is still unclear what the effect has been on corporate earnings and investment.[17] Machinery orders from sectors other than export and ICT-related industries started to rise

in the second half of 1999 and this should have been reflected in production figures by the beginning of 2000.[18] Whether this will be sufficient to offset the decline in export and ICT-related sectors due to the slowdown in the United States will be a factor determining whether or not the economy falls back into recession.

The Government has traditionally opted for the fiscal tool to spur expansion. However, the fiscal stance became increasingly cautious as government indebtedness rose. In response to the signs of a slowdown in the second half of 2000, a further budget was introduced in November which proposed to increase government spending by 4.8 trillion yen. However, not all of this amount constitutes a new stimulus, since the legislation limits the issuance of new government securities to 2.0 trillion yen and provides for the balance to come from a rollover of the 1999 fiscal year surplus of 1.5 trillion yen (i.e. carry-over of budgeted expenditures that did not in fact take place) and an estimated increase of 1.2 trillion yen in tax revenues. The stimulus resulting from the proposed budget for the fiscal year starting in April 2001 is again modest, and another supplementary budget will, in all likelihood, be required by mid-year.

Local governments are under heavy pressure to shore up their finances by cutting expenditure. Consequently, with little contribution expected from exports, continued recovery will depend primarily on private domestic demand. Investment has shown signs of acceleration, but the implication is that the consumer demand is expected to take the lead. This will mean wage growth will have to pick up to at least match productivity growth.

Considerable uncertainty remains over the future direction of monetary policy. There are increasing concerns that a return to a zero interest rate policy could delay corporate restructuring measures that are urgently needed to restore profitability. However, the return to negative growth in the third quarter raises the possibility that the recovery may be cut off just as it gathers momentum.[19] The fact that the unemployment rate is still increasing in conditions of rising employment indicates that previously discouraged workers are being drawn back into the labour force and that the economy could expand without inflationary risks substantially faster than at the potential rate (estimated at 1 per cent).

Assessment of the impact of the current monetary policy stance is difficult because prices have been falling for most of the 1990s, so that real interest rates are positive even if they are close to zero in nominal terms. Problems with the balance sheets of financial institutions also make it difficult to assess the amount of liquidity that has been injected. Bank profitability and capital have improved over the last several years, without this having led as yet to an increase in bank lending or equity values. The loan books of domestic commercial banks continue to contract at about 4 per cent per annum and the Tankan surveys during the year do not indicate any change in the negative perception of banks' willingness to lend.

> In Japan the return to negative growth in the third quarter raises the possibility that the recovery may be cut off just as it gathers momentum.

The tightening of monetary policy since August 2000 has been reinforced by the appreciation of the yen. At the same time, equity prices peaked in April 2000, but following the trend in the NASDAQ in the United States, fell sharply in April and May. However, rather than stabilizing, as in the United States, equity prices continued to fall, with a particularly sharp drop in mid-December as it became clear that the economy was slowing down. This set off renewed speculation about difficulties in the banking sector and a proposal for a special government investment fund to shore up equity prices. If the recent increase in investment is cyclical – primarily due to the recovery in Asia and the prolonged growth of the United States economy – rather than the result of microstructural factors and the spread of investment to non-export sectors, it may not survive the anticipated slowdown in global demand.

C. Developing countries

1. Latin America

In all Latin American countries economic performance improved in 2000 (table 1.2). In some there was a very strong recovery, pushing the regional rate of expansion to nearly 4 per cent, the highest since the outbreak of the Asian crisis. However, marked differences in performance among countries that prevailed in 1999 persisted in 2000. Mexico and the economies of Central America and the Caribbean, with close trading links to the United States, continued to outperform those economies that are more dependent on commodity exports and intra-regional trade.

Growth accelerated strongly in the two largest economies, Brazil and Mexico. Thanks to higher oil prices, continued expansion in the United States and robust domestic demand, growth in Mexico reached 7 per cent, the best performance in many years, while an aggressive policy of monetary easing allowed Brazil not only to raise output growth (to 4 per cent) but also to reduce its fiscal deficit. The effect on prices of the currency depreciation of early 1999 remained muted despite the recovery, but the current-account balance improved less than had been expected. In Chile, too, there was a sharp rebound in growth (to almost 6 per cent) from a recession in 1999.

In both Argentina and Uruguay the economy contracted (but more slowly) for the second consecutive year. In Argentina deflationary adjustment to the external shocks of 1998–1999 continued, resulting in some improvement in competitiveness and a trade surplus. However, since the services balance deteriorated due to considerably higher financing costs, there was only a modest reduction in the large current-account deficit. International financial markets, which are crucial for financing the deficit, have been closely watching the Government's efforts to bring its debt under control and to curb wage and price increases sufficiently to restore competitiveness and achieve current account sustainability (see chapter II, box 2.1).

Prospects for most countries in Latin America depend on the extent of the downturn in the United States. For the region as a whole growth is expected to slacken, although further depreciation of the dollar would help increase competitiveness in the "dollarized" economies.

The external environment for the Latin American economies was generally favourable as the recovery of certain commodity prices, which had started during the second half of 1999, continued into 2000. In particular, the hike in petroleum prices benefited several countries, especially Venezuela, where GDP growth rebounded to over 3 per cent in 2000 after a sharp decline of more than 7 per cent in 1999. Several other countries, however, particularly Chile, Paraguay and Uruguay, suffered seriously from higher oil prices.

Prices of metals, including copper, aluminium, iron ore, nickel, tin and zinc, also recovered, as they did for some soft commodities, such as

Table 1.2

GROWTH IN DEVELOPING COUNTRIES BY REGION, 1990–2000

(Percentage change over previous year)

Region/country	1990–1995[a]	1995–2000[a]	1990–2000[a]	1998	1999	2000[b]
Latin America	3.6	2.9	3.3	1.9	0.1	3.7
of which:						
Argentina	5.8	2.7	4.2	3.9	-3.2	-0.5
Bolivia	4.1	3.2	3.7	4.7	0.6	2.0
Brazil	3.1	2.2	2.7	-0.1	0.8	4.0
Chile	8.7	4.5	6.6	3.4	-1.1	5.7
Colombia	4.7	0.9	2.7	0.5	-4.5	3.0
Ecuador	3.4	0.1	1.8	0.4	-7.3	2.6
Mexico	1.5	5.5	3.5	4.8	3.7	7.0
Peru	5.5	3.4	4.5	0.3	3.8	3.9
Uruguay	3.7	2.1	2.9	4.6	-3.2	-1.0
Venezuela	3.4	0.3	1.9	-0.1	-7.2	3.2
Africa	1.5	3.6	2.5	3.2	2.9	3.5
of which:						
Algeria	0.1	3.5	1.8	5.1	3.3	4.3
Cameroon	-1.9	4.8	1.4	5.1	4.4	4.2
Côte d'Ivoire	1.9	4.6	3.2	4.5	2.8	2.2
Egypt	3.4	5.2	4.3	5.6	6.0	3.9
Ghana	4.3	4.4	4.3	4.7	4.4	4.0
Kenya	1.6	2.3	1.9	2.1	1.5	1.6
Mozambique	3.3	8.7	5.9	12.0	8.8	4.5
Nigeria	2.4	3.2	2.8	1.9	1.1	3.5
South Africa	0.8	2.2	1.5	0.6	1.2	2.7
Uganda	7.0	6.2	6.6	5.5	7.8	5.0
Asia	6.1	5.0	5.6	1.1	4.9	6.6
Newly industrializing economies	6.9	5.0	6.0	-2.6	7.6	8.6
Hong Kong, China	5.3	3.5	4.4	-5.1	3.1	10.4
Republic of Korea	7.4	4.8	6.1	-6.7	10.7	9.3
Singapore	8.6	6.3	7.4	0.4	5.4	10.1
Taiwan Province of China	6.4	5.8	6.1	4.7	5.7	6.0
ASEAN-4	7.0	1.6	4.3	-9.4	2.8	5.3
Indonesia	7.1	0.7	3.9	-13.0	0.3	5.2
Malaysia	8.7	4.6	6.6	-7.4	5.4	8.7
Philippines	2.2	3.4	2.8	-0.6	3.2	3.5
Thailand	8.6	0.3	4.3	-10.2	4.2	4.2
ASEAN-4 plus Republic of Korea	7.2	3.2	5.2	-8.2	6.5	7.3
South Asia	4.5	5.5	5.0	5.6	5.7	5.5
Bangladesh	4.4	5.1	4.7	5.1	4.4	5.5
India	4.5	6.1	5.3	6.3	6.4	5.7
Nepal	5.2	4.1	4.6	2.3	2.3	5.5
Pakistan	4.8	3.2	4.0	2.6	2.7	4.7
Sri Lanka	5.4	4.8	5.1	4.7	4.2	5.0
West Asia	1.3	3.4	2.4	3.3	-0.5	4.3
China	12.0	8.3	10.1	7.8	7.1	8.0

Source: UNCTAD secretariat calculations, based on data in 1995 dollars.
a Annual average.
b Estimates.

cotton, fish meal, pulp, soybeans and wool. On the other hand, there was a continued decline in prices for food and beverages, particularly cocoa, coffee and sugar. Nevertheless, the terms of trade for the region as a whole improved. Since, in addition, relatively weak domestic demand kept increases in imports well below those of exports, there was a (modest) improvement in the regional current-account deficit. FDI inflows declined in 2000 and total net capital inflows remained far below the levels of 1996–1998.

For 2001, prospects for most of the Latin American countries depend on the extent of the downturn and the speed of the recovery in the United States economy. For the region as a whole, growth is expected to slacken as a result of a weaker export performance, although further depreciation of the dollar would help increase competitiveness in the "dollarized" economies. The impact of reduced import demand in the United States will be the greatest in Mexico, and probably small in Brazil, Chile and Peru. The two latter countries, in particular, will continue to benefit from higher prices for base metals and from relatively robust growth in the Asian economies, which are important export markets. The outlook is particularly uncertain for Ecuador, where hyperinflation continues to pose a major challenge to policy makers, as well as in Venezuela and Colombia. Fiscal imbalances remain a serious problem in some countries, including Argentina and Brazil, while others, having experienced financial crises during the 1980s and 1990s, are still contending with weak and fragile banking systems.

Latin America continues to face large financing constraints. While the region remains dependent on capital inflows, it continued in 2000 to experience a negative net resource transfer. Lower United States interest rates mean reduced costs of new borrowing and, eventually, of carrying of old debt, provided that sovereign risk spreads do not increase by more than the reduction in the benchmark rates. On the other hand, the financing constraints may be aggravated if the slowdown in the United States leads to reduced global trade growth. With more countries choosing a regime of full dollarization, the region will become increasingly dependent on conditions and policy decisions in the United States.

2. Asia

Growth in the developing countries of Asia as a whole (excluding China) accelerated further in 2000, reaching 6.2 per cent, after having already recovered in 1999 from the contraction of almost 1 per cent in the previous year (table 1.1). There were, however, considerable differences in performance among the subregions and their constituent countries (table 1.2).

A sharp turnaround was registered in West Asia, from slightly negative growth in 1999 to more than 4 per cent in 2000. Wary of the volatility of oil prices, oil producers in the subregion were initially cautious about spending their windfall of additional earnings, preferring to replenish their foreign exchange reserves and increase their holdings in foreign assets. However, as oil prices remained high because of strong world demand and low world stocks (see chapter II, section C), governments started to increase their spending on infrastructure, education and health care. Higher revenues reduced borrowing requirements and domestic arrears. At the same time, stronger fiscal and external balances, improved confidence and strong domestic demand greatly boosted economic activity, contributing to overall economic growth in the oil-exporting economies of the region. Many oil-importing countries in the subregion, however, suffered from substantial terms-of-trade losses.

The Turkish economy recovered well from the severe damage caused by the earthquake in 1999 and the spillover effects of the Russian crisis. However, its exchange-rate-based stabilization programme started running into difficulties in late 2000, casting doubts on its ability to sustain growth (see chapter II, box 2.2).

The outlook for West Asia in 2001 is broadly favourable. Driven by increases in oil revenues, growth is expected to accelerate in Kuwait, Oman, Saudi Arabia, United Arab Emirates, Yemen and, to a lesser extent, in the Islamic Republic of Iran, where external debt repayments and higher food imports because of drought are offsetting features. Qatar will additionally benefit from the rise in its gas production and exports. Drought will also, to some extent, offset the gains from higher oil prices

in several countries. From a longer-term perspective, for most countries in the subregion growth will continue to be constrained by low investment rates. Moreover, without substantial diversification of production, they will remain exposed to terms-of-trade shocks. Many countries are pressing ahead with reforms to improve the efficiency of the public sector and have also introduced measures to privatize and deregulate economic activity with a view to encouraging the private sector and promoting domestic and foreign investment.

In South Asia, overall economic activity continued to be dominated by the performance of the Indian economy. Despite the lingering effects on exports of the Asian financial crisis and the more recent sharp increase in oil prices, growth for the region as a whole remained at the level of the two preceding years. Growth in India, which has expanded strongly in recent years, slowed down slightly. The drought in northern India affected agricultural production less than anticipated and, despite flooding in the state of Andhra Pradesh during late August and early September, which affected the rice crop, the country has a large grain surplus. Strong overall growth was underpinned by a robust industrial performance and rapidly growing foreign demand for ICT-related services; in order to promote exports of services, legislation was introduced to support the ICT sector and develop e-business infrastructure.

Continued strong growth in Sri Lanka in 2000 was led by exports, especially garments. Higher tea and rubber prices also contributed to the sharp rise in export earnings. The more than 5 per cent growth in Bangladesh was also export-led. In Pakistan growth accelerated, but still lagged behind the other countries in the region; the external sector remained fragile, reserves continued to decline from already low levels and the currency came under pressure following the depreciation of other currencies in the subregion.

The short-term prospects for the subregion are mixed. Growth in India will remain relatively strong, despite some negative repercussions from world trade, underpinned by the country's huge agricultural sector, which stands to benefit from moves to reform price-control policies and stimulate domestic trade in agricultural products. Export-oriented manufacturing sectors are also expected to benefit from a relaxation of the FDI regime in special economic zones, and robust expansion of the ICT sector will support service activities. In Sri Lanka, growth will continue to be driven by strong demand for its two major exports, garments and tea, whereas in Pakistan, financial difficulties are likely to be a restraining factor. All countries in South Asia, but especially the smaller ones, are heavily dependent on energy imports and agricultural exports. Adjustments to terms-of-trade losses from the recent adverse movements in primary commodity prices may dampen growth to some extent, and further structural reforms in agriculture and industry may be needed to strengthen competitiveness.

In East Asia, almost all major economies further consolidated their recovery. The five countries that had been most affected by the financial crisis – the ASEAN-4 (Indonesia, Malaysia, the Philippines and Thailand) and the Republic of Korea – registered an overall growth in 2000 of more than 7 per cent, compared to 6.5 per cent in 1999. Despite substantial currency devaluations and the rapid pace of recovery, inflation rates have remained low. In Malaysia and Thailand there is a possibility of price deflation (which is already a reality in China and Hong Kong (China)).

In addition to strong export performance, growth has been supported by low interest rates and expansionary monetary policies. Although capital outflows have continued as banks have reduced their foreign exposure, they have not outgrown current-account surpluses. This suggests that the generalized currency depreciation has been the result of deliberate policy. There has been a significant recovery in intra-Asian trade, which is now growing more rapidly than trade with either the United States or EU. For several East Asian economies the internal driving forces behind recovery have started to shift from inventory adjustment and government spending to the more self-sustaining elements of business investment and private consumption. On the other hand, the gains from export volume growth and higher export prices were partly offset by higher oil prices during 2000.

Among the ASEAN-4, Malaysia continued to be the best performer, with growth accelerating to 8.7 per cent. However, by the end of the

year, domestic demand had slowed markedly and manufacturing sales were growing considerably faster than output, which would indicate a decline in inventories. Producer prices have been declining, and the rise in December 2000 of consumer prices was at an annual rate of just over 1 per cent. In Thailand exports rose by 20 per cent in 2000, contributing more to growth than in previous years, when domestic consumption had been the driving force. Despite higher energy prices, inflation has virtually disappeared; capacity utilization is still below 60 per cent and there is still excess labour. As in Thailand, recovery in the Philippines has been relatively slow. At the beginning of 2001, the country faced an extremely large fiscal imbalance and the peso came under pressure, despite a very strong current-account position. Indonesia experienced its first year of strong growth since the financial crisis, but domestic demand, which has become increasingly important in sustaining growth in the other ASEAN countries, remains weak.

Prospects for many developing countries in East Asia in 2001 are closely linked to the high-tech cycle in the United States.

In the Republic of Korea, which has already regained its pre-crisis level of per capita income, growth slowed somewhat in 2000, but still exceeded 9 per cent. Economic activity continued to be driven by exports, particularly of computers, and there was a strong increase in manufacturing output, notably of semiconductors. A second year of fast growth has led to a resurgence of capital inflows, and although the currency depreciated by an average of around 10 per cent, there was a recovery in the exchange rate at the end of the year. Inflation started to rise, reflecting, in part, the impact of higher oil prices in a country that relies on imported oil for about half its energy needs. This prompted the Bank of Korea to raise its overnight call rate in October for the second time in 2000. Consumer prices declined in October and November, resulting in an annual increase in the price index of just over 2 per cent.

Output growth picked up sharply in Hong Kong (China) as tourism recovered, and Singapore experienced another sharp acceleration of growth in 2000. However, in all the NIEs exports began to fall in the course of the year. For example, in Singapore, electronic exports in December were over 11 per cent lower than in December 1999 and exports of semiconductors some 17 per cent lower. Exports to all major markets except Japan and China declined. In Hong Kong (China) consumption has remained weak despite a fall in real interest rates and in the unemployment rate and a stabilization of the property market, and in Taiwan Province of China the revival of domestic demand in the first quarter of 2000 could not be sustained.

In China, economic activity continued to gather momentum in 2000, resulting in a one percentage point increase in output growth over the previous year and reversing the deflationary trend that had been caused by weak domestic demand in recent years. Expansionary policies, strong exports and progress in structural reforms resulted in rapid growth in construction and industry, which more than compensated for a sluggish performance in agriculture. Exports and imports also benefited from a real depreciation of the renminbi and higher export tax rebates. There was also a sharp increase in new FDI commitments, which had been declining for nearly four years. However, given its growing dependence on the United States market, the slowdown in that country is likely to reduce export growth in 2001. Exports and imports may also be affected by the prospect of China's accession to WTO and the implications thereof for the exchange rate. Although export growth is expected to be slower in 2001, the economy should receive a stimulus from current stimulative fiscal and monetary policies. Infrastructure investment, in particular, can be expected to increase, especially in the western provinces.

Prospects for many developing countries in East Asia in 2001 are closely linked to the high-tech cycle in the United States and the movement of their currencies against the dollar and the yen. Growth in the subregion depends to a large extent on external demand for electronics, and would therefore be hit by any deceleration of global demand. The rate of increase in new orders received from the United States for electronic goods had

already declined by half in October 2000. The outlook is for further declines as inventories in the United States continue to increase, and there were clear signs of declining semiconductor prices in early 2001. Additionally, there is still a drag on growth from ongoing financial and corporate sector restructuring. The NIEs are likely to grow at a slower pace in 2001, and Singapore and Taiwan Province of China, in particular, will be affected by weak demand for electronic products. Slower growth in the Republic of Korea will be a reflection, in part, of the continuing problems of the major *chaebols* and the associated risks of further problems arising in the banking sector.

In Malaysia, lower electronics exports may cut the growth rate considerably in 2001. This may require reconsideration of the policy of maintaining a fixed exchange rate, but a lower dollar may alleviate the need to move the peg. Reversing the expectations of deflation and lower growth will require aggressive monetary easing and fiscal stimulus. Growth prospects for Thailand are also dampened by the likelihood of slower export growth in 2001; and the slow pace of debt restructuring and the weakness of the banking sector are also matters of concern in that country. However, with ample room for interest rate reductions and the expectation of a vigorous fiscal stimulus, Thailand is better placed to resist the downturn in the United States than other countries in the subregion. The impact of external shocks remains a threat for Indonesia and the Philippines. Moreover, fiscal positions are a cause for concern in these countries, and much remains still to be done in the area of financial and corporate restructuring. In those two countries prospects are thus fraught with considerable downside risks.

3. Africa

Even more than in other regions, external factors continue to dominate growth and development prospects in Africa. Economic activity in the oil-exporting countries was boosted by the rise in oil prices, which led to significant improvements in fiscal and external balances. The economies of oil-importing countries, however, were severely affected by high oil prices and external financing constraints. In particular, sub-Saharan countries continued to be affected in varying degrees by the fallout from the 1997–1999 emerging-market crises as prices of some of their major non-fuel export commodities remained depressed.

GDP growth in Africa picked up from 2.9 per cent in 1999 to 3.5 per cent in 2000 (table 1.2). In contrast to some recent years, it was the lowest among developing regions and barely kept pace with population growth. Even before the confirmation of the slowdown in the United States, growth forecasts for Africa were being lowered, owing to weaker performance by some of the larger economies, worsening weather conditions and disruptions caused by civil and political unrest.

Growth performance in 2000 varied much among the different subregions.[20] Growth was close to the continental average in Central, East and West Africa, whereas it was higher in North Africa but lower in Southern Africa. Output growth in Botswana, Mozambique, Uganda and the economies of the CFA franc zone was above the African average, but in Angola, the Democratic Republic of the Congo, Ethiopia, Sierra Leone and Zimbabwe it was well below this average.

Among the countries of North Africa, Algeria and the Libyan Arab Jamahiriya benefited from higher oil revenue, which provided a strong boost to growth. In Algeria, however, these benefits were offset, to some extent, by adverse weather conditions, especially poor rainfall, which also seriously affected Morocco and Tunisia. After a decline in 1999, output growth in Morocco is estimated at 0.7 per cent in 2000, despite a decline of 17 per cent in agricultural production, which accounts for some 40 per cent of aggregate output. Agricultural output also fell in Tunisia (by 15 per cent), leading to a reduction of the growth rate from 6.2 per cent in 1999 to 4.2 per cent in 2000. With more favourable weather conditions, both countries may experience faster growth in 2001. In Egypt, growth slowed to less than 4 per cent in 2000, due to a tightening of monetary policy to keep inflation in check. The rapid expansion of domestic credit in recent years and the rise in the real effective exchange rate as a result of a de facto peg to the dollar led to mounting

pressures on the external accounts and a substantial loss of foreign reserves.

Growth in Southern Africa in 2000 was restrained by the continued weakness of the economy of South Africa. While in most countries in the subregion growth continued to be healthy, recovery in the continent's largest economy continued to remain fragile. GDP growth rose to 2.6 per cent in 2000, supported by improved competitiveness and the expansion in global output and trade, but a depreciation of the rand, a surge in food prices after flooding in some areas, together with higher oil prices, led to a build-up of inflationary pressure. In Zimbabwe, the economic crisis continued to deepen and is estimated to have resulted in an output contraction of some 6 per cent in 2000. In Mozambique, where the implementation of the Government's comprehensive reconstruction plan received generous and timely international support, output is estimated to have grown by more than 4 per cent (after 8.8 per cent in 1999), although flooding caused substantial damage early in the year.

Most African economies remain highly vulnerable to changes in prices of primary commodities, and growth continues to be severely constrained by inadequate infrastructure.

The potential for higher growth in East Africa failed to be realized partly on account of policy formulation and implementation and partly because of various adverse shocks. Economic activity in the Democratic Republic of the Congo was adversely affected by war, and in Eritrea and Ethiopia by both drought and war. On the other hand, the United Republic of Tanzania managed to withstand the adverse impact of weak prices for its main exports (coffee and cotton) even though it was hit by food shortages due to the failure of seasonal rains. Kenya, which has been among the slowest-growing economies in Africa in recent years, was also plagued by drought and weak export prices, but the resumption of IMF lending may boost confidence and the inflow of aid. Uganda, a major coffee producer, continued to achieve growth of about 5 per cent, despite a further drop in international coffee prices.

Among the countries in West Africa, Nigeria benefited greatly from rising oil prices, raising its GDP growth by more than 2 percentage points, to 3.5 per cent. The Government has initiated steps to restore macroeconomic stability and improve relations with creditors. Ghana, maintained an output growth above 4 per cent, as it has done consistently since 1995. Countries in Central and West Africa which are members of the CFA franc zone (see also chapter V, box 5.2) have been among the best performers on the continent in recent years. Because their currencies are linked to the euro, some of them have benefited from increased competitiveness due to the euro's weakness vis-à-vis the dollar. However, growth in Côte d'Ivoire is estimated to have continued its downward trend since 1998 as the economy had to contend with weak cocoa prices and a significant slowdown in disbursements of external assistance. Overall, output growth in the CFA franc zone has remained fairly robust and is expected to accelerate in 2001.

For Africa as a whole, the rate of output growth in 2001 is expected to pick up moderately, supported by faster recovery in South Africa. It should remain strong particularly in Cameroon, Ghana, Mozambique, Uganda and the United Republic of Tanzania, which have begun to reap some of the benefits of macroeconomic and structural reforms. Underlying this improvement is the expectation that the terms of trade of commodity exporters will stabilize or improve moderately due to lower oil prices. Recent European and United States initiatives to open up their markets to the poorest economies in Africa as well as bilateral debt reduction accorded by some industrialized countries should bring benefits. In addition, around 80 per cent of debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative concerns economies in sub-Saharan Africa. Presently, nine African countries (Benin, Burkina Faso, Cameroon, Mali, Mauritania, Mozambique, Senegal, Uganda and the United Republic of Tanzania) have already qualified, and several more are expected to reach the completion point in the near future.[21] However, the impact of these international measures will not be felt immediately, and many countries in sub-Saharan

Africa continue to suffer from a debt overhang. Moreover, most African economies remain highly vulnerable to changes in prices of primary commodities, and growth continues to be severely constrained by inadequate infrastructure in transport and communications. Levels of official assistance remain insufficient to fill the resource gap.

D. Transition economies

There was a strong recovery in the transition economies in 2000 (table 1.1) and, on average, the growth rate was the highest since 1989. While domestic demand continued to expand in most countries, the main stimulus was from exports. However, it is too early to judge whether this growth will be sustainable in all cases and whether the process of catching up has really begun. The recovery in 2000 was from a very low base and export prospects are less promising in the light of global conditions. The immediate policy challenges vary for the different economies: some will have to accelerate progress towards a market economy, while others will need to correct macroeconomic imbalances or to cope with adverse shocks.

After the devastating financial crisis in 1998, the Russian Federation had one of the highest rates of growth in 2000, at 7.6 per cent (table 1.3). Due to their strong links with the Russian economy, most of the other CIS countries also posted high growth rates in 2000, with double-digit figures in Kazakhstan and Turkmenistan. Depreciation of the rouble and of the CIS currencies stimulated exports and led to import substitution, all of which boosted industrial output. It thus seems that the business sector in these economies may be much more flexible and able to respond to market signals than commonly believed, even though the process of corporate restructuring has yet to be completed.

Among the central European countries, growth in the Czech Republic, Hungary and Slovenia in the first nine months of 2000 exceeded expectations. Hungary was the fastest growing economy (6 per cent). Industrial output accelerated sharply in the Czech Republic and Slovakia. While initially growing much faster than in 1999, the Polish economy showed some signs of slowing down in the course of the year. Romania also reported positive growth but without clear signs of a breakthrough to sustained expansion, while in Bulgaria output continued to grow for the third successive year. The Baltic States recovered early from the recession of 1999, but growth flagged in the second half of 2000.

For the European transition economies as a whole, exports to the rest of the world increased by one third. Whereas the CIS countries benefited from the boom in commodities, those of Central and Eastern Europe increased their exports of manufactured goods, as did also the Baltic States. Imports also increased everywhere, but in most cases less than exports, resulting in a significant improvement in current-account balances. Substantial terms-of-trade gains in the relatively small group of commodity-exporting CIS countries contrasted with sizeable losses for the net commodity importers, comprising all the Central and Eastern European and Baltic States, as well as a number of CIS countries.

Table 1.3

TRANSITION ECONOMIES: SELECTED ECONOMIC INDICATORS, 1998–2000

	GDP			Consumer prices			Current-account balance		
	Change over previous year[a]								
	(Percentage)						(Percentage of GDP)		
Region/country	*1998*	*1999*	*2000*[b]	*1998*	*1999*	*2000*[c]	*1998*	*1999*	*2000*[d]
Central and Eastern Europe									
of which:									
Bulgaria	3.5	2.4	4.5	0.9	6.2	11.0	-0.5	-5.5	-8.1
Croatia	2.5	-0.4	2.8	5.6	4.6	7.3	-7.0	-7.5	-7.7
Czech Republic	-2.2	-0.8	2.7	6.7	2.5	4.2	-2.4	-1.9	-3.0
Hungary	4.9	4.5	6.0	10.4	11.3	9.2	-4.9	-4.3	-3.6
Poland	4.8	4.1	4.2[e]	8.5	9.9	10.6	-4.3	-7.4	-7.4
Romania	-5.4	-3.2	1.5	40.7	54.9	41.0	-7.2	-3.8	-2.9
Slovakia	4.1	1.9	1.6	5.5	14.2	15.4	-9.7	-5.5	-1.6
Slovenia	3.8	4.9	4.8	6.6	8.1	9.9	-0.8	-3.9	-2.7
Baltic States									
of which:									
Estonia	4.7	-1.1	5.5	6.8	3.9	3.0	-9.2	-5.7	-5.5
Latvia	3.9	0.1	4.5[f]	2.8	3.3	2.6	-10.7	-10.3	-5.6
Lithuania	5.1	-4.2	2.1	2.4	0.3	1.3	-12.1	-11.2	-4.2
CIS									
of which:									
Belarus	8.4	3.4	2.5[g]	181.6	251.3	190.7	-7.6	-2.4	-3.3
Russian Federation	-4.9	3.2	7.6[e]	84.5	36.6	20.2	0.4	13.7	22.2
Ukraine	-1.9	-0.4	6.0[e]	20.0	19.2	30.3	-3.2	2.8	1.5

Source: ECE (2000, tables 1.2.1 and 1.2.2) and subsequent updates.
a For consumer prices change from December to December unless otherwise indicated.
b October official forecast unless otherwise indicated.
c June 1999 to June 2000.
d January–June.
e Preliminary estimates.
f 4–5 per cent.
g 2–3 per cent.

The strong performance of most of the transition economies was accompanied by increased inflationary pressures. Despite sharply rising productivity and a predominantly export-driven recovery, consumer prices generally rose faster than expected, mostly on account of soaring prices for fuel. In some cases, the resurgence of inflation spurred a tightening of monetary policy. The rise in fuel prices threatened export competitiveness, since there is still a relatively high energy intensity of output in the transition economies. So far this adverse effect has been more than offset by productivity gains, but if productivity growth slows down and nominal wages are increased to offset past inflation, exports could be adversely affected.

The fiscal position has been better than expected in most transition economies, not only due to the strength of the recovery but also because of windfall gains related to price-sensitive revenue items such as duties and excise taxes. In most countries, the recovery has not led to a significant increase in employment, which suggests that there was slack to be taken up and also that there has been a further deepening of the process of economic restructuring. Indeed, unemployment rates in several countries have increased or remained high.

The factors that were favourable to growth in the transition economies in the last two years are not in place in 2001.

The factors that were favourable to growth in the last two years are not in place in 2001. World trade expansion is slowing, the stimulating effect of currency depreciations in the aftermath of the Russian crisis is fading away and commodity prices have peaked. The stimulus to continued growth will thus have to come from domestic demand. The task will be all the more difficult as inflation was on the rise in 2000. Several transition economies are determined to achieve the conditions necessary for association with, or even accession to, the European Union, to which end they may be obliged to take strong measures, in particular a restrictive monetary policy to combat the inflationary tendencies. However, such measures would aggravate the employment situation, which is particularly serious in south-east Europe, where unemployment already exceeds 20 per cent of the labour force in a number of countries. ■

Notes

1 At the end of September 2000, the International Monetary Fund (IMF) revised its growth estimates upwards because: "The global economic expansion has continued to gain strength, with global output growth now projected at 4.7 per cent in 2000, 0.5 percentage points higher than expected in the May *World Economic Outlook* … Growth is projected to increase in all major regions of the world, led by the continued strength of the United States economy; the robust upswing in Europe; the consolidation of the recovery in Asia; and a rebound from last year's slowdowns in emerging markets in Latin America and the Middle East and Europe" (IMF, 2000a: 1).

2 The proposed tax cuts reflect the policies of the new Administration and their primary purpose is not the short-term stabilization of domestic demand. Hence they may not be reversed in response to a macroeconomic need. If the optimists are proved right, the impact will be felt just when the economy is again growing at its potential, forcing a sharp tightening of monetary policy. This potential inconsistency between fiscal and monetary stances raises familiar concerns for the rest of the world, particularly developing countries. Furthermore, to the extent that the increase in disposable income resulting from tax cuts is spent on consumer goods rather than saved, aggregate domestic savings would be reduced with the effect of aggravating external imbalances.

3 Speech by ECB Governing Council member and Deutsche Bundesbank President, Ernst Welteke, at the University of Hohenheim, 23 January 2001, reported in *Market News International.* The reluctance to revise its estimate of potential growth is based on the view that: "on all the available evidence we cannot as yet conclude that a decisive shift in the

trend rate of productivity growth is discernible" (W. Duisenberg, ECB Press Conference, 14 December 2000).

4 In 1999, non-resident companies spent $283 billion to acquire or establish businesses in the United States, up sharply from $215 billion in 1998 and $70 billion in 1997 (Zeile, 2000: 141). Of Europe's $425.5 billion worth of FDI outflows in 1999, $235 billion were directed to the United States (UNCTAD, 2000a, annex tables B1 and B2; Zeile, 2000, table 16).

5 Indeed, since non-repatriated profits of foreign-owned affiliates are counted as FDI inflows into the United States, a decline in sales there would reduce recorded FDI inflows and may lead to decisions to repatriate more profits, thereby increasing downward pressure on the dollar.

6 Since 1997 the share of cross-border M&As financed by stock swaps rather than cash has increased dramatically. For developed countries as a whole, less than 10 per cent were financed by stock swaps in 1997, but the share rose to 31 per cent in 1998 and reached 40 per cent in 1999. For the United States, it is estimated that roughly half of all inward M&As have not involved direct acquisition of dollar assets with foreign currency, but have been financed by means of stock swaps, and that much of the remaining M&As have been financed by borrowing in the United States. Thus the European M&A boom in the United States after 1997 may have had a smaller direct impact on the foreign exchange market than is commonly supposed. Nonetheless, there may be indirect portfolio effects, since stock swaps increase the foreign currency denomination of assets in United States investors' portfolios. If United States investors were to sell their foreign equity, repatriate the proceeds and invest in dollar-denominated securities, the demand for dollars would increase in much the same way as a direct purchase.

7 The extent of the region's dependence on United States growth is reflected in the share of its exports to the United States. They account for more than 20 per cent of GDP in Malaysia, Singapore and Hong Kong (China), more than 10 per cent in the Philippines and Taiwan Province of China, and 7 per cent in the Republic of Korea.

8 As a result of the new productivity performance and the absence of any wage or price reactions to tight labour markets, the Federal Reserve now appears to accept that the natural growth rate is above the 2.0–2.5 per cent commonly cited in the first half of the decade, although it has not explicitly endorsed a specific target. The latest *Economic Report of the President* estimates a potential growth rate of 3.8 per cent.

9 ICT investment includes business outlays for computers and peripherals, software, communications gear, instruments, photocopying equipment and office equipment. The first three categories account for 88 per cent of the total, while software alone accounts for 43 per cent. Expenditures on communications equipment are only half as important as those on software.

10 Since the United States investment boom was driven primarily by companies attempting to exploit new technological advances to create new markets, it differs from the late 1980s investment boom in Japan and the early 1990s boom in the Republic of Korea, both of which were driven primarily by expanding capacity in existing lines of business or by the entry of new competitors into existing lines.

11 The Conference Board index at year-end was about 11 per cent lower than its peak in May 2000, and the University of Michigan index was about 12 per cent below its peak of January 2000. The declines in these two indices have been especially noticeable since both had previously been at historically high levels for extended periods. The University of Michigan index dropped sharply from December 2000 to January 2001.

12 Confidence indicators in the major EU economies have been in decline since early in the third quarter. The German IFO index of future expectations has declined since October 2000, and that of the overall business climate in industry had already been in decline since May 2000; the French INSEE indicator, which had peaked in July at 40, fell to 17 in January 2001. The Italian ISAE index fell from 40 in January 2000 to 18 in November 2000 and even further in December 2000.

13 See Credit Suisse/First Boston, *Euro Area Weekly*, 12 January 2001.

14 Domestic demand seems to have played a more important role in the strong growth performance of some smaller European economies in the second half of the 1990s than in the larger economies.

15 Nominal interest rates adjusted for core inflation.

16 However, since Japan is still suffering from deflation, the estimated real growth is slightly higher.

17 Over 40 per cent of Japanese exports are to Asia and over 25 per cent to the United States. Exports to EU are less than 20 per cent and are probably more sensitive to exchange rate changes. Consequently, they should improve with a recovery of the euro relative to the yen.

18 Although the December Tankan survey revised second half profits downwards and excess capacity figures rose.

19 The Central Bank appears to take the view that, to the extent that higher interest rates create pressure for restructuring, they will through increased efficiency lead to lower prices and deflation. However, a Bank of Japan study (6 October 1999: 56, box E) finds that: "data do not show evidence that techno-

logical innovation increases the number of industries that make profits while decreasing their prices even more in Japan".

20 The subregions distinguished in this subsection are as defined by the United Nations Economic Commission for Africa: (1) *Central Africa* (Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon; Sao Tome and Principe); (2) *East Africa* (Burundi, Comoros, Democratic Republic of the Congo, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Seychelles, Somalia, Rwanda, Uganda and United Republic of Tanzania); (3) *North Africa* (Algeria, Egypt, Libyan Arab Jamahiriya, Mauritania, Morocco, Sudan and Tunisia); (4) *Southern Africa* (Angola, Botswana, Lesotho, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Zambia and Zimbabwe); and (5) *West Africa* (Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone and Togo). North Africa and Southern Africa account respectively for about 40 per cent and 35 per cent of African output, while the shares of West Africa, East Africa and Central Africa were 14 per cent, 7 per cent and 4 per cent, respectively.

21 Potential qualifiers include Chad, Ethiopia, Gambia, Guinea, Guinea-Bissau, Madagascar, Malawi, Niger, Rwanda, Sao Tome and Principe, and Zambia.

Chapter II

INTERNATIONAL TRADE AND FINANCE

A. Recent developments in international trade

After the Asian financial crisis world trade went through a period of slow growth in 1998 and 1999 (table 2.1); this phase ended in 2000. Estimates available at the beginning of 2001 indicate that world trade in 2000 grew at around twice the rate for 1999 and considerably faster than world output (table 2.2).[1] The resilience of the United States economy, a pick-up in economic activity in the EU and Japan, stronger than expected recovery in Latin America and the transition economies, and sustained growth in Asia all helped to stimulate trade. The prolonged period of boom in the United States has left its mark on the global trading system. Already in 1999, the United States economy accounted for an unprecedented 18.5 per cent of global imports in value terms and the proportion in 2000 was even higher (see WTO, 2000, tables III.1 and III.2). In 2001 world trade expansion is expected to moderate, due to the slowdown in world industrial production and more stable oil prices.

All major regions recorded an expansion in trade volumes in 2000, but it was particularly marked in the developing and, according to some estimates, transition economies (table 2.2). For the developing countries as a group, the volume of imports is estimated to have increased by more than 11 per cent in 2000, compared to less than 6 per cent in 1999 and a decline in 1998. In Latin America and in the transition economies, imports had declined in 1999 but are estimated to have grown by more than 10 per cent in 2000. In Asia, imports continued to grow, in some cases even more rapidly than they had in 1999. Growth in the volume of imports accelerated sharply in Hong Kong (China) and Taiwan Province of China, but was slower in Singapore and the Republic of Korea. Among the ASEAN-4, the volume of imports grew faster than in 1999 in Indonesia and the Philippines but slower in Malaysia and Thailand. China again registered strong growth in import volumes in 2000, exceeding even the 26 per cent of the previous year. In Africa, which has been less affected by the recent volatility in global markets, imports grew, but at a slower rate than in other developing regions.

Import growth accelerated also in the developed countries in 2000, albeit at a slower rate than in the developing countries for the first time since 1997. Imports into the United States again grew

Table 2.1

EXPORTS AND IMPORTS BY REGION AND ECONOMIC GROUPING, 1997–1999

(Percentage change over previous year)

	Export value			*Export volume*		
Region/economic grouping	*1997*	*1998*	*1999*	*1997*	*1998*	*1999*
World	3.5	-1.6	3.5	10.7	5.0	4.8
Developed market-economy countries	2.0	0.8	1.7	10.0	4.6	4.3
of which:						
Japan	2.4	-7.8	8.1	11.8	-1.3	2.1
United States	10.2	-0.9	1.9	11.9	2.3	4.3
European Union	-0.5	4.0	-1.0	9.4	6.3	3.7
Transition economies	4.2	-4.7	-0.6	10.4	5.1	-1.7
Developing countries	7.0	-6.9	8.7	12.5	5.6	7.1
of which:						
Africa	2.0	-15.9	8.7	6.7	-1.8	3.8
Latin America	10.6	-1.3	6.4	11.7	7.6	7.5
Middle East	4.7	-22.5	23.6	12.6	6.9	-3.0
Asia	7.2	-4.5	7.5	13.6	5.3	10.1
of which:						
Newly industrializing economies [a]	3.5	-7.5	5.3	11.6	3.8	7.0
ASEAN-4 [b]	5.1	-4.0	10.7	12.2	10.7	13.1
China	21.1	0.4	6.3	20.6	3.5	15.5
Memo item:						
ASEAN-4 plus Republic of Korea	5.0	-3.5	10.2	18.0	13.7	12.6

	Import value			*Import volume*		
Region/economic grouping	*1997*	*1998*	*1999*	*1997*	*1998*	*1999*
World	3.5	-0.9	4.0	9.9	4.3	6.0
Developed market-economy countries	2.3	3.1	4.9	9.4	7.7	7.0
of which:						
Japan	-3.0	-17.2	11.0	1.7	-5.3	9.5
United States	9.4	5.0	12.2	12.1	11.7	11.3
European Union	-0.3	5.9	0.8	8.9	8.3	4.2
Transition economies	6.5	-1.8	-11.6	13.7	4.7	-8.8
Developing countries	6.1	-10.2	4.2	10.5	-3.8	5.6
of which:						
Africa	5.7	1.2	0.0	10.0	5.2	-2.0
Latin America	18.2	5.0	-3.0	21.4	8.6	-1.0
Middle East	8.1	-3.2	2.6	10.8	-3.8	1.7
Asia	2.2	-18.5	8.9	7.3	-10.6	12.1
of which:						
Newly industrializing economies [a]	3.4	-19.5	7.3	7.4	-10.0	8.2
ASEAN-4 [b]	-2.4	-27.9	7.3	4.9	-23.1	9.2
China	2.4	-1.3	18.2	5.4	2.5	25.7
Memo item:						
ASEAN-4 plus Republic of Korea	-3.0	-30.9	15.0	3.5	-22.2	16.4

Source: UNCTAD secretariat calculations, based on statistics of WTO.

a Hong Kong (China), Republic of Korea, Singapore and Taiwan Province of China.

b Indonesia, Malaysia, Philippines and Thailand.

Table 2.2

EXPORTS AND IMPORTS BY REGION AND ECONOMIC GROUPING, 2000: ESTIMATES BY VARIOUS INSTITUTIONS

(Percentage change over previous year)

	Export value		Export volume		
Region/economic grouping	*IMF*	*UN*	*IMF*	*OECD*	*UN*
World	9.9	.	10.4[a]	13.3[a]	10.6
Developed market-economy countries	.	.	10.2[b]	12.9	10.2
of which:					
Japan	.	.	9.7[c]	12.5	8.6
United States	.	.	8.8[c]	12.6	10.6[d]
European Union	.	.	9.5[c]	12.6	10.8[e]
Transition economies	.	28.4[f]	.	.	8.3 (15.8[f])
Developing countries	20.4	.	10.3	.	11.9
of which:					
Africa	25.6	.	6.6	.	4.7
Latin America	17.9	20.5[g]	10.8	.	6.4 (4.2[g])
Asia	14.0	.	10.9	.	.
of which:					
East and South Asia	.	.	.	.	13.5
China	.	.	.	.	21.6

	Import value		Import volume		
Region/economic grouping	*IMF*	*UN*	*IMF*	*OECD*	*UN*
World	.	.	10.4[a]	13.3[a]	10.8
Developed market-economy countries	.	.	10.4[b]	12.7	8.8
of which:					
Japan	.	.	6.8[c]	11.5	6.4
United States	.	.	13.0[c]	14.5	13.1[d]
European Union	.	.	8.7[c]	11.0	6.8[e]
Transition economies	.	13.2[f]	.	.	11.8 (17.0[f])
Developing countries	15.1	.	11.2	.	15.7
of which:					
Africa	9.0	.	6.2	.	7.1
Latin America	13.9	17.5[g]	14.4		9.2 (12.3[g])
Asia	17.3	.	13.2	.	.
of which:					
East and South Asia	.	.	.	.	15.1
China	.	.	.	.	45.3

Source: IMF (2000a); OECD (2000a); UN/DESA-UNCTAD (2001).
a Average of annual percentage change for world exports and imports.
b Including NIEs.
c Including services.
d North America.
e Western Europe.
f ECE (January to September).
g ECLAC.

faster than those into other developed economies; on some estimates they expanded by more than 14 per cent in 2000. The continued role of the United States as a buyer of last resort for the rest of the world underpinned the strong performance of world trade in 2000. But import demand also picked up quite significantly in some of the larger EU countries, despite the weakness of the euro; overall import growth for the euro zone is estimated to have exceeded 10 per cent in 2000. Japan, although failing to match growth in either the United States or Europe, also had an accelerated growth in its import volume in 2000, in part due to a rebound in investment spending, especially on equipment related to information and communication technology.

The strong expansion in global import demand in 2000 was accompanied by a correspondingly robust overall global export performance.[2] A particularly rapid turnaround was registered in terms of export volume growth in the Middle East and in the transition economies. For the latter, this is partly attributable to the increasingly closer ties with western Europe (particularly Germany), where output growth picked up in 2000. The strong rise in export volume in the Russian Federation was also due to higher demand for its commodities, notably oil and metals. Higher export growth to other regions continued to power recovery in Asia and in parts of Latin America, aided by currency depreciations. For Asian economies, an additional factor was the revival of intraregional trade, which also contributed to the fast growth of Chinese exports.[3] Similarly, the expansion in export volume in Mexico owes much to its strong links to the United States economy. The exceptions to this trend are those countries, mainly in Africa and Latin America, whose exports are highly concentrated in a small number of non-oil primary commodities. The problems faced by these countries have been compounded by stagnant or declining world prices.

An acceleration in export volume in 2000 is also discernible in developed countries, particularly in the euro zone, which benefited from the competitive edge given by the weakness of the euro. Double-digit export growth in some of the larger European economies, such as France and Germany, is particularly notable. Strong export growth also helped to revive the Japanese economy in 2000.

The trade imbalances among major economic regions that had been building up in recent years, due to significant growth differentials between the United States and other developed economies and to the strong dollar, increased further in 2000. While the United States trade deficit reached a record high, close to 4 per cent of GDP,[4] there was little change in the overall trade surpluses of Japan and the European Union despite considerably higher oil import bills. Oil-exporting developing countries and several transition economies, notably the Russian Federation, registered increasing trade surpluses.

For 2001, growth in overall import demand is expected to be lower than in 2000 owing to the economic slowdown in the United States and in some countries which have recently experienced a rapid recovery. The level of private capital inflows is likely to limit increases in the import capacity of a number of developing countries, particularly in Latin America.

B. Non-oil commodity markets

In 2000, world non-oil commodity prices recovered slightly from sharp declines in 1998 and 1999. Although the overall increase of almost 2 per cent was the first positive growth in five years (table 2.3), prices remained well below 1996–1997 levels. Faster growth in all the major economic regions resulted in increases in demand for a large number of commodities, leading to lower stock levels and higher prices in some cases. These increases were sufficient to offset acute declines in the prices of certain key commodities, notably coffee, cocoa and rice. The combined adverse effects of the persistent weakening of some non-oil commodity prices, on the one hand, and the increase in oil prices, on the other, generated severe balance-of-payments problems and welfare losses for oil-importing developing countries heavily dependent on the production and export of a few commodities.

Thus, underlying the overall improvement in prices are sharply divergent trends among various commodity groups. The lingering effects of the decline in demand during 1998–1999 have left producers and exporters of a number of commodities – including coffee, cocoa, rice and tropical logs – with a large stock overhang that needs to be significantly reduced further before prices can begin to recover. For some commodities, particularly nickel and zinc, the fall in stocks which began in late 1999 continued throughout 2000, as a result of strong demand. Changes in the stock levels of agricultural commodities, on the other hand, have been mixed.

Prices of minerals, ores and metals as a group increased by 12 per cent in 2000 from the low of the previous year, on account of nickel, copper, aluminium and tungsten. Nevertheless, prices for all metals, except nickel, remained below their 1996–1997 average. The marked rebound in prices of base metals and some other industrial raw materials is the outcome of strong demand, cutbacks in production and a reduction in inventories. Aluminium prices, which began to recover in 1999 after marked declines in 1998 and early 1999, rose by 14 per cent in 2000 in spite of large stocks and rising production. Copper prices increased by more than 15 per cent because of strong demand, which reduced the large overhang in inventories built up during 1997–1999. Nickel prices rose by 44 per cent, following an increase of 30 per cent in 1999, largely because of strong demand created by a rapid growth in steel production. With demand growth outstripping supply, nickel stocks declined significantly, falling to their lowest levels in many years. Iron ore and zinc prices have increased moderately, while tin and phosphate rock prices remained relatively unchanged. For the fourth consecutive year, lead prices continued to fall, owing to large inventories and weak demand.

Changes in the prices of agricultural commodities in 2000 showed large variations, reflecting significant changes in the balance of supply and demand as well as changes in stock levels. Prices of key agricultural products remained weak owing to continued production increases and large inventories. Continued high output of commodities such as coffee, cocoa and rice resulted in a further build-up of stocks and exerted further downward pressure on prices. Coffee prices continued to fall sharply in 2000, after a cumulative decline of 45 per cent over the two preceding years also due, in part, to weak demand, particularly in Europe and the United States. But a significant increase in coffee pro-

Table 2.3

WORLD PRIMARY COMMODITY PRICES, 1996–2000

(Percentage change over previous year)

Commodity group	*1996*	*1997*	*1998*	*1999*	*2000*
All commodities [a]	**-4.2**	**0.0**	**-13.0**	**-14.2**	**1.9**
Food and tropical beverages	**2.1**	**2.8**	**-14.3**	**-18.3**	**1.0**
Tropical beverages	-15.2	33.3	-17.3	-20.9	-13.2
Coffee	-19.1	54.7	-28.5	-23.2	-16.2
Cocoa	1.2	11.2	3.7	-32.1	-22.2
Tea [b]	...	35.1	4.3	-7.0	6.8
Food	6.8	-3.5	-13.8	-18.1	5.9
Sugar	-9.9	-4.9	-21.2	-30.0	30.5
Beef	-6.4	4.0	-7.0	6.1	5.7
Maize	25.0	-25.3	-13.4	-5.5	-1.0
Wheat	16.2	-22.6	-19.9	-10.9	3.5
Rice	5.0	-10.7	1.3	-18.6	-18.1
Bananas	7.5	4.3	-3.1	-9.9	-2.3
Vegetable oilseeds and oils	**-4.2**	**-0.9**	**7.1**	**-23.3**	**-22.8**
Agricultural raw materials	**-9.9**	**-10.3**	**-10.8**	**-10.3**	**-1.0**
Hides and skins	-23.7	-19.8	-22.7	-27.6	73.8
Cotton	-14.8	-8.9	-8.3	-22.9	3.5
Tobacco	15.6	15.6	-5.5	-7.0	-3.4
Rubber	-11.9	-28.3	-29.8	-12.6	7.9
Tropical logs	-20.1	-5.5	-1.2	-7.2	-4.3
Minerals, ores and metals	**-12.1**	**0.0**	**-16.0**	**-1.8**	**12.0**
Aluminium	-16.6	6.2	-15.1	0.3	13.8
Phosphate rock	8.6	7.9	2.4	4.6	0.2
Iron ore	6.0	1.1	2.8	-9.2	2.6
Tin	-0.8	-8.4	-1.9	-2.5	0.6
Copper	-21.8	-0.8	-27.3	-4.9	15.3
Nickel	-8.8	-7.6	-33.2	29.8	43.7
Tungsten ore	-17.9	-9.3	-6.4	-9.3	12.1
Lead	22.7	-19.4	-15.3	-5.0	-9.7
Zinc	-0.6	28.4	-22.2	5.1	4.8

Source: UNCTAD, *Monthly Commodity Price Bulletin,* various issues.
a Excluding crude petroleum.
b New series, with data starting in 1996.

duction in Viet Nam, which became the world's second largest coffee exporter after Brazil, also contributed to the downward trend in coffee prices. Despite an increase in demand, cocoa prices reached a record low in 2000 because of a large oversupply which led to a further build-up of stocks. The 7 per cent increase in the price of tea offset the decline experienced in 1999, and was due primarily to a reduction in supply volumes, particularly from Kenya and India.

The 6 per cent rise in food prices in 2000 was the first increase since 1996, reflecting a sharp recovery in sugar prices, which rose more than

expected because of a large drawdown in stocks. Wheat prices recovered slightly but remained well below their 1996 levels, while rice prices fell by about 18 per cent. Surplus production capacities in major exporting countries have led to depressed price levels of rice over the past few years. Vegetable oilseeds and oils also remained depressed, dropping by 23 per cent in 2000 following a fall of similar magnitude in 1999.

For 2001, changes in the prices of non-oil commodities will continue to be mixed among individual commodities and commodity groups. On the whole, most commodity markets can be expected to remain weak; short-term prospects are clouded by considerable uncertainties associated with the performance of the United States economy and the impact of a slowdown there on the rest of the world.

C. Recent developments and emerging trends in oil markets

1. Prices, supply and demand

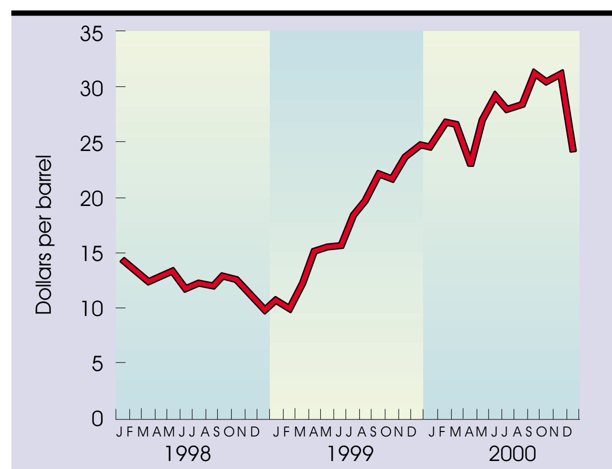
The annual average price of crude oil increased by 58 per cent to $27.6 a barrel in 2000, the highest level since 1985, and monthly average oil prices reached a peak of $31.5 a barrel in September 2000[5] (chart 2.1). Throughout 1998 and early 1999 oil prices had fallen, hitting a low of about $10 a barrel, due largely to the Asian economic crisis, which had greatly reduced global oil demand.[6] In an effort to reverse the price decline, members of the Organization of the Petroleum Exporting Countries (OPEC) and some non-OPEC oil exporters (Mexico, Norway, Oman and the Russian Federation) jointly cut oil production by over 2 million barrels per day (bpd) in April 1999. The implementation of these supply cutbacks coincided with a revival of demand associated with economic recovery in East Asia and continued high rates of growth in the United States. The overall outcome was a large drawdown in world oil stocks, while prices tripled from February 1999 to February 2000.

As the price hikes began to be felt in many oil-importing countries, OPEC increased its production quota by 1.7 million bpd in April 2000 and informally adopted a production scheme aimed at keeping the oil price per barrel within the $22–28 range (see *TDR 2000*, chap. III, sect. C). Thus, as prices rose above the $28 limit, OPEC

Chart 2.1

MONTHLY AVERAGE SPOT PRICES OF OPEC CRUDE OILS, 1998–2000

(Dollars per barrel)



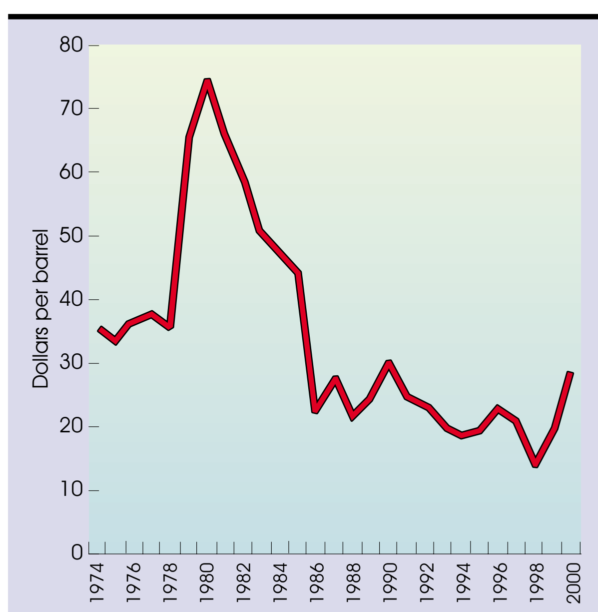
Source: OPEC, *Monthly Oil Market Report,* various issues.

raised its production target in July and October by a total of 3.2 million bpd. Prices reached a peak in September and again in November 2000, as traders continued to worry about the decline in stocks of crude oil, particularly in the United States. However, prices dropped sharply in December 2000, to their lowest level in eight months. Fears of a collapse in prices replaced concerns over high prices. In an effort to prevent a price slide below its target price band amid concerns of slowing oil demand growth, particularly in the United States, OPEC cut production quotas of members, on a pro rata basis, by 1.5 million bpd as of February 2001.

Chart 2.2

REAL OIL PRICES, 1974–2000

(Dollars per barrel[a])



Source: UNCTAD secretariat calculations, based on data from BP Amoco, *Statistical Review of World Energy 2000,* and United States Department of Labor (www.stls.frb.org/fred/data/cpi).

a Prices in current dollars have been deflated by the United States consumer price index with the base year 2000.

2. *Impact of the increase in oil prices*

It is commonly believed that higher oil prices depress global economic activity. The negative real income effect of an oil price hike is considered similar to a tax or levy on the real income of private households and companies in oil-importing countries, reducing global demand. However, this view takes into account only the negative effects on consumers in the western world, ignoring the positive effect on oil producers. Any rise in the price of oil which is not fully compensated by a fall in the quantity traded brings about a redistribution of real income from consumers to producers. This redistribution is likely to change the structure of demand for goods on the world market but does not necessarily reduce aggregate global demand and activity.

In any event, even the direct impact of the recent oil price increase on the industrialized oil-importing countries has been much less severe than the increases in 1973 and 1979–1980 for various reasons. Economic activity in the industrialized countries is much less oil-intensive than it was 20 or 30 years ago, and despite the recent sharp increase in nominal terms, oil prices are still relatively low in real terms, with the average real price of a barrel of oil in 2000 being about one third of that in 1980, and 20 per cent lower than in 1974 (chart 2.2). The importance of oil in trade has thus declined considerably in the past two decades, and so has the potential impact of oil prices on inflation in the industrialized countries. Since February 1999, in spite of a nearly threefold increase in crude oil prices, end-use prices in most industrialized countries increased by only about 30 per cent, causing a rise in the overall consumer price index in the order of 0.5 percentage points in both 1999 and 2000 (OECD, 2000a, tables I.8 and I.9).

Nevertheless, the oil price increases in 2000 sparked a wide-ranging debate in major oil-consuming countries on issues relating to oil prices, oil taxation and oil security. The United States Government decided to release some of its strategic reserves, normally earmarked for major emergencies. And some European Governments granted compensation to certain groups, in response to a consumer rebellion against high pump prices. Oil-exporting countries, particularly members of OPEC, have often been held responsible for allegedly high prices of petrol and heating oil.

Table 2.4

G-7 COUNTRIES: AVERAGE PUMP PRICES OF GASOLINE[a] AND REVENUES FROM TAXES ON OIL PRODUCTS[b]

Country	Price	Tax	Taxes	Revenue from taxes on oil products, 1999
	($ per litre)		(Percentage of total price)	($ billion)
United Kingdom	1.15	0.85	73.7	59.6
Japan	1.02	0.55	53.6	79.0
Italy	0.96	0.61	63.4	47.9
France	0.94	0.64	68.0	53.2
Germany	0.90	0.61	67.4	58.2
Canada	0.49	0.42	40.8	14.8
United States	0.41	0.10	24.8	95.7

Source: UNCTAD secretariat calculations, based on International Energy Agency, *Monthly Market Report,* 11 December 2000.
a Average prices in November 2000.
b 1999.

However, consumer prices have risen even during periods of declining prices for crude oil, mainly because of the impact of taxation of fuel consumption in the industrialized countries, particularly in Europe (table 2.4). Gasoline taxes in the EU, for example, on average amount to some 68 per cent of the final price, with the remaining 32 per cent equally distributed between industry margin (i.e. refiners and traders) and oil-exporting countries. In 1999, fuel taxes yielded a revenue of nearly $358 billion in the G-7 countries, an amount almost double that earned by OPEC members from their exports of crude oil.

For the developed countries, rising oil prices in 1999 and 2000 represented an additional import cost of less than 0.5 per cent of GDP, but they also encouraged higher exports to oil-producing countries. Given their different export structure, oil-importing developing countries typically receive much less benefits from any additional demand from oil exporters. As oil use per unit of output is higher in developing than in developed countries, the overall impact of the oil price rise since 1999 has been much more severe in the former.

Indeed, for many developing countries the impact was stronger than that of the oil-price rises in the 1970s and early 1980s as their efforts to industrialize and build their manufacturing industries have increased their dependence on modern fuels; their use of motor vehicles has also increased considerably. As a result, they have become more oil-intensive over time, using almost twice as much oil as developed countries per unit of output. According to one recent estimate, the implied terms-of-trade loss due to the recent price rise in oil has amounted to 1.4–2.0 per cent of GDP for countries in South-East Asia, around 1 per cent for India and South Africa, and 0.5 per cent for Brazil (OECD, 2000a: 15).

Oil import bills of the oil-importing developing countries rose by about $21 billion in 1999 and by another $43 billion in 2000 (table 2.5). As oil generally accounts for a large share of their total imports, their current-account balance deteriorated considerably, by more than 1 per cent of GDP in 2000 alone. Such an effect is likely to have severe consequences for growth and living standards in many instances. For the oil-importing countries of Africa, many of which are LDCs, the

Table 2.5

OIL IMPORT BILLS OF OIL-IMPORTING COUNTRIES, 1998–2000

(Billions of dollars)

Country/region	*1998*	*1999*	*2000*
United States	47.3	67.2	106.3
Japan	23.5	34.0	53.6
Western Europe	45.2	63.3	99.5
Central Europe	5.0	7.2	11.4
Developing countries	52.1	72.8	116.1
Africa	5.0	7.0	11.0
Asia	41.6	58.3	91.6
Latin America	5.5	8.5	13.5

Source: UNCTAD secretariat calculations.

combined increase in the oil import bill over the past two years amounted to about $6 billion, or 2 per cent of their GDP. Given their external financing constraints and inability to achieve offsetting export growth, many of them were forced to reduce their imports of other goods.

On the other hand, the hike in oil prices has alleviated balance-of-payments and budget constraints in many of the oil-exporting developing countries that had suffered severe terms-of-trade losses in 1998. The oil export revenues of OPEC members doubled from 1998 to 2000, reaching their highest level since 1981.

3. Prospects

The outlook for oil prices depends to a large extent on the production policies of OPEC. With the exception of Kuwait, Saudi Arabia, and the United Arab Emirates, whose combined spare production capacity is estimated to be about 3–4 million bpd, all other countries have been producing at full capacity. The major market uncertainty relates to oil exports from Iraq. On the demand side, a key determinant will be GDP growth and energy policies in the major industrial countries. Over the next 12 months, world demand for oil is expected to ease, depending on the extent of the slowdown in the United States and its impact on world economic activity. Oil stocks have increased but remain at relatively low levels, and this will continue to contribute to market fragility and price volatility. However, in the absence of any serious disruptions in supply, average oil prices in 2001 may fall to below $20 a barrel.

Over the medium to long term, oil prices will largely be determined by the development of new production capacities and alternative energies. Apart from providing 40 per cent of global oil supplies, OPEC members account for some 78 per cent of the world’s proven crude oil reserves. Most of these known reserves are characterized by low development and operating costs and can be exploited fairly rapidly.

Investment in exploration and production has generally increased in response to the rise in prices, but the bulk of any new production capacity will not come on-stream until after 2001. In particular, international oil companies and other independent producers have been investing in new oil exploration and development ventures which are likely to increase non-OPEC supply capacity substantially. Production increases are expected not only from the Russian Federation and the Central Asian oil exporters, but also from countries in Latin America, Africa and the Middle East. Moreover, technological advances have reduced the cost of exploration and production by nearly one half over the past decade, and have also made it possible for oil companies to explore in new frontier areas, particularly offshore, and to discover oil more easily than ever before. On the other hand, the recent increase in oil prices has, once again, renewed interest in energy conservation, alternative sources of energy and new fuel technologies, such as hybrid engines and hydrogen fuel-cells, so that oil, while remaining a major source of energy, may lose further in importance for economic activity.

D. Currency markets and selected financial indicators in emerging markets

In its discussion of developments in international financial markets during the early part of 2000, *TDR 2000* noted the especially high level of uncertainty attaching to any prognosis. The second half of the year was indeed marked by crises and financial support packages for Argentina (box 2.1) and Turkey (box 2.2), as well as by movements of financial indicators, such as increases in yield spreads on the international bonds of some developing countries, pointing to perceptions of increased risk. But elsewhere in emerging markets, shifts in monetary conditions and pressures on exchange rates were generally more gradual or largely absent (except during brief periods of political unrest in some countries). However, the year was also notable for sharp falls in equity prices.

In Asia there have been few major changes since early 2000 in exchange-rate policy or regimes of exchange control, but in Latin America there has been a trend towards full dollarization. The range of currency regimes in developing and transition economies thus continues to span the spectrum from rigid pegs (in Argentina and Hong Kong (China)) and outright dollarization (in Ecuador and El Salvador) to various types of floating. Several countries have adopted freer floats since 1997, while in some cases retaining the discretion to intervene in the market for their currencies in certain circumstances, such as to maintain orderly conditions or to avoid sudden depreciations or appreciations.[7] Venezuela has maintained its moving band under which the spot rate for the dollar is allowed to fluctuate within a range of 7.5 per cent on either side of an adjustable central rate. Malaysia has maintained a fixed exchange rate of the ringgit with the dollar since September 1998. In Indonesia in January 2001, in order to reduce volatility of the rupiah and given the danger of further destabilization of a still vulnerable financial sector, the Government introduced a package of restrictions on selected capital transactions with non-residents (foreign persons and firms and Indonesian entities abroad), which took the form of ceilings on derivatives transactions, and of prohibition on borrowing, lending and investment, likely to affect the exchange rate.

Ecuador adopted a scheme of dollarization in March 2000, and El Salvador in January 2001. In Ecuador, the dollar became legal tender, but the national currency (fully backed by dollars) remained in circulation to facilitate small transactions. A major objective of such a step is to bring interest rates down towards United States levels. However, this process may be slowed by increased credit and political risk stemming from price changes associated with adjustments to the exchange rate at which dollars are substituted for the national currency and by associated disruptions of output and employment. So far, short-term interest rates in Ecuador have fallen substantially, but those with longer maturities remain greatly in excess of dollar rates.

Amongst major financial indicators there was a dramatic change of direction during 2000 in indices of equity prices in emerging markets (chart 2.3). After rises of more than 50 per cent in indices for all major regions in 1999, there were sharp falls in 2000, the decline being largest in Asia. While these declines were partly fuelled by increased economic uncertainty and a less favour-

Box 2.1

EXTERNAL SHOCKS, ADJUSTMENT AND CRISIS IN ARGENTINA

Despite substantial efforts by the new Government to implement an economic programme announced in December 1999 and supported by an IMF stand-by credit, economic performance in 2000 was disappointing, as the economy failed to recover from the recession caused by a fallout from the Russian default.

Since the adoption of the Convertibility Law in 1991, the peso has traded at parity with the United States dollar, supported by a currency board. This, of course, precluded the use of exchange rate or monetary policy to offset dollar appreciation or higher United States interest rates, so that the only possible adjustment was through a deflationary process to improve competitiveness. This adjustment affected the attainment of economic policy goals in different ways. On the one hand, deflation produced a real depreciation of around 10 per cent in 2000 in the effective exchange rate (when measured in terms of relative unit labour costs). Together with higher prices of energy (which represents over 10 per cent of the country's merchandise exports) and the slow growth of imports due to recession, this has resulted in a marked swing in the trade balance, from a deficit in 1999 to a surplus in 2000. On the other hand, however, tax yields were sharply reduced and the fiscal deficit failed to improve. Moreover, the rate of unemployment, which before the downturn in 1998 had fallen to below 13 per cent, resumed its rise, exceeding 14 per cent. Although the net financing requirement of the Government fell in 2000, its net external borrowing increased somewhat.

The improving trade performance and the IMF stand-by credit failed to contain yield spreads, which rose sharply in May and remained at 650–700 basis points until August as markets, became concerned about the deteriorating social climate produced by the renewed economic slowdown and its impact on public finances. There was also concern about the effects of a further tightening of interest rates in the United States. The Government was, nonetheless, able to implement its external financing plan: by early September it had raised over $14.5 billion, more than 80 per cent of the gross financing required for 2000. However, the increase in interest rates charged to prime borrowers, from about 9 per cent to a peak of nearly 20 per cent in November, contributed to a further slowing of economic activity.

In October and November, political instability created turbulence in capital markets, and by the end of the latter month yield spreads rose to nearly 900 basis points and total international reserves fell by about $3 billion.[1] In order to prevent an additional drain on reserves, the Central Bank decided to limit commercial banks' use of short-term Treasury paper (*Letes*) as collateral for their *pases activos*.[2] It also drew on its stand-by arrangement with the Fund.

At the same time, the Government launched a revised economic plan and approached IMF to raise its financing commitment. In the package announced in January 2001, the Fund increased Argentina's existing stand-by credit to $13.7 billion, corresponding to 500 per cent of the country's quota (about $3 billion of which is to be provided under the Supplemental Reserve Facility).[3] The World Bank and the Inter-American Development Bank (IDB) promised new loans of about $4.8 billion over two years, and the Spanish Government contributed $1 billion. Disbursements from these multilateral and bilateral sources are expected to cover about one third of the Government's estimated gross financing requirements of some $30 billion in 2001. The remainder will be financed by agreements with local banks through rollover of maturing bonds and new issues and through

Box 2.1 (concluded)

expected purchases of bonds by local pension funds. The Government is also planning other placements in international capital markets.

Basing itself on the experience of similar agreements with IMF made by Thailand, Indonesia and the Republic of Korea, where targeted reductions in fiscal deficits had to be revised in conditions of recession, the Argentine letter of intent provides for an increase in the deficit to 2.2 per cent of GDP in order to avoid a fiscal contraction in the early stages of recovery. This figure includes the cost of measures to stimulate investment, some additional spending on temporary public employment programmes, and other social spending aimed at mitigating economic hardship for the most vulnerable groups. Federal primary spending is, nonetheless, expected to decline in 2001 by 0.5 per cent of GDP from the previous year's level, and the primary surplus to rise to 1.7 per cent GDP (from 1 per cent in 2000). The overall deficit is to be eliminated by 2005, and fiscal consolidation to be extended to provincial governments. The ratio of public debt to GDP is programmed to decline from 2003 onwards. This implies a freeze on non-interest nominal federal expenditure at the 2000 level and likewise on expenditure by those provincial governments that are in deficit. In addition, IMF conditionality relates to reform of fiscal administration, social security, industrial and competition policy, trade policy, the financial sector, and corporate governance.

Following the implementation of the new package, which coincided with a fall in United States interest rates and depreciation of the dollar, equity prices recovered, and Argentina has been able to raise new funds in the international market.[4] Current global conditions could enable Argentina to emerge from the vicious circle in which the need to increase the external surplus requires lower wages and prices, thus reducing tax yields and undermining the target of a lower fiscal balance. Lower interest rates should enable the interest costs of the debt – and thus the fiscal deficit – to be reduced without cutting expenditures, while a cheaper dollar would help boost exports without the need for lowering wages and prices.

Nevertheless, since there is an outstanding debt of $120 billion, equivalent to 350 per cent of the country's annual export earnings, and since two thirds of foreign exchange receipts are absorbed by debt service, the downside risks should not be underestimated, particularly if there is a loss of investor confidence in emerging markets.

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1 The figure refers to reserve holdings of the Central Bank plus deposits held by the financial system abroad.

2 These are repurchase agreements which the Central Bank uses to provide liquidity to the banking system because under the Convertibility Law, it cannot rediscount commercial bank assets.

3 Argentina received about $3 billion immediately, with three additional drawings of about $1.3 billion each programmed for the remainder of 2001 following the continuous review process. About $4 billion will be available in 2002 and $1 billion in 2003.

4 In February 2001 the Government launched a 500 million euro-bond issue with a maturity of six years and an interest rate of 10 per cent, representing a 550 basis-point spread over German and French government issues. It also completed a debt swap of $3 million short-term debt for a new five-year treasury note and a new 11-year global bond, with another one announced for before the end of the first quarter.

Box 2.2

STABILIZATION AND CRISIS IN TURKEY

The recent Turkish crisis has a number of features common to crises in emerging-market economies that implement exchange-rate-based stabilization programmes. Such programmes typically use the exchange rate as an anchor for inflationary expectations, often relying on capital inflows attracted by arbitrage opportunities to finance growing external deficits, with a resulting appreciation of the currency. The consequent build-up of external financial vulnerability eventually gives rise to a rapid exit of capital, leading to overshooting of the exchange rate in the opposite direction and/or hikes in interest rates. Through such a boom-bust financial cycle, some countries (e.g. Mexico and Brazil) have succeeded in overcoming their chronic price instability and avoiding a return of rapid inflation, despite the collapse of their currencies and the external adjustment necessitated by the crisis. The Turkish programme initially followed a similar path, but ran into difficulties at a much earlier stage of the disinflation process, causing it to abandon the peg and casting doubts on its chances of success. The difficulties arose largely because the programme was launched in a climate of structural problems and fragilities on many different fronts, notably in the public finances and the banking sector.

Following chronic inflation since the mid-1980s averaging an annual 70 per cent, the Government launched a stabilization programme in December 1999 supported by an IMF stand-by credit, with the aim of bringing the rate of inflation down to 25 per cent by the end of 2000 and to the single-digit level by the end of 2002. The programme was adopted after a poor economic performance in 1999, when GNP fell by 6 per cent, partly due to devastating earthquakes and the fallout from the Russian crisis. Furthermore, there were large public sector deficits (an operational deficit of 14 per cent of GNP for the consolidated public accounts), mainly on account of mounting interest payments on government debt and the losses of public enterprises. The banking sector was also highly fragile and largely dependent for its earnings on high-yielding T-bills associated with rapid inflation. Financial markets were consequently highly vulnerable to disinflation, and there emerged an inconsistency in policy since much of the fiscal adjustment was predicated on declines in the very nominal and real interest rates on which many banks depended for their viability. By contrast, the external account was almost in balance. The Central Bank of Turkey (CBOT) was effectively following a policy of an adjustable peg designed to prevent a significant real appreciation of the lira.

The stabilization programme was based on a preannounced crawling peg. The exchange rate targets were set in terms of a basket made up of the dollar and the euro, with greater weight accorded to the former. The value of the basket in lira was set to increase by 20 per cent for the year 2000 as a whole (equal to the target rate for wholesale price inflation), at declining monthly rates. July 2001 was set as the date for exit from the preannounced crawling peg to more flexible rates within a band. The programme also provided for a "quasi-currency board" (whereby money-printing against domestic assets was precluded), as well as for targets for primary budget surpluses. As the CBOT was committed not to engage in sterilization, macroeconomic equilibrium was to be attained mainly through changes in interest rates: if capital inflows fell short of the current-account deficit, liquidity would be withdrawn from the economy and interest rates would rise, thus restoring external equilibrium by attracting more capital inflows, on the one hand, and by restraining domestic demand and imports, on the other.

In the event, during the first 11 months the targets for the nominal exchange rate, net domestic assets, and primary budget deficits were attained, but prices proved to be stickier than expected; annual inflation had come down only to some 40 per cent at the end of 2000, from an average of 65 per cent in 1999. The consequent real appreciation of the currency was aggravated by the rise of the dollar against the euro. Interest rates fell significantly faster than the rate of inflation, even though they were highly volatile: annualized rates on 3-month T-bills averaged less than 40 per cent in January–November 2000, compared to over 100 per cent in 1999. Despite fiscal tightening,

Box 2.2 (continued)

the economy made a sharp recovery, growing over 6 per cent for the year 2000 as a whole. Together with the appreciation of the currency and a rising oil import bill, this led to a doubling of the trade deficit, to an estimated $20 billion, and pushed the current-account deficit to an unprecedented 5 per cent of GNP.

Even though real interest rates fell sharply during the year, there were considerable arbitrage opportunities for foreign capital, since the nominal depreciation of the currency fell far short of the differentials with foreign interest rates. Consequently, until the crisis broke out in November, private capital inflows and large-scale foreign borrowing by the Treasury were more than sufficient to meet the growing current-account deficit, resulting in increases in reserves and an expansion of domestic liquidity. The latter, together with the shift in government borrowing from domestic to international markets, helped to lower interest rates, thereby supporting aggregate demand.

As in most emerging-market crises, it is difficult to identify a single event behind the collapse of confidence and flight from domestic assets that occurred in November 2000. Probably the most important factors included: disappointing inflation results for October; unexpectedly high monthly trade deficits; political difficulties encountered in privatization; worsening relations with the EU; the economic situation in Argentina; and disclosure of irregularities in the banking system and a criminal investigation into several banks taken over by the Deposit Insurance Fund. There may also have been a rush to liquidity due to competitive manoeuvring among some private banks. However, quite apart from all this, the programme had clearly run into the familiar problems of exchange-rate-based stabilization that relies on short-term arbitrage flows. As confidence eroded, foreign creditors refused to roll over their contracts with local banks. For their part, the banks sold liras in an effort to reduce their end-of-year open foreign exchange positions. The exit from the lira created difficulties for banks relying on foreign funds and resulted in a liquidity crunch and a hike in interest rates by draining international reserves. Banks carrying large T-bill portfolios with funds borrowed in overnight markets suffered significant losses and bid for funds in the interbank market, at the same time unloading large amounts of government paper. Within a few days stock prices plummeted and overnight rates reached three-digit levels. The CBOT faced the classical dilemma posed by loss of confidence under currency-board regimes: either to defend the monetary rule and, ultimately, the currency peg, at the expense of a deeper financial crisis, or to act as a lender of last resort and rescue the financial system by injecting liquidity over and above its net domestic asset targets. After some hesitation it started supplying liquidity to troubled banks. But this only served to accelerate the erosion of international reserves as the sale of liras on the foreign exchange market accelerated.

Within a few days the CBOT reversed its policy and – evidently after consultations with, and securing commitments from, the IMF – reinstated the currency-board rule, with a new ceiling on domestic assets. As liquidity injection was discontinued and reserves were still sufficient to meet short-term external liabilities, capital outflows stopped, but interest rates shot up, overnight rates reaching four-digit levels. At the beginning of December a new agreement was reached with the IMF, including a financial package of some $10.5 billion. The Government undertook fresh commitments, including further spending cuts and tax increases, dismantling of agricultural support policies, liberalization of key goods and services markets, financial sector restructuring and privatization. It also extended guarantees for foreign creditors, as well as for all depositors at local banks, in order to help restore confidence in the banking system.

Although reserves and interest rates were stabilized, it became increasingly clear that the programme was not viable. Inflation remained above the monthly rates of depreciation of the currency vis-à-vis the basket, leading to further appreciation of the currency. Interest rates stayed very high, at some 65 per cent on the newly issued T-bills, as lira assets continued to be viewed as highly risky, and the economy went into contraction. The last straw was a political skirmish in February 2001, at

Box 2.2 (concluded)

the time of writing this report, which triggered a massive outflow of capital, forcing the Government to abandon the currency peg and move to floating, again with the support of the Bretton Woods institutions. Within a few days the currency lost about one third of its value against the dollar and overnight rates reached four-digit figures.

The Government declared its intention of continuing to implement the stabilization programme, targeting directly the inflation rate. This would effectively mean a return to traditional stabilization policies, the success of which would depend in large part on macroeconomic tightening. The combination of fiscal tightening, interest rate hikes and the collapse of the currency could push the economy into a deep recession, in much the same way as in the Republic of Korea. However, the burden placed on the poor may become politically unacceptable, particularly since it would be coming on top of a highly unequal income distribution and falling living standards. If inflation is not rapidly reduced and growth restored with the help of exports and official aid, it may prove very difficult to persist with tight macroeconomic policies. Under such circumstances inflation may come back with greater force.

able macroeconomic outlook, they also reflected a recent strengthening of the links between equity prices in emerging markets and those in major developed countries. This was evident, for example, in increased daily correlations between emerging-market indices and the NASDAQ index (see IIF, 2001; Mathieson, Schinasi et al., 2000, box 3.3). In part, this is a response to the growing importance in emerging stock markets of firms belonging to the technology, media and telecommunications sector: from the end of 1995 to the end of 2000 the share in equity indices of such firms increased from 18 per cent to 32 per cent in Latin America, and from below 15 per cent to more than 23 per cent in Asia.[8] But the correlations are probably also due to a growing tendency amongst international investors to associate emerging-market equities as a class more closely with high-risk segments of developed-country markets.

In Asian emerging-market economies there has generally been little change in monetary conditions (see chart 2.4 for selected countries). The main exceptions were Indonesia, where conditions tightened slightly throughout 2000, and the Philippines, where they tightened in the last quarter, partly in response to political uncertainty. Several countries in the region experienced currency depreciations in 2000: these varied from minor movements (Singapore and Taiwan Province of China) to relatively large declines (15 per cent in Thailand, 24 per cent in the Philippines, and 38 per cent in Indonesia). Movements of real effective exchange rates were smaller, and the indices for the great majority of Asian emerging-market countries remain below their levels of early 1997.[9]

In Latin American emerging markets, monetary conditions were subject to greater variation. The sharp tightening in Argentina in response to its financial crisis is described in box 2.1. A number of other countries (Brazil, Chile, Colombia and Mexico) have adopted inflation targets as a major element in determining their monetary policy (JP Morgan, 2000b: 19–22.), though the definition of the target varies and, thus, the relation between the monetary stance and the current rate of inflation. In Brazil and Chile monetary conditions tended to ease during 2000, while in Colombia gradual tightening was followed by stabilization, and in Mexico short-term rates of interest were subject to substantial fluctuation (chart 2.4). In Venezuela interest rates drifted for much of the year and subsequently decreased, and in Peru the overall direction was also towards greater ease, though this movement was subject to interruptions,

Chart 2.3

EQUITY PRICE INDICES OF SELECTED EMERGING-MARKET ECONOMIES, JANUARY 1999 TO JANUARY 2001

(January 1999 = 100; local currency terms)

Source: Primark Datastream.

Chart 2.4

EXCHANGE RATES AND MONEY-MARKET RATES IN SELECTED EMERGING-MARKET ECONOMIES, JULY 1999 TO JANUARY 2001

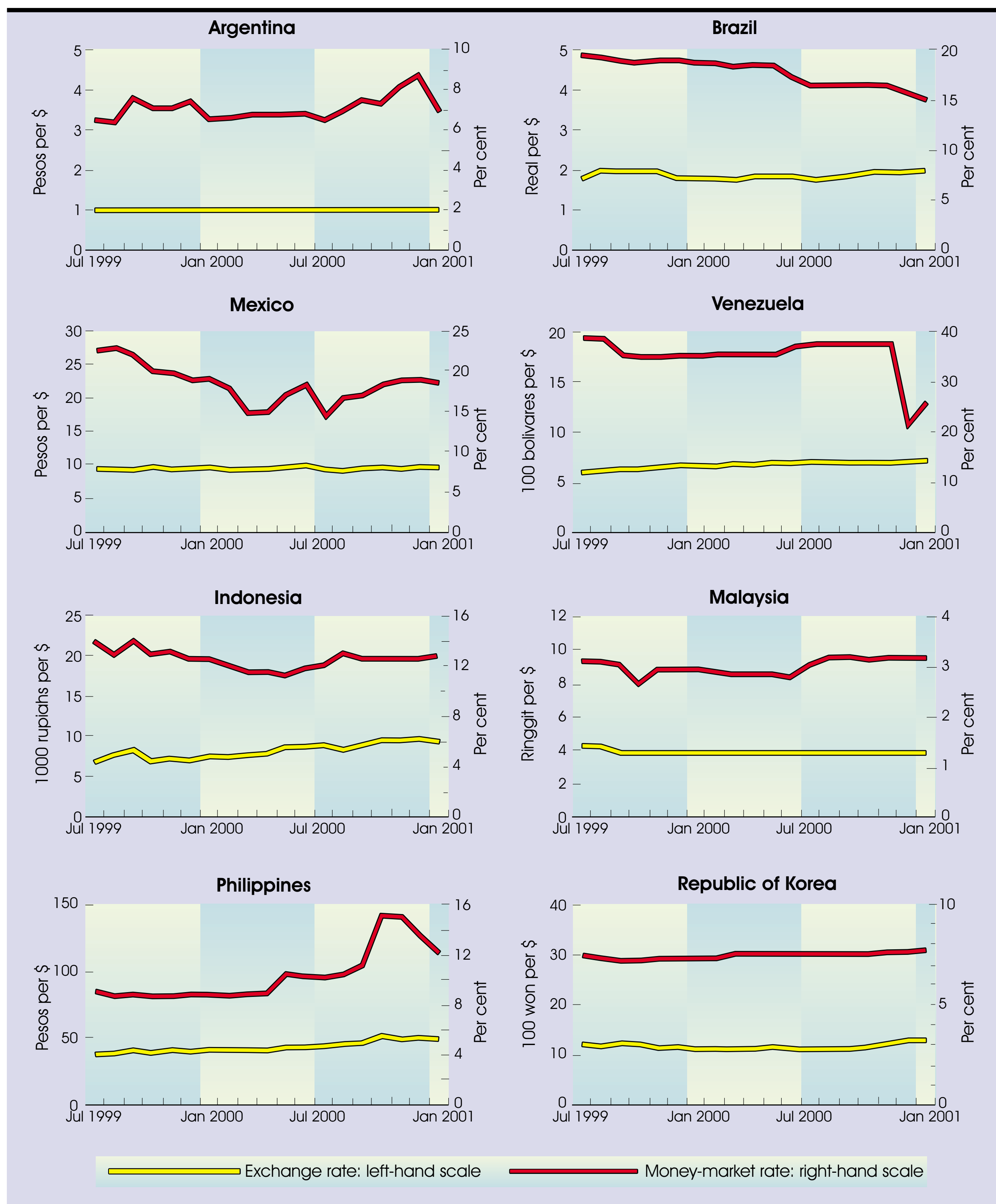

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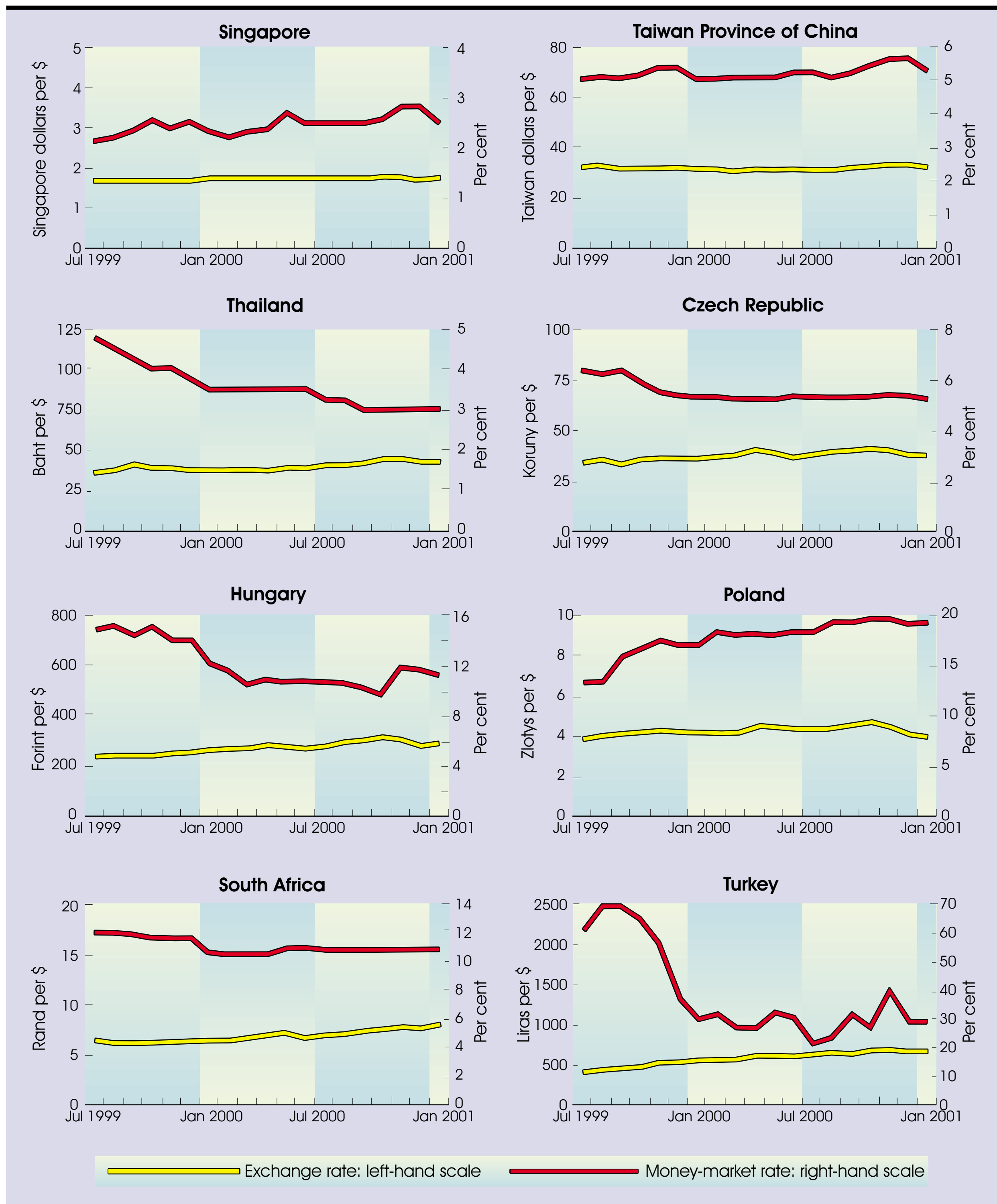
Chart 2.4 (concluded)

EXCHANGE RATES AND MONEY-MARKET RATES IN SELECTED EMERGING-MARKET ECONOMIES, JULY 1999 TO JANUARY 2001



Source: Primark Datastream; JP Morgan, *Global Data Watch*, various issues.

Note: Argentina, Brazil, Mexico, Indonesia, Malaysia, Philippines, Republic of Korea, Singapore, Taiwan Province of China, Thailand, Czech Republic, Hungary and Poland: three-month domestic money-market rates or nearest equivalent; Venezuela: average lending middle rate; South Africa: discount three-month middle rate; Turkey: three-month Treasury bill rate.

for example, owing to political unrest in the third quarter. The spot exchange rates of Latin American emerging-market countries generally remained fairly stable, Brazil and Chile experiencing small depreciations and Colombia a larger one. Movements of real effective exchange rates were more marked, generally in the direction of appreciation. Since 1997, relative competitiveness as measured by this indicator has improved somewhat in Brazil and Peru, but declined in Argentina, Chile and Mexico.

Turkey was struck by a financial crisis in the final quarter of 2000, as creditors' confidence broke down in an exchange-rate-based stabilization programme that relied heavily on capital inflows (box 2.2). In other emerging-market economies, exchange rates and interest rates were mostly subject to only small movements (chart 2.4). The principal exception was South Africa, where the exchange rate came under attack in late 2000, a year during which the rand depreciated more than 20 per cent. In Hungary, monetary conditions tightened late in 2000, and in Poland monetary policy loosened at the end of the year after earlier tightening, while conditions changed little in the Czech Republic. The currencies of the three latter countries depreciated slightly during part of the year but strengthened subsequently. Their real effective exchange rates appreciated, with the rise for Poland being more than 10 per cent. The longer-term movements have also tended towards appreciation since 1997, though for Hungary the change has been minimal.

E. Private capital flows to emerging-market economies

The uncertainty surrounding the forecasts in early 2000 of private capital flows to emerging markets proved to be justified: during the second part of the year there were substantial downward revisions of both provisional estimates of such financing and of new forecasts. Provisional figures for 2000 still point either to little change or to a fall from 1999 levels. The outlook for 2001 is again highly uncertain, owing partly to the difficulty in forecasting the impact on financial flows of slowing economic growth in major industrial countries, particularly the United States (see chapter I, section A), and partly to the awareness that links and fault lines in the new global network of financial markets are not fully understood and thus hard to identify in advance.

1. Developments in 2000

Of the two sets of estimates in table 2.6, one shows a small rise in net private external financing for developing and transition economies and the other a sharp decline.[10] Since both series are provisional, they may yet be substantially revised. Nonetheless, they are indicative of the continuing shortfall of such financing in comparison with the levels achieved in 1996–1997. The totals reflect considerable regional divergences. The IMF estimates show substantial declines for Asia, the Middle East and Europe, a slight recovery for Latin America, and little change for Africa. If allowance is made for the effect of outflows due to

Table 2.6

NET CAPITAL FLOWS TO DEVELOPING AND TRANSITION ECONOMIES, 1997–2000: ESTIMATES OF THE INSTITUTE FOR INTERNATIONAL FINANCE AND THE IMF

(Billions of dollars)

Type of flow/region	*1997*	*1998*	*1999*	*2000*
	Estimates of the Institute for International Finance			
Net private capital inflows				
Total	269	139	148	154
by category:				
Private creditors				
Commercial banks	44	-54	-43	-16
Non-bank private creditors	84	59	28	20
Equity investment				
Direct equity	116	119	146	128
Portfolio equity	25	15	18	22
by region:				
Africa/Middle East	15	6	10	7
Asia/Pacific	73	-1	31	49
Europe	74	56	36	30
Latin America	107	99	71	68
Memo item:				
Resident lending/other, net [a]				
Total	-197	-147	-125	-127
Africa/Middle East	-4	1	-5	-6
Asia/Pacific	-105	-73	-60	-73
Europe	-56	-26	-25	-27
Latin America	-33	-49	-36	-20
	Estimates of the International Monetary Fund			
Net private capital inflows				
Total	115	66	67	36
Net direct investment	141	152	155	142
Net portfolio investment	39	0	5	17
Other net flows [b]	-66	-86	-92	-123
Africa	12	7	10	9
Net direct investment	8	7	9	8
Net portfolio investment	7	7	9	5
Other net flows [b]	-3	-6	-7	-4
Asia	7	-41	2	-18
Net direct investment	55	60	54	48
Net portfolio investment	8	-15	4	5
Other net flows [b]	-57	-85	-56	-71
Middle East and Europe	23	10	1	-18
Net direct investment	7	8	5	8
Net portfolio investment	-6	-17	-10	-7
Other net flows [b]	21	19	6	-20
Western hemisphere	68	62	40	48
Net direct investment	53	57	65	57
Net portfolio investment	19	20	9	6
Other net flows [b]	-5	-15	-34	-15
Transition economies	6	28	13	16
New direct investment	17	20	21	22
Net portfolio investment	11	6	-7	8
Other net flows [b]	-22	2	0	-14

Source: IIF (2001); IMF (2000a).

a For explanation of this term, see note 10.

b Other net flows comprises other long-term net investment flows, including official and private borrowing.

Table 2.7

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING[a] AREA VIS-À-VIS DEVELOPING AND TRANSITION ECONOMIES, 1997–2000

	1997	1998	1999	2000[b]	Stock (end-June 2000)
	Percentage rates of increase[c]				$ billion
Total[d]	**8.6**	**-7.7**	**-8.5**	**0.4**	**884**
of which in:					
Latin America	11.3	-2.8	-5.6	2.7	288
Africa	19.6	0.3	0.8	-0.9	43
West Asia	16.5	18.0	1.4	-0.2	78
East and South Asia	1.1	-21.7	-17.1	-1.5	305
Central Asia	35.5	17.6	26.9	-2.1	3
Eastern Europe	19.4	-0.4	-1.5	-4.4	95
Other Europe[e]	27.1	9.4	15.6	11.1	54
All borrowers[f]	15.4	3.0	2.5	5.8	10252

Source: BIS, *International Banking and Financial Market Developments*, various issues.
a Including certain offshore branches of United States banks.
b First two quarters.
c Based on data for the end of the period after adjustment for movements of exchange rates.
d Excluding offshore banking centres, i.e. in Latin America: Bahamas, Barbados, Bermuda, Cayman Islands, Netherlands Antilles, and Panama; in Africa: Liberia; in West Asia: Bahrain and Lebanon; and in South-East Asia: Hong Kong (China), Singapore and Vanuatu, but including residual amounts which could not be attributed to countries.
e Malta, Bosnia and Herzegovina, Croatia, Slovenia, The former Yugoslav Republic of Macedonia, and Yugoslavia.
f Including multilateral institutions.

net lending by residents and selected other adjustments to the estimated net private flows, the regional pattern for 2000 displayed by the IIF figures is not dissimilar, with some recovery in Latin America, little change in Africa, a decline in Europe and continuing net outflows for Asia.

A major factor in the decline in net private financial flows to developing and transition economies since 1997 has been the contraction of bank lending. Since 1998, repayments to banks have tended to exceed new loans, and the total exposure of BIS-reporting banks to these economies has decreased by more than $150 billion since 1997 (table 2.7). The contraction in lending of BIS-reporting banks slowed in the first two quarters of 2000. It reflected primarily developments in East and South Asia, net repayments by which were responsible for a larger part of the decline in net total lending to developing and transition economies in 1999.

Elsewhere, experience in the first half of 2000 was varied. The decrease in banks' exposure to Eastern Europe was strongly influenced by the figure for the Russian Federation. In Latin America, much of the rise was due to lending to Mexico, much of which was associated with the financing of Spanish banks' purchases of Mexican financial firms (BIS, 2000a: 19). The growth in BIS-reporting banks' claims on Africa was relatively little affected by the financial crises of the 1990s. Although exposure to certain countries such as Egypt, Morocco and Tunisia has increased significantly in recent years, the total borrowing of the region nonetheless remains relatively small.

Table 2.8

INTERNATIONAL ISSUANCE OF DEBT SECURITIES[a] BY DEVELOPING AND TRANSITION ECONOMIES,[b] 1997–2000

(Billions of dollars)

	Gross issues[c]				*Net issues*			
	1997	*1998*	*1999*	*2000[d]*	*1997*	*1998*	*1999*	*2000[d]*
Total	**123.6**	**78.3**	**79.2**	**69.8**	**82.1**	**37.4**	**34.1**	**30.8**
of which in:								
Latin America	64.0	43.0	48.0	39.9	41.1	22.5	26.4	21.8
East and South Asia	39.8	10.8	16.7	15.2	25.4	-0.7	-1.1	1.9
Europe	11.4	20.4	10.3	11.1	11.1	15.1	6.5	4.7
Memo item:								
World	1508.6	1657.2	2305.0	993.0	560.4	681.1	1215.4	797.7

Source: UNCTAD secretariat calculations, based on BIS, *International Banking and Financial Market Developments*, various issues.

a International money market instruments and international bonds and notes, classified by residence of issuer.

b Other than offshore financial centres.

c Gross issues include gross issuance of money market instruments and announced issues of international bonds and notes.

d First three quarters.

Recent financial crises have been followed by a lengthening of the maturity profile of outstanding bank loans to the countries affected. Thus, in Indonesia, Malaysia, Philippines, the Republic of Korea and Thailand, the proportion of bank claims with a residual maturity of one year or less fell from over 65 per cent in late 1993 to about 50 per cent by the end of 1998.[11] Since then, movements have been less marked, though there has been a continuing decline in the proportion of loans with short maturities for the Philippines and a rise for the Republic of Korea (where much of the upturn was due to maturing longer-term debt rather than new short-term borrowing). In the Russian Federation, loans with a residual maturity of up to one year declined (partly as a result of restructuring exercises), from 46 per cent in mid-1998 to 26 per cent in mid-2000, and in Brazil they fell from 63 per cent to 54 per cent during the same period. Elsewhere the degree of concentration of bank debt at short-term maturities has varied among countries and regions, the share of such maturities for African and West Asian countries, for example, being about 55 per cent and that for Eastern European countries only 40 per cent.

Latin American borrowers were once again the most important issuers of international bonds and other debt securities, accounting for more than 50 per cent of total net issues in the first three quarters of 2000 (table 2.8). During the year a number of such borrowers also exchanged Brady bonds for Eurobonds at lower interest rates and longer maturities.[12] Preliminary figures indicate a decrease in issuance in the fourth quarter of 2000 (which reflects, inter alia, the absence from the market of Argentina and Turkey, substantial issuers earlier in the year), and a recovery early in 2001 (as in 2000, driven mainly by Latin American borrowers). Outstanding issues of debt securities by developing countries remain heavily concentrated among a restricted group of borrowers and amount to less than half of BIS-reporting banks' exposure to them (a figure similar in magnitude

to that of outstanding bank loans with a residual maturity of up to one year).

The spreads on the international bonds of emerging-market economies (chart 2.5) were subject to considerable country-by-country variation until October, when there were widespread increases with the advent of more unsettled conditions in financial markets, the rises being most marked for Argentina, Brazil, the Philippines and Turkey. Spreads then stabilized or fell slightly towards the end of the year, probably partly in response to the packages of international financial support put together for Argentina and Turkey.

After a period of relative buoyancy in the aftermath of the financial crises of the late 1990s, net flows of foreign direct investment (FDI) to developing and transition economies decreased in 2000. But much of the contraction was accounted for by a limited number of recipients; for some Asian countries the rise in FDI which followed the region's financial crisis may have largely run its course, and the figures for the Republic of Korea were reduced by an increase in outward FDI; as regards Argentina, the figure fell back from a level boosted in the previous year by the proceeds of a single privatization project (the petroleum conglomerate, YPF; *TDR 2000*, chap. III, sect. E.1). Flows of FDI to Brazil continued to remain high, preliminary estimates being of a magnitude similar to the country's deficit on current account.

Capital flows to developing and transition economies in the form of private equity can take two forms: international equity issues and foreign investment in local equity markets. Sums raised in the first form amounted to more than $32 billion in the first three quarters of 2000, a little more than 50 per cent of the figure being due to issuers in East and South Asia (BIS, 2000a, table 18). Separate figures for foreign investment in local equity markets in 2000 are not yet available, but provisional estimates of the IIF for all forms of foreign portfolio equity investment fall well short of that given above for international issues for the first three quarters only, pointing to the probability of substantial net foreign disinvestment in local equity markets. Much of the disinvestment is likely to have taken place in the second half of the year in response to the widespread price falls described in the preceding section. Indeed, a two-way connection between such falls and foreign disinvestment was probably at work here, each giving additional impetus to the other.

2. Outlook

The outlook for private financial flows to developing and transition economies remains uncertain. One view emphasizes that emerging-market economies as a group are now less susceptible to financial shocks owing to such features as lower dependence on short-term bank debt and more flexible exchange rate regimes. But as the experience of Argentina and Turkey during the past year has shown, reduced vulnerability for the group does not necessarily imply that individual countries are innoculated against the outbreak of serious balance-of-payments problems. Moreover, the access of emerging-market economies to private external financing remains linked, through various channels, to global conditions. Some of these channels involve traditional connections between their access to financing and prospects for global economic growth, trade, as well as for the terms of trade.[13] Others involve a prominent role for impulses between different financial markets which are generally very difficult to forecast: these include contagion effects between emerging markets themselves as well as destabilizing influences transmitted from markets in the North to those in the South.

Relations between markets in developed and transition economies, on the one hand, and in industrial countries, on the other, are subject to change as a result of various processes associated with greater financial integration. In the preceding section reference was made to recent strengthening of the links between equity markets in emerging-market economies and developed countries. Other changes have been in the direction of greater decoupling. For example, during the first half of 2000 the trend in spreads on the debt of developing countries was downwards at a time when spreads of high-yield debt of developed-country borrowers denominated in dollars and euros were moving upwards (BIS, 2000b: 5–6; IIF, 2001: 9). Moreover, the heightened volatility of

Chart 2.5

YIELD SPREAD[a] OF SELECTED INTERNATIONALLY ISSUED EMERGING-MARKET BONDS, JULY 1999 TO JANUARY 2001

(Basis points[b])

Source: Primark Datastream.

a Differential between the yield on a representative bond issued by the borrowing country and those of the same maturity issued by the Government of the country in whose currency the borrower's bonds are denominated.

b One basis point equals 0.01 per cent.

the NASDAQ index during 2000 was accompanied by a weakening of its link with the yield on the debt of emerging market economies.[14] Nevertheless, major turbulence in the financial markets of developed countries may continue to have important spillover effects in emerging markets. And recent experience indicates that owing to new methods of risk management, such as techniques of cross-border hedging, some of the fault lines associated with these effects are difficult to identify in advance.[15] Thus, financial flows to developing and transition economies are now subject not only to traditional supply-driven influences originating in industrial countries, such as those due to shifts in monetary policy and in the risk aversion of investors and lenders, but also to the impact of portfolio management decisions of international financial firms which may have little connection to the fundamentals of the countries whose markets are affected.

F. External financing and debt of the least developed countries

The LDCs are the major "pocket of poverty" in the world economy. As domestic savings in these countries are insufficient to attain a faster pace of growth, they continue to depend on external finance, and especially on official capital flows, for the financing of their development. But aggregate net capital inflows fell in the 1990s, in real as well as in nominal terms and in relation to the recipient countries GDP (table 2.9).

Given their weak economic fundamentals and high-risk profiles, most LDCs have practically no direct access to international capital markets. While for developing countries as a group, private flows other than FDI represented almost half of the net aggregate capital inflow in the 1990s, and about 2.3 per cent of their GDP, such private inflows into LDCs were negligible over much of the past decade and were even negative in 1998 and 1999. Flows of FDI to LDCs are also relatively small, but in relation to GDP they have been almost as important for LDCs as a group as for other developing countries. However, FDI in LDCs has been mainly in mineral extraction rather than in manufacturing, and has essentially been concentrated on a few countries that are rich in oil, gas and other natural resources.

Official capital continues to be the predominant source of external financing of the LDCs; for more than a decade, the share of official flows in their long-term inflows has remained at around 88 per cent, whereas in other developing countries this share had steadily declined to around 20 per cent by the end of the 1990s (*TDR 1999*, table 5.1, and UNCTAD, 2000b: 56).

During the 1990s, official capital flows to all developing countries declined considerably in both nominal and real terms,[16] and despite the rhetoric about poverty alleviation, ODA grants and bilateral credits to LDCs, where the incidence of poverty is the highest, have also fallen. Indeed, unlike other aid recipients, the LDCs did not benefit from the partial recovery in nominal official flows during 1998–1999. As a share of donor GNP, aggregate official flows from the members of the OECD's Development Assistance Committee (DAC) to the LDCs amounted to only 0.05 per cent from 1997 through 1999 – far short of the target ratio of 0.15 per cent set at the Second United Nations Conference on the Least Developed Countries in 1990. It is also only half of what it was at the beginning of the 1990s, in spite of the commitments by donors to increase aid to the

LDCs. Among the members of DAC, only five countries met the 0.15 per cent target in 1999: Denmark (0.32 per cent), Luxembourg (0.16 per cent), the Netherlands (0.16 per cent), Norway (0.30 per cent) and Sweden (0.17 per cent) (OECD, 2000b, table 31).

Apart from insufficient inflows of capital, especially in the form of long-term credit and grants, the majority of LDCs continue to be burdened with a serious debt overhang. In 1999, outstanding external debt of the LDCs as a share of their aggregate GDP amounted to 89 per cent, and the average ratio of debt service paid (as opposed to scheduled payments) to exports was 15 per cent. A number of countries continued to be unable to meet their obligations in full, accumulating further arrears on scheduled payments.

Given their debt overhang, there is an urgent need to reduce the debt burden of LDCs. Among the 41 countries identified as heavily indebted poor countries (HIPCs), 31 are LDCs. By the end of 2000, a total of 22 countries, 17 of which are African LDCs, had reached the "decision point" under the HIPC Initiative, and are due to start receiving interim debt relief from multilateral creditors as well as enhanced relief from Paris Club creditors. So far, Uganda is the only LDC to have reached the "completion point" under the Initiative, whereby it is entitled to enjoy the full benefits provided by the Initiative. Meanwhile, an additional 11 LDCs, most of which are affected by conflicts, have a debt burden that is regarded as unsustainable according to HIPC criteria, even after the application of traditional relief mechanisms. However, under current procedures it may take several years before these countries are able to fulfil the conditions required to reach the decision point. Moreover, there are several debt-stressed LDCs which are not defined as HIPCs (UNCTAD, 1999, box 3).

Current expectations regarding the economic impact of the HIPC Initiative on countries which have reached decision point are unrealistic. First, the additional fiscal space which is opened up by the Initiative is not particularly large. While the magnitude of debt relief appears significant in terms of a reduction in the present value of future debt service obligations, the annual savings on debt service provided through HIPC assistance per se up to 2005 are modest for most countries that have reached decision point. Secondly, the medium-term forecasts of a durable exit from the debt problem assume high rates of economic and export growth, sustained over a long period, often over and above the rates achieved in the 1990s, as well as declining import intensity of growth. Thirdly, there is a risk that the financial resources freed by the debt relief will not be fully additional. For 14 of the 17 African LDCs which have reached decision point, official flows fell considerably between 1996 and 1999. This suggests that, with the provision of HIPC assistance, there may be a general reduction in such flows unless there is a change in official attitudes; throughout the 1990s official capital flows to LDCs were closely related

Table 2.9

CAPITAL INFLOW OF LDCs BY TYPE OF FLOW, AND NET TRANSFER, 1990–1999

(Percentage of GNP)

Type of flow	*1990–1997*	*1998*	*1999*
Total net inflow	10.5	7.7	7.5
Official inflows	9.2	6.4	6.0
ODA grants [a]	6.5	4.8	4.7
Official credit	2.7	1.6	1.4
Bilateral	0.3	-0.1	-0.4
Multilateral	2.4	1.7	1.7
Private inflows	1.3	1.3	1.5
Foreign direct investment	1.1	1.5	1.6
Other	0.2	-0.2	-0.1
Interest payments	0.9	0.8	0.8
Profit remittances	0.6	0.5	0.6
Net transfer [b]	9.0	6.4	6.1

Source: UNCTAD secretariat calculations, based on World Bank, *Global Development Finance, 2001,* preliminary version (CD-ROM).

a This item corresponds to "Grants" as defined by the World Bank in the source and excludes funds allocated through technical cooperation.

b Net capital inflow less interest payments on external debt and profit remittances.

to their indebtedness and levels of debt service payments (UNCTAD, 2000b: 123–6).

Furthermore, the HIPC process has become even more complicated with the explicit linking of debt relief to poverty alleviation, through Poverty Reduction Strategy Papers. As has recently been suggested by the Dutch Minister for Development Cooperation, if the successful implementation of these wide-ranging poverty reduction strategies requires broader and faster debt relief, then development partners will have to be prepared to provide additional financing.[17]

An important and welcome development in 2000 was the commitment by an increasing number of creditor countries, in the context of the HIPC Initiative, to grant full cancellation of bilateral debt. However, the commitment does not involve a rapid or across-the-board cancellation for all LDCs, and implementation will depend on their progress in economic policy reforms and poverty reduction. Country coverage, timing of relief, and the coverage of debts (including post-cut-off-date debt) can also be expected to vary among creditors.

The underlying economic problems of LDCs are manifold, so that debt write-off alone will be insufficient to set them on a path of sustainable development. A solution to their debt problem is nonetheless a necessary condition, and the special situation of LDCs requires an assessment of their needs for debt relief quite independently of HIPC considerations. Given that debt forgiveness cannot be expected to be forthcoming swiftly, interim arrangements should be considered to allow for immediate alleviation of their acute debt burden. To that end, and pending the full implementation of the HIPC Initiative, an immediate suspension of the debt-service payments of all LDCs, without any additional interest obligations, should be considered. In this way, rather than having to divert scarce resources to service debt, governments would be able to use them to finance badly needed social expenditure programmes and productive investments. For the same reason, it is also necessary to reverse the declining trend of official financing. In the absence of adequate private capital inflows, a greater injection of official external finance is indispensable for kick-starting the capital accumulation process in LDCs.[18] ■

Notes

1 It is not easy to fully account for serious discrepancies, in magnitude and even in direction in some cases, in time series for trade published by WTO, IMF and UN/DESA.

2 For some of the reasons underlying the discrepancy between world exports and imports, see *TDR 2000* (chap. III, note 1).

3 For a detailed discussion on the role of intra-Asian trade in the recovery of the East Asian economies, see *TDR 2000* (chap. III).

4 The United States deficit on trade in goods and services in 2000 is estimated by IMF to be in the order of $360 billion, and the current-account balance in the order of $420 billion (4.2 per cent of GDP). JP Morgan estimates it to be as high as $439 billion (4.4 per cent of GDP). See IMF (2000a, table I.2 and appendix tables 27 to 29) and JP Morgan (2000a).

5 Average spot price of the basket of seven crude oils produced by members of OPEC.

6 The marginal cost of production in the highest-cost areas of non-OPEC countries ranges from $10 to $15 per barrel. Consequently, an oil price of not much higher than $15 per barrel should, in principle, provide oil companies with sufficient incentives to operate in these high-cost areas. However, unlike other commodities, oil is a strategic resource

and its price is also influenced by speculative factors. For a more detailed discussion of the factors shaping the world oil market in recent years, see *TDR 1999* (Part One, chap. III, sect. E).

7 For a discussion of recent debate on different regimes for the exchange rate, see Part Two, chap. V.

8 See IIF (2001: 11). The technology, media and telecommunications sector has accounted for an even higher share of recent international equity issuance by emerging-market economies: 57 per cent in 1999 and 77 per cent in the first half of 2000. See Mathieson, Schinasi et al. (2000, box 3.5).

9 The real effective changes cited here are the estimates of JP Morgan available at www.jpmorgan.com.

10 Differences among institutions in estimates of private financial flows to developing and transition economies reflect mainly differences in coverage and in methods of estimation. The estimates of IMF cover the great majority of its member countries. They are on a balance-of-payments basis and, thus, net of outflows by residents. The IIF covers a sample of 29 "emerging-market economies", and its estimates of net private flows are before adjustments for net lending by residents, changes in monetary gold, and errors and omissions in the balance of payments, which typically represent a substantial proportion of its figures for net private flows. The IIF estimates of January 2001 reflect a substantial downward adjustment in comparison with those of September 2000, which projected a figure of $188 billion for net private flows for the year as a whole, with an offsetting item of $127 billion for "resident lending/other".

11 The data on the residual maturity of BIS-reporting banks' exposure to countries have been taken from various BIS press releases on BIS-consolidated international banking statistics.

12 Exchanges of Brady for new bonds are partly the reason for the substantial divergence between gross and net issues of international bonds reported in table 2.8. The incentives for such exchanges typically include: gaining access to collateral in the form of United States Treasury instruments backing the Brady bonds; reduction of the country's debt stock in cases where the Brady bonds are exchanged at a discount; and extension of the yield curve for the country's internationally issued debt instruments to the extent that the new bonds carry long maturities.

13 For a discussion of the various channels of transmission between developments in the global economy and capital flows, see JP Morgan (2000c: 7–8).

14 For a discussion of correlations between the yield on emerging-market debt and the NASDAQ index, see Mathieson, Schinasi et al. (2000, chap. III, box 3.3).

15 For further discussion of evidence concerning the effects of these methods, see Cornford (2000a: 3).

16 For a more detailed analysis of the long-term patterns of external financing in the developing countries, see *TDR 1999* (Part Two); and for a discussion of external financing in Africa, where most LDCs are located, see UNCTAD (2000c).

17 E. Herfkens, "Bringing Solidarity to Brussels", speech given at UNCTAD Trade and Development Board, Geneva, 27 February 2001.

18 For a more detailed discussion, see *TDR 1998* (Part Two), and UNCTAD (2000c).

REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

Chapter III

TOWARDS REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE: WHICH WAY FORWARD?

A. Introduction

The increased frequency and virulence of international currency and financial crises, involving even countries with a record of good governance and macroeconomic discipline, suggests that instability is global and systemic. Although there is room to improve national policies and institutions, that alone would not be sufficient to deal with the problem, particularly in developing countries, where the potential threat posed by inherently unstable capital flows is much greater. A strengthening of institutions and arrangements at the international level is essential if the threat of such crises is to be reduced and if they are to be better managed whenever they do occur. Yet, despite growing agreement on the global and systemic nature of financial instability, the international community has so far been unable to achieve significant progress in establishing effective global arrangements that address the main concerns of developing countries.

In the aftermath of the Asian crisis a number of proposals have been made by governments, international organizations, academia and market participants for the reform of the international financial architecture.[1] They cover broadly four areas: global rules and institutions governing international capital flows; the exchange rate system; orderly workouts for international debt; and the reform of the IMF, with special reference to surveillance, conditionality, the provision of international liquidity, and its potential function as lender of last resort. Implementation of any of these proposals would entail the creation of new international institutions and mechanisms as well as reform of the existing ones.

Some of these proposals have been discussed in the IMF itself, as well as in other international financial institutions, such as BIS and the newly established Financial Stability Forum (FSF), and also among the Governments of G-7 countries. While certain initiatives have been taken as a result, the reform process, rather than focusing on international action to address systemic instability and risks, has placed emphasis on what should be done by national institutions and mechanisms. Even in this regard it has failed to adopt an even-handed approach between debtors and creditors. Efforts have concentrated on disciplining debtors, setting guidelines and standards for major areas of national policy, principally in debtor countries,

and providing incentives and sanctions for their implementation. Debtor countries have been urged to better manage risk by adopting strict financial standards and regulations, carrying adequate amounts of international reserves, establishing contingent credit lines and making contractual arrangements with private creditors so as to involve them in crisis resolution. The international financial system has continued to be organized around the principle of *laissez-faire,* and developing countries are advised to adhere to the objective of an open capital account and convertibility, and to resort to controls over capital flows only as an exceptional and temporary measure. All this has extended the global reach of financial markets without a corresponding strengthening of global institutions.

The failure to achieve greater progress is, to a considerable extent, political in nature. The proposals referred to above have often run into conflict with the interests of creditors. But governments in some debtor countries also oppose reform measures that would have the effect of lowering the volume of capital inflows and/or raising their cost, even when such measures could be expected to reduce instability and the frequency of emerging-market crises. Many observers have been quick to dismiss such proposals as not only politically unrealistic but also technically impossible. However, as long as systemic failure continues to threaten global welfare, resistance to more fundamental reform of the international financial architecture must be overcome:

> It is easy to fall into the trap of thinking that big institutional changes are unrealistic or infeasible, especially in the United States where macroeconomic policy institutions have generally evolved only slowly for the past few decades. Not so long ago, the prospects for a single European currency seemed no more likely than those for the breakup of the Soviet empire or the reunification of Germany. Perhaps large institutional changes only seem impossible until they happen – at which point they seem foreordained. Even if none of the large-scale plans is feasible in the present world political environment, after another crisis or two, the impossible may start seeming realistic. (Rogoff, 1999: 28)

Rather than focusing on international action to address systemic instability and risks, the reform process has placed emphasis on what should be done by national institutions and mechanisms. Even in this regard it has failed to adopt an even-handed approach between debtors and creditors.

Part Two of this Report reviews the main initiatives undertaken so far in the reform of the international financial architecture, and the advice given to developing countries in some key policy areas, such as structural reforms and exchange rate policy, for the prevention and management of instability and crises. The discussion follows from an earlier analysis, made in *TDR 1998*, and concentrates on more recent developments. This chapter provides an overview of the issues, comparing briefly what has so far been achieved with the kind of measures proposed in order to address systemic failures and global instability. The next chapter reviews recent initiatives regarding global standards and regulation, while chapter V discusses whether developing countries can both keep an open capital account and avoid currency instability and misalignments by choosing appropriate exchange rate regimes, despite persistent misalignments and gyrations of the three major reserve currencies and large swings in international capital flows. It also assesses the scope for regional cooperation for establishing collective defence mechanisms against financial instability, drawing on the EU experience. The final chapter takes up the question of the management of financial crises and burden-sharing, and discusses the current state of play in two crucial areas, namely the provision of international liquidity and the involvement of the private sector in crisis management and resolution.

B. The governance of international capital flows

As the Second World War drew to an end, a set of organizations was envisaged which would deal with exchange rates and international payments, the reconstruction and rehabilitation of war damaged economies, and international trade and investment. The institutions established to handle these issues were the IMF, the World Bank, and the GATT. However, international capital movements did not fall within their purview. The original structure did not include a global regime for capital movements in large part because it was considered that capital mobility was not compatible with currency stability and expansion of trade and employment. However, no such regime was established even after the breakdown of the Bretton Woods arrangements, despite the growing importance of private capital flows (Akyüz and Cornford, 1999: 1–7).

The only global regime applying to cross-border monetary transactions was that of the IMF, but the most important obligations in its Articles of Agreement relate to current and not capital transactions. Concerning the latter, Article IV states that one of the essential purposes of the international monetary system is to provide a framework facilitating the exchange of capital among countries, a statement which is included among general obligations regarding exchange arrangements. The more specific references to capital transfers, in Article VI, permit recourse to capital controls so long as they do not restrict payments for current transactions, and actually give the Fund the authority to request a member country to impose controls to prevent the use of funds from its General Resources Account to finance a large or sustained capital outflow. The only recent initiative regarding the global regime is the attempt to include capital convertibility among the objectives of the IMF.

The BIS was originally set up as a forum for a small number of countries to deal with only certain aspects of international capital flows.[2] Since the 1970s it has provided secretariat support for a number of bodies established to reduce or manage the risks in cross-border banking transactions. These bodies are not responsible for setting rules for international capital movements as such. Their work is aimed at reaching agreements on standards to be applied by national authorities for strengthening the defences of financial firms, both individually and in the aggregate against destabilization due to cross-border transactions and risk exposures.

> The obligations contained in the new codes and standards initiatives seem to reflect the view that the main flaws in the system for international capital movements are to be found in recipient countries, which should thus bear the main burden of the adjustments needed to prevent or contain financial crises.

The increased frequency of financial crises, together with the increasingly global character of financial markets, has prompted both analysts and practioners to formulate proposals for the creation of a number of international institutions explicitly designed to regulate and stabilize international capital flows. One such proposal is for the creation of a global mega-agency for financial regulation and supervision, or World Financial Authority, with responsibility for setting regulatory standards for all financial enterprises, offshore as well as onshore (Eatwell and Taylor, 1998; 2000).

Another proposal is to establish a Board of Overseers of Major International Institutions and Markets, with wide-ranging powers for setting standards and for the oversight and regulation of commercial banking, securities business and insurance.[3] Yet another proposal, which focuses on stabilizing international bank lending, is for the establishment of an International Credit Insurance Corporation designed to reduce the likelihood of excessive credit expansion (Soros, 1998).

These proposals are based on two arguments. The first is that, since financial businesses are becoming increasingly interrelated and operate across borders, their regulation and supervision should also be carried out on a unified and global basis. The second argument focuses on the instability of capital movements under the present patchwork of regimes, which only more globally uniform regulation could be expected to address. Whatever their specific strengths and weaknesses, these proposals emphasize the need for international institutions and mechanisms that can prevent excessive risk-taking in cross-border lending and investment, reduce systemic failures, and eliminate several, often glaring, lacunae in the national regulatory regimes of creditor and debtor countries. The official approach to these problems has been quite different, focusing on lowering the risk of financial distress and contagion by strengthening the domestic financial systems in debtor countries. It has also emphasized the provision of timely and adequate information regarding the activities of the public sector and financial markets in debtor countries in order to allow international lenders and creditors to make better decisions, thereby reducing market failure, as well as to improve bilateral surveillance.

As examined in some detail in chapter IV, various codes and standards have been established through institutions such as the IMF, BIS and the FSF not only for the financial sector itself, but also in respect of macroeconomic policy and policy regarding disclosure. While their application should be generally beneficial, particularly over the long term, they will not necessarily contribute to financial stability, and in many cases they will involve substantial initial costs. Moreover, the programmes of reform required of recipient countries are wide-ranging and do not always accommodate differences in levels of development and the availability of human resources.

> "… there are dangers in throwing at developing countries a Washington-consensus view of economic policy, even if this consensus is now refurbished with new international codes and standards … the new set of external disciplines come hand-in-hand with a particular model of economic development of doubtful worth …"

Considered from the standpoint of systemic reform, the reform package contains many omissions and reflects an asymmetric view of different parties' responsibilities for the changes required. In particular, it does not adequately address the concerns of developing countries over the frequently supply-driven character of fluctuations in international capital flows, which are strongly influenced by monetary conditions in major industrial countries, especially the United States, and over the liquidity positions and herd behaviour of lenders and investors in those countries. The obligations contained in the new codes and standards initiatives seem to reflect the view that the main flaws in the system for international capital movements are to be found in recipient countries, which should thus bear the main burden of the adjustments needed to prevent or contain financial crises. By contrast, new measures to reduce volatile capital flows at source or to increase the transparency of currently largely unregulated cross-border financial operations are notable mostly for their inadequacy or their complete absence. The recommendations directed at source countries call for only limited actions that are beyond the bounds of existing policies or initiatives or involve changes in market practices beyond those already being undertaken.

Despite the emphasis on ownership and voluntary participation, implementation of the codes and standards is to be backed by an extensive system of externally applied incentives and sanctions, some of which risk becoming features of IMF

conditionality. Although the rules and guidelines are mostly of a fairly general nature, there remains a danger that their actual implementation will incorporate elements from particular developed-country models, owing to the role in assessment exercises of multilateral financial institutions and supervisors from G-7 countries. As one writer has put it:

> … there are dangers in throwing at developing countries a Washington-consensus view of economic policy, even if this consensus is now refurbished with new international codes and standards and with "second-generation reforms". The dangers arise from several sources. First, the new set of external disciplines come hand-in-hand with a particular model of economic development of doubtful worth … Second, it is doubtful that the new policy agenda will make the international system itself much safer. … Indeed, by focusing attention on internal structural reforms in the developing world, the current approach leads to complacency on short-term capital flows, and could increase rather than reduce systemic risks. Finally, the practical difficulties of implementing many of the institutional reforms under discussion are severely underestimated. (Rodrik, 1999: 3)

What has been proposed so far under the heading of codes and standards falls well short of amounting to an integral component of a new global policy framework for reducing financial instability. It should be recalled that an essential element of the rationale of the codes and standards initiatives consisted of their role as the necessary counterpart of further financial liberalization, particularly in developing economies. But the initiatives currently under consideration hardly justify imposing further obligations on countries as to capital-account convertibility, cross-border investment, or the liberalization of financial services more generally. In the absence of effective global action, much of the burden of coping with international financial instability still falls on national governments. It is thus vital that they remain free in their choice of policy.

C. The exchange rate system

The second key area in the reform of the international financial architecture is the exchange rate system, notably the arrangements regarding the three major reserve currencies (the dollar, the euro and the yen). Indeed, it would be more appropriate to speak of the need to establish a global system of exchange rates rather than reform the existing system; ever since the breakdown of the Bretton Woods system of fixed, but adjustable, exchange rates there have in effect been no global arrangements. While floating was adopted on the understanding that success depended upon the prevalence of orderly underlying conditions, the international arrangements to that end as specified in the Articles of Agreement of the IMF, and in the April 1977 decision on exchange rate arrangements, failed to define the obligations and commitments that such arrangements involved. As pointed out by Robert Triffin, the obligations were "so general and obvious as to appear rather superfluous", and the system "essentially proposed to legalize … the widespread and illegal repudiation of Bretton Woods commitments, without putting any other binding commitments in their

place" (Triffin, 1976: 47–48). While the April 1977 decision required members to "intervene in the exchange market if necessary to counter disorderly conditions", it failed to define these conditions and to provide explicit guidelines for intervention. Similarly, the principles of surveillance over exchange rate policies "were sufficiently general for constraint on behaviour to depend almost entirely on the surveillance procedures" (Dam, 1982: 259), and the consultation procedures have so far failed to generate specific rules of conduct that could lend support to any contention that the present arrangements constitute a "system".[4]

Given this institutional hiatus and lack of policy coordination among the major industrial countries, it should come as no surprise that floating has failed to deliver what was originally expected: reasonably stable exchange rates; orderly balance-of-payments adjustment; greater macroeconomic policy autonomy; and removal of asymmetries between deficit and surplus countries. Rather, the system is characterized not only by short-term volatility, but also by persistent currency misalignments and gyrations. The major industrial countries have continued to favour floating and have refrained from intervening in currency markets except at times of acute stress and imbalances, such as the events leading to agreements on coordinated monetary policy actions and exchange market interventions in the Plaza and Louvre Accords of 1985 and 1987, respectively.

Can emerging-market countries attain exchange rate stability purely by adopting appropriate macroeconomic policies and exchange rate regimes when the currencies of the major industrial countries are still so unstable? The exchange rate system as such has hardly figured on the agenda for the reform of the international financial architecture.

The damage inflicted by disorderly exchange rate behaviour tends to be limited for the reserve currency (G-3) countries themselves, compared to developing countries, because they have large economies that are much less dependent on international trade. Moreover, the exposure of their economic agents to exchange rate risks is limited because they can both lend and borrow in their national currencies. By contrast, exchange rate misalignments and gyrations among the G-3 currencies are a major source of disturbance for developing countries that has played an important role in almost all major emerging-market crises (Akyüz and Cornford, 1999: 31). Thus, the question arises whether it is meaningful to predicate attainment of exchange rate stability by emerging-market countries purely on their adoption of appropriate macroeconomic policies and exchange rate regimes when the currencies of the major industrial countries are still so unstable. Indeed, many observers have suggested that the global economy will not achieve greater systemic stability without some reform of the G-3 exchange rate regime, and that emerging markets will continue to be vulnerable to currency crises as long as the major reserve currencies remain highly unstable.

Certainly, given the degree of global interdependence, a stable system of exchange rates and payments positions calls for a minimum degree of coherence among the macroeconomic policies of major industrial countries. But the existing modalities of multilateral surveillance do not include ways of attaining such coherence or dealing with unidirectional impulses resulting from changes in the monetary and exchange rate policies of the United States and other major industrial countries. In this respect governance in macroeconomic and financial policies lacks the kind of multilateral disciplines that exist for international trade.

One proposal to attain stable and properly aligned exchange rates is through the introduction of target zones among the three major currencies together with a commitment by the countries to defend such zones through coordinated intervention and macroeconomic policy action.[5] It is felt that such a commitment would secure the policy coherence needed for exchange rate stability without undermining growth and could alter the behaviour of currency markets, which, in turn, would reduce the need for intervention. Such an arrangement could be institutionalized and placed under IMF surveillance.

A more radical proposal is to do away with exchange rates and adopt a single world currency, to be issued by a World Monetary Authority which could also act as a lender of last resort. There has been growing interest in such an arrangement since the introduction of the euro and the recurrent currency crises in emerging markets. However, it is generally felt that the present extent of economic convergence and depth of global integration fall far short of what would be required for such an arrangement to operate effectively (Rogoff, 1999: 33–34).

Governance in macroeconomic and financial policies lacks the kind of multilateral disciplines that exist for international trade.

In any event, it is interesting to note that the exchange rate system has hardly figured on the agenda for the reform of the international financial architecture. The report by the then Acting Managing Director of IMF to the International Monetary and Financial Committee (IMF, 2000b) recognized the difficult choice faced by most countries between maintaining, on the one hand, truly flexible rates and, on the other, hard pegs. Referring to the three major currencies, the report pointed to "large misalignments and volatility" in their exchange rates as a cause for concern, particularly for small, open commodity-exporting countries. However, it did not discuss any initiatives that might be taken by the international community in this respect, implying that the matter could only be sorted out between the United States, Japan and the EU (see also Culpeper, 2000: 15).

Indeed, as noted in chapter V, discussions on exchange rates have concentrated on the kind of regimes that developing countries would need to adopt in order to attain greater stability. The mainstream advice is to choose between free floating or locking into a reserve currency through currency boards or dollarization (the "hard" pegs), thus opting for one of the two "corner" solutions, as opposed to intermediate regimes of adjustable or soft pegs. Increasingly questions are being raised as to whether the existence of so many independent currencies makes sense in a closely integrated global financial system.

However, much of this is a false debate. Whichever option is chosen, it will not be able to ensure appropriate alignment and stability of exchange rates in developing countries as long as major reserve currencies themselves are so unstable and misaligned, and international capital flows are volatile and beyond the control of recipient countries. Moreover, such conditions create inconsistencies within the developing world in attaining orderly exchange rates. Briefly put, there is no satisfactory unilateral solution to exchange rate instability and misalignments in emerging markets, particularly under free capital movements.

Since global arrangements for a stable system are not on the immediate agenda, the question arises as to whether regional mechanisms could provide a way out. Indeed, there is now a growing interest in East Asia and some countries of South America in regionalization (as opposed to dollarization) as a means of providing a collective defence mechanism against systemic failures and instability. The EU experience holds useful lessons in this respect, including the institutional arrangements for the maintenance and adjustment of intraregional currency bands, intervention mechanisms, regimes for capital movements, and various facilities designed to provide payments support to individual countries and regional lender-of-last-resort services. However, applying this experience to arrangements among developing countries poses certain difficulties, particularly with respect to the exchange rate regime to be pursued vis-à-vis reserve currencies and access to international liquidity, issues of special importance under conditions of intraregional contagion. Regional monetary arrangements among emerging markets

There is now a growing interest in East Asia and some countries of South America in regionalization as a means of providing a collective defence mechanism against systemic failures and instability.

could thus be greatly facilitated if they involved also the major reserve-currency countries. In this respect, the recent initiatives taken by ASEAN+3 (see chapter V, box 5.1) constitute an important step along what may prove to be a long and difficult path to closer regional monetary integration.

D. Orderly workout mechanisms for international debt

A third major area of reform concerns orderly workout mechanisms for international debt. Such mechanisms have gained added importance in view of shortcomings in global arrangements for the prevention of financial crises. The prospect that crises will continue to occur, even with increasing frequency and severity, poses a dilemma for the international community. Once a crisis occurs, it is difficult to avoid widespread messy defaults on external liabilities in the absence of bailouts, with attendant consequences for international financial stability. But bailouts are becoming increasingly problematic. Not only do they create moral hazard for lenders, but also they shift the burden onto debtor countries and their taxpayers, who ultimately pay off the official debt. Furthermore, the funds required have been getting larger and more difficult to raise. For these reasons, one of the main issues in the reform agenda is how to "involve" or "bail in" the private sector in crisis management and resolution so as to redress the balance of burden-sharing between official and private creditors as well as between debtor and creditor countries.

One way out of this dilemma would be recourse to the principles of orderly debt workouts along the lines of chapter 11 of the United States Bankruptcy Code, a proposal first put forward by the UNCTAD secretariat (in *TDR 1986*) in the context of the debt crisis of the 1980s, and more recently re-examined by it (in *TDR 1998*) in relation to emerging-market crises. Application of these principles would be especially relevant to international currency and debt crises resulting from liquidity problems because they are designed primarily to address financial restructuring rather than liquidation. They allow a temporary standstill on debt servicing based on recognition that a grab race for assets by creditors is detrimental to the debtor as well as to the creditors themselves as a group. They provide the debtor with access to the working capital needed to carry out its operations while granting seniority status to new debt. Finally, they involve reorganization of the assets and liabilities of the debtor, including extension of maturities and, where needed, debt-equity conversion and debt write-off.

One way to implement these principles is to create an international bankruptcy court in order to apply an international version of chapter 11 (or, as appropriate, chapter 9) drawn up in the form of an international treaty ratified by all members of the United Nations (Raffer, 1990). However, full-fledged international bankruptcy procedures are not necessary to ensure an orderly workout for international debt. Another option would be to establish a framework for the application to international debtors of key insolvency principles, namely debt standstill and lending into arrears (i.e. lending to a debtor in arrears to its creditor). Since prompt action is necessary to ward off speculative attacks and financial panic, the decision for standstill should rest with the debtor country and then be sanctioned by an international body, so as to provide the debtor with insolvency protection in the national courts of creditor countries. Restructuring of private debt could then be left to national bankruptcy procedures, while for sovereign debt direct negotiations with creditors appear to be the only feasible solution.

As discussed in chapter VI, while it has been increasingly accepted that market discipline will only work if creditors bear the consequences of the risks they take, the international community has not been able to reach an agreement on how to involve the private sector in crisis management and resolution. Even though a framework such as the one described above has found considerable support among many industrial countries, there is strong opposition from some major powers, and from participants in private markets, to mandatory mechanisms for "binding in" and "bailing in" the private sector. Considering that such mechanisms would alter the balance of negotiating strength between debtors and creditors and create moral hazard for debtors, they advocate, instead, voluntary and contractual arrangements between debtors and creditors to facilitate debt workouts, such as the insertion of collective action clauses in bond contracts. Moreover, a number of middle-income countries, particularly those with a relatively high degree of dependence on financial inflows, are opposed to both mandatory standstills and the inclusion of collective action clauses in bond contracts for fear that their access to international financial markets would be impaired.

The IMF Board recognized that, "in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally". However, there is no agreement over empowering the IMF to impose a stay on creditor litigation in order to provide statutory protection to debtors imposing temporary standstills.

The discussions in the IMF Executive Board on this issue emphasized the catalytic role of the Fund in involving the private sector and that, if the latter did not respond, the debtor country should seek agreement with its creditors on a voluntary standstill. The Board recognized that, "in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally". However, there is no agreement over empowering the IMF, through an amendment of its Articles of Agreement, to impose a stay on creditor litigation in order to provide statutory protection to debtors imposing temporary standstills. While it is generally accepted that the Fund may signal its acceptance of a unilateral standstill by lending into arrears, no explicit guidelines have been established on when and how such support would be provided, thus leaving considerable discretion to the Fund and its major shareholders regarding the modalities of its intervention in financial crises in emerging markets.

As in other areas, the reform process has thus been unable to establish an appropriate international framework for involving the private sector in the management and resolution of financial crises, passing the buck again to debtor countries. True enough, contractual arrangements, such as collective action clauses in bond contracts and call options in interbank credit lines, can provide considerable relief for countries facing debt servicing difficulties, and the misgivings that such arrangements may impede access to capital markets may be misplaced. But these are not matters for consideration in the reform of the international financial architecture, unless global mechanisms are introduced to facilitate such arrangements. There is also resistance to introducing automatic rollover and collective action clauses in international debt contracts based on an international mandate. Furthermore, certain features of external debt of developing countries, including wide dispersion of creditors and debtors and the existence of a large variety of debt contracts, governed by different laws, render it extremely difficult to rely on voluntary mechanisms for securing rapid debt standstills and rollovers. Without a statutory protection of debtors, negotiations with creditors for restructuring loans cannot be expected to result in equitable burden sharing. Indeed, in recent examples of negotiated settlements the creditors have not borne the consequences of the risk they had taken; rather, they have forced the developing country governments to assume responsibility for the private debt and accept a simple maturity extension at penalty rates.

E. Reform of the IMF

Naturally, reforms and recent initiatives in the areas discussed above generally imply significant changes in the mandate and policies of the IMF, particularly with respect to bilateral and multilateral surveillance, conditionality and the provision of international liquidity. As noted above, the Fund is closely involved in setting codes and standards for macroeconomic and financial policies and monitoring compliance, and effective multilateral surveillance is a prerequisite for a stable system of exchange rates. Private sector involvement in crisis management and resolution also crucially depends on IMF lending policies, as well as on its support and sanctioning of standstills and capital and exchange controls. Consequently, the reform of the international financial architecture presupposes a reform of the IMF.

1. Surveillance and conditionality

As discussed in *TDR 1998*, asymmetries in IMF surveillance, in the aftermath of the East Asian crisis, along with excessive conditionality attached to IMF lending, were widely considered to be two of the principal areas deserving attention in the reform of the international financial architecture. However, the recent approach to reform has resulted in increased asymmetries in surveillance and in enhanced conditionality, since it has focused primarily on policy and institutional shortcomings in debtor countries.

As already noted, surveillance has not been successful in ensuring stable and appropriately aligned exchange rates among the three major reserve currencies. Nor has it been able to protect weaker and smaller economies against adverse impulses originating from monetary and financial policies in the major industrial countries. It is true that the need for stronger IMF surveillance in response to conditions produced by greater global financial integration and recurrent crises was recognized by the Interim Committee in April 1998, when it agreed that the Fund "should intensify its surveillance of financial sector issues and capital flows, giving particular attention to policy interdependence and risks of contagion, and ensure that it is fully aware of market views and perspectives" (IMF Interim Committee Communiqué of 16 April 1998). However, despite the reference to interdependence and contagion, these proposals have not so far been effectively extended to cover weaknesses arising from the lack of balance in existing procedures.

Rather, there has been an intensification of IMF surveillance and conditionality as a result of their extension to financial sector issues in debtor countries, in accordance with the diagnosis that this is where the main problem lies. As noted above, new codes and standards are likely to result in enhanced conditionality, particularly for the use of new facilities, including contingency financing, for overcoming financial crises. Quite apart from whether the result could be unnecessary interference with the proper jurisdiction of a sovereign government, as some commentators believed it was in the Republic of Korea (Feld-

stein, 1998), there is also the potential problem that the type of measures and institutions promoted may not be the appropriate ones:

> An unappreciated irony in this is that conditionality on developing countries is being ratcheted up at precisely the moment when our comprehension of how the world economy works and what small countries need to do to prosper within it has been revealed to be sorely lacking. (Rodrik, 1999: 2)

The International Monetary and Financial Committee (IMFC, formerly the Interim Committee), recognizing the need to streamline IMF conditionality, has urged "the Executive Board to take forward its review of all aspects of policy conditionality associated with Fund financing in order to ensure that, while not weakening that conditionality, it focuses on the most essential issues".[6] For his part, the Fund's new Managing Director, Horst Köhler, has likewise concluded that:

> To strengthen its efficiency and legitimacy, the Fund needs to refocus. The Fund's focus must clearly be to promote macroeconomic stability as an essential condition for sustained growth. To pursue this objective, the Fund has to concentrate on fostering sound monetary, fiscal and exchange rate policies, along with their institutional underpinning and closely related structural reforms. … I trust that ownership is promoted when the Fund's conditionality focuses in content and timing predominantly on what is crucial for the achievement of macroeconomic stability and growth. Less can be more if it helps to break the ground for sustained process of adjustment and growth.[7]

Perhaps it is too early to judge how far in practice this refocusing has been pursued, but it is notable that the recent Fund programmes in Turkey and Argentina show no significant tendency to depart from past practice (see chapter II, boxes 2.1 and 2.2). They stipulate a wide range of policy actions not only in the purview of other international organizations, such as WTO and the development banks, but also of national economic and social development strategies, including actions relating to privatization and deregulation, agricultural support, social security and pension systems, industrial and competition policy, and trade policy.

2. Liquidity provision and lender-of-last-resort financing

The other major area of reform concerns the provision of adequate liquidity. A consensus has emerged over the past decade that the Fund should provide international liquidity not only to countries facing payments difficulties on current account but also to those facing crises on capital account. Two main facilities have been established for this purpose: a Supplemental Reserve Facility (SRF) for countries already facing payments difficulties, and a Contingency Credit Line (CCL) to provide a precautionary line of defence against international financial contagion (see chapter VI, box 6.3). While there are difficulties regarding the terms and conditions attached to such facilities, the real issue is whether and to what extent provision of such financing conflicts with, or complements the objective of, involving private creditors and investors in the management and resolution of emerging-market crises.

In several debtor countries, governments appear to favour unlimited liquidity support, regardless of the terms and conditions and the burden that may eventually be placed on the country's tax payers by international rescue operations. This attitude is consistent with their aversion to imposing temporary payments standstills and capital and exchange controls at times of crisis. On the other hand, while there is no consensus in the IMF Board on mandatory arrangements for involving the private sector, there is now a growing emphasis on making official assistance conditional on private sector participation. However, no formal limits have been set for access to Fund resources beyond which such participation would be required. As discussed in chapter VI, absence of explicit access limits as well as of mandatory standstill mechanisms may render it extremely difficult to secure private sector involvement, forcing the Fund to engage in large-scale interventions.

Indeed, since the main objective of large-scale contingency or crisis financing would be to allow debtor countries to remain current on payments to their creditors, it is difficult to see how this could be reconciled with a meaningful private sector involvement in crisis resolution and burden sharing. Consequently, a credible and ef-

fective strategy for involving the private sector should combine temporary standstills with strict limits on access to Fund resources. While there is growing agreement on the need to limit crisis lending, it is also suggested that there may be a need for exceptionally large contingency financing when the crisis appears to be "systemic". In practice, such an approach could result in differentiation among debtor countries: those for which the crisis is considered "systemic" would be eligible for considerable liquidity support without any prior condition for private sector participation, as in recent operations in Argentina and Turkey; those where the crisis is not so considered would face strict limits and would be encouraged to involve the private sector through default, as seems to have been the case for Ecuador and Pakistan.

Since the main objective of large-scale contingency or crisis financing would be to allow debtor countries to remain current on payments to their creditors, it is difficult to see how this could be reconciled with a meaningful private sector involvement in crisis resolution and burden sharing.

There are proposals to go further and allow the IMF to act as, or to transform that institution into, an international lender of last resort for emerging markets. Proposals of this nature have been put forward by the Deputy Managing Director of the Fund (Fischer, 1999) and, in the broader context of reforming the international financial institutions, by the International Financial Institutions Advisory Commission (Meltzer Commission). Indeed, the idea has received much greater sympathy than any other proposal for institutional changes at the global level, from among people with sharply different views about the reform of the IMF and situated at opposite ends of the political spectrum, although certain aspects of the Meltzer Commission's recommendations are highly contentious.[8] The key suggestion is that countries meeting certain *ex ante* conditions for solvency should be eligible for lender-of-last-resort financing. In the proposal by the Meltzer Commission, access to liquidity would be automatic for countries meeting a priori requirements, and no additional conditionality or negotiations would be required. Lending would be limited to a maximum of one year's tax revenue of the borrowing country. This could result in far greater packages than any crisis lending by the IMF so far. The problem of moral hazard would be tackled by conditionality rather than by tighter limits on lending. By contrast, the report does not make any recommendation for involving the private sector, except to suggest that, for the time being, the matter should be left to negotiations between debtors and creditors.

Arrangements of this nature would, however, compound certain problems encountered in the current practice regarding IMF bailouts. Without discretion to create its own liquidity, the Fund would have to rely on major industrial countries to secure the funds needed for such operations. In such circumstances it is highly questionable whether it would really be able to act as an impartial lender of last resort, analogous to a national central bank, since its decisions and resources would depend on the consent of its major shareholders, who are typically creditors of those countries experiencing external financial difficulties. This problem could be partly overcome by authorizing the Fund to issue permanent or reversible SDRs, but attributing such a key role to the SDR would face strong opposition from the same source.

Furthermore, there are also political and technical difficulties regarding the terms of access to such a facility. Financing by a genuine international lender of last resort, which would be unlimited and unconditional except for penalty rates, would require very tight global supervision over borrowers to ensure their solvency, which it would not be easy to reconcile with national sovereignty. Nor would prequalification be compatible with the practice of "constructive ambiguity" that all modern national lenders of resort are said to follow.[9] It would also require the IMF to act as a de facto credit-rating agency. However, it is very difficult to establish generally agreed standards for solvency, and assessments of a given set of economic indicators can vary considerably, as evidenced by differences among private rating agencies (Akyüz and Cornford, 1999: 48). Dis-

agreements in this respect between the developing countries concerned and the Fund staff could lead the countries to opt out and seek alternative arrangements, thereby reducing the effectiveness of the proposed mechanism. Moreover, since it would be necessary constantly to monitor the fulfilment of the preconditions, adjusting them as necessary in response to changes in financial markets or other changes beyond the control of the Government of the recipient country, prequalification would not avoid difficulties in relations between the Fund and the member concerned.

Transforming the Fund into an international lender of last resort would involve a fundamental departure from the underlying premises of the Bretton Woods system, which provided for the use of capital controls to deal with instability. In discussion of such a facility its introduction is frequently linked to concomitant arrangements regarding rights and obligations with respect to international capital transactions, together with a basic commitment to capital-account liberalization. This departure from the Bretton Woods arrangements is particularly notable in the report of the Meltzer Commission, which virtually proposes, inter alia, the discontinuation of all other forms of IMF lending, including those for current account financing. Such a drastic shift in the nature of IMF lending, from current account to capital account financing, would lead to a further segmentation of the Fund's membership, with consequences for its governance and universality. Indeed, as noted by a former United States Treasury Secretary, only a small number of relatively prosperous emerging economies would be eligible for lender-of-last-resort financing.[10]

Moreover, under these proposals, a large majority of developing countries would be excluded from multilateral financing. The Meltzer Commission argued, throughout its discussion of lending policies by both IMF and the World Bank, that current account financing to developing countries should, in principle, be provided by private markets. However, markets cannot always be relied on to fulfil this task properly. One of the original objectives of the IMF was to provide short-term financing when reserves were inadequate to meet current account needs resulting from temporary trading shocks and disturbances, while the World Bank was to meet longer-term financing needs of reconstruction and development. For temporary payments disequilibrium, it was agreed that short-term financing was necessary in order to avoid sharp cuts in domestic absorption or disruptive exchange rate adjustments. Even when the effects of such shocks were deemed to be more lasting, IMF financing was believed to be necessary to allow orderly adjustment. Experience shows that financial markets often fail to meet such needs since they tend to be pro-cyclical, with the result that credit lines are cut off just when they are most needed. Given the increased instability of the external trading and financial environment of developing countries, a reform of the Bretton Woods institutions should seek to improve, rather than eliminate, counter-cyclical and emergency financing of the current account.

Given the increased instability of the external trading and financial environment of developing countries, a reform of the Bretton Woods institutions should seek to improve, rather than eliminate, counter-cyclical and emergency financing of the current account.

F. Governance of international finance

There are certainly conceptual and technical difficulties in designing effective global mechanisms for the prevention and management of financial instability and crises. Such difficulties are also encountered in designing national financial safety nets, and explain why a fail-safe system is unreachable. At the international level there is the additional problem that any system of control and intervention would need to be reconciled with national sovereignty and accommodate the diversity among nations. Political constraints and conflicts of interest, including among the G-7 members themselves, rather than conceptual and technical problems, appear to be the main reason why the international community has not been able to achieve significant progress in setting up effective global arrangements.

So far the major industrial countries have not addressed the establishment of a multilateral system for international finance based on a few core principles and rules preferring instead a strengthening of the financial systems of debtor countries in crisis prevention, and favouring a differentiated, case-by-case approach to crisis intervention. This approach not only has created asymmetry between debtors and creditors, but also has left far too much discretion with the major creditor countries, on account of their leverage in international financial institutions. It has kept out of the reform agenda many issues of immediate concern to developing countries, which are discussed in the following chapters. However, even a rules-based system raises concerns for developing countries: under the current distribution of power and governance of global institutions, such a system would be likely to reflect the interests of larger and richer countries rather than to redress the imbalances between international debtors and creditors. Such biases against developing countries already exist in the rules-based trading system, although relations here are more symmetrical than in the financial domain.

If reforms to the existing financial structures are to be credible, they must provide for greater collective influence from developing countries and embody a genuine spirit of cooperation among all countries, facing many different problems but sharing a common desire to see a more stable international financial and monetary system. No less than a fundamental reform of the governance of multilateral institutions is therefore necessary.[11] The areas in which reform is needed are explored in a study undertaken for the G-24, which argues that governance within the Bretton Woods institutions needs to be improved regarding such matters as representation and ownership, accountability and transparency, and adaptation and change:

> The allocation of quotas and the correlate membership rights in both institutions no longer reflect the application of a coherent, justifiable set of principles: quotas no longer reflect relative economic and political power, and the principle of equal representation, which was once implemented by the allocation of "basic votes", has been significantly eroded. Furthermore, decision-making practices have not adapted to the changed mandates of both institutions, whose work now takes them further and further into influencing domestic policy choices in developing countries. (Woods, 1998: 95)

While, as recognized in that study, efforts have been made to respond to calls for more transparent, accountable and participatory governance, the basic modalities and procedures for taking decisions remain largely unchanged. Thus, whereas developed countries account for only 17 per cent of voting strength in the United Nations, 24 per cent in WTO, and 34 per cent in the International Fund for Agricultural Development (IFAD), they account for over 61 per cent in the Bretton Woods institutions. And a single country holds virtual veto power over important decisions such as capital increases or SDR allocations. It is now agreed in many quarters that the procedures for selection of the Managing Director of IMF and the President of the World Bank should give greater weight to the views of developing and transition economies, since the *raison d'être* of these institutions is now to be found mainly in their mandates and operations with respect to these economies. More fundamentally, crucial decisions on global issues are often taken outside the appropriate multilateral forums in various groupings of major industrial countries such as the G-7 or G-10, where there is no developing country representation or participation. Consequently, "nothing consequential happens in the formally constituted organizations that *do* have operational capabilities – the IMF, the World Bank, the Bank for International Settlements – without the prior consent, and usually the active endorsement, of the 'Gs' (here used as a short form for all the deliberative groups and committees dominated by the major industrial countries)" (Culpeper 2000: 5).

If reforms to the existing financial structures are to be credible, they must provide for greater collective influence from developing countries and embody a genuine spirit of cooperation.

The inclusion of developing countries in the discussions of financial architecture reform that take place outside the Bretton Woods institutions, notably in the newly created G-20, is thus generally welcomed as an important step in ensuring better participation and governance in international finance. However, even though its first chairman, the Canadian Finance Minister Paul Martin, declared that the G-20 "has a mandate to explore virtually every area of international finance and the potential to deal with some of the most visible and troubling aspects of today's integrated world economy",[12] so far the focus of its work has not substantially deviated from the G-7 reform agenda, including a stock-taking of progress made by all members in reducing vulnerabilities to crises, an evaluation of countries' compliance with international codes and standards, the completion of the so-called transparency reports, and an examination of different exchange rate regimes and their role in debtor countries in cushioning the impact of international financial crises (Culpeper, 2000: 19). Furthermore, despite the G-20's broader membership, there are still serious limitations on participation and accountability:

> The G-20 is severely flawed in that it contains no representation … from the poorest and smallest developing countries. … Presumably, this is because the poorest and smallest are unlikely ever to constitute any systemic threat. But there are major "architectural" issues surrounding the provision of adequate development finance to these countries and their peoples. … Nor does the G-20 possess any mechanisms either for reporting or for accountability to the broader international community, such as the constituency system provides within the IMF and World Bank, or any provisions for non-governmental inputs or transparency. (Helleiner, 2000: 13–14)

A number of proposals have been made on how to reform the multilateral process as well as to improve the membership, accountability and reform agenda of the G-20. Certainly, progress in these areas will depend on the willingness of the major industrial countries to extend the reform agenda and process so that they also address the concerns of developing countries. It will depend no less on positions taken by developing countries themselves. As noted above, there is no consensus among the developing countries on several issues of the reform agenda. Many of the differences pertain to the modalities of official intervention in the management and resolution of

financial crises. Most countries appear to give priority to access to large amounts of contingency financing as a defence against contagion and instability, despite their concerns as to the appropriateness of several of its features. At times of crisis many countries seem unwilling to impose temporary standstills, preferring official bailouts, even though they often complain that their terms and conditions deepen the crisis, put an unfair share of the burden of adjustment on the debtors, and allow the creditors to get away scot-free. This unwillingness may partly reflect an assessment that the risks of imposing a standstill are excessively high when such action is still considered an aberrant response to a crisis (so far resorted to by only a few countries).

> Progress will depend on the willingness of the major industrial countries to extend the reform agenda and process so that they also address the concerns of developing countries. It will depend no less on positions taken by developing countries themselves.

There appears to be greater convergence of views and interests regarding measures for crisis prevention and governance of international finance. Objectives commonly shared by developing countries include: more balanced and symmetrical treatment of debtors and creditors regarding codes, transparency and regulation; more stable exchange rates among the major reserve currencies; effective IMF surveillance of the policies of the major industrial countries, especially with respect to their effects on capital flows, exchange rates and trade flows of developing countries; a less intrusive conditionality; and, above all, more democratic and participatory multilateral institutions and processes. Effective reform of the international monetary and financial system will ultimately depend on the ability and willingness of developing countries to combine their efforts around these common objectives, and on acceptance by developed countries that accommodating these objectives is essential to building a more inclusive system of global economic governance. ■

Notes

1 For a survey of these proposals, see *TDR 1998*, Part One, chap. IV; Akyüz (2000a); and Rogoff (1999).

2 For a useful summary of the history, structure, functions and legal status of the BIS, see Edwards (1985: 52–63). Until recently the principal shareholders of the BIS were 28 predominantly West European central banks, with those of Belgium, France, Germany, Italy and United Kingdom holding over 50 per cent of the votes. The United States Federal Reserve participates in meetings and committees linked to the BIS without being a shareholder. More recently the BIS invited additional central banks from emerging markets to become shareholders.

3 Kaufman (1992: 57); and "Preventing the next global financial crisis", *Washington Post*, 28 January 2001, A.17. See also speaking notes by H. Kaufman for the Extraordinary Ministerial Meeting of the Group of 24, Caracas, February 1998.

4 See also UNCTAD secretariat (1987), which reviews the experience with floating in the 1980s. In respect

of both the institutional hiatus and exchange rate behaviour little has changed in the past 15 years.

5 This proposal was first made in Williamson (1983).

6 Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, 24 September 2000, Washington, DC: para. 11.

7 Horst Köhler, Address to the Board of Governors, Fifty-fifth Annual Meeting, Prague, 26 September 2000.

8 See, for example, Wolf (2000); Eichengreen and Portes (2000); Summers (2000a); and also L.H. Summers' Testimony before the Banking Committee of the House of Representatives, 23 March 2000; and Goldstein (2000). For similar proposals, see the references in Rogoff (1999).

9 The concept belongs to Gerald Corrigan, quoted in Rogoff (1999: 27).

10 L.H. Summers, Testimony Before the Banking Committee of the House of Representatives, 23 March 2000: 14.

11 For an illuminating discussion of global governance issues, see Helleiner (2000).

12 Paul Martin, Speech to the House of Commons Standing Committee on Foreign Affairs and International Trade, Ottawa, 18 May 2000.

Chapter IV

STANDARDS AND REGULATION

A. Introduction

Many recent initiatives for international financial reform are directed at reaching agreement on, and implementation of, standards for major areas of economic policy. Most of these standards are ultimately intended to contribute to economic stability both at the national and international level. Their main proximate targets are the strengthening of domestic financial systems and the promotion of international financial stability "… by facilitating better-informed lending and investment decisions, improving market integrity, and reducing the risks of financial distress and contagion" (FSF, 2000a, para. 23). In pursuit of these objectives, the standards cover not only the financial sector, but also aspects of macroeconomic policy and policy on disclosure. Many features of these standards reflect concerns arising out of the experience of recent financial crises, though in a number of cases they also build on initiatives involving mainly industrial countries and originating from events of the more distant past. While the standards themselves are designed to promote stability, their development can also be viewed as part of a process of arriving at a set of globally accepted rules for policy in the financial and monetary spheres. Such rules could furnish one of the prerequisites for the provision of international financial support for countries experiencing currency crises. In this sense, they are an international analogue of the national rules for the financial sector, compliance with which is a condition for lender-of-last-resort financing.

The Financial Stability Forum (FSF)[1] has identified a number of standards which it considers particularly relevant to strengthening financial systems. These vary in the precise degree to which they have received international endorsement, but they have been broadly accepted, in principle, as representing basic requirements for good practice. As can be seen from table 4.1, the standards cover the areas of macroeconomic policy and data transparency, institutional and market infrastructure, and financial regulation and supervision – areas that are closely interrelated in many ways. Macroeconomic policy, for example, can crucially affect the more sectoral dimensions of financial stability through its impact on the values of financial firms' assets and liabilities (and thus on the context in which financial regulation and supervision are conducted). It can also affect the functioning of the system for payments and settlement, which is at the heart of the infrastructure of financial markets. Similarly, effective financial regulation and supervision are inextricably related to accounting, auditing and insolvency procedures.

Table 4.1

KEY STANDARDS FOR FINANCIAL SYSTEMS

Subject area	*Key standard*	*Issuing body*
Macroeconomic policy and data transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices in Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard (SDDS) General Data Dissemination System (GDDS) [a]	IMF
Institutional and market infrastructure		
Insolvency	Principles and Guidelines on Effective Insolvency Systems [b]	World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS) [c]	IASC [d]
Auditing	International Standards on Auditing (ISA)	IFAC [d]
Payment and settlement	Core Principles for Systemically Important Payment Systems	CPSS
Market integrity	The Forty Recommendations of the Financial Action Task Force on Money Laundering	FATF
Financial regulation and supervision		
Banking supervision	Core Principles for Effective Banking Supervision	BCBS
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance supervision	Insurance Supervisory Principles	IAIS

Source: FSF (2000a: 19).

a Economies that have, or might seek, access to international capital markets are encouraged to subscribe to the more stringent SDDS and all other economies are encouraged to adopt the GDDS.

b The World Bank is coordinating a broad-based effort to develop these principles and guidelines. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the *Model Law on Cross-Border Insolvency* in 1997, will help facilitate implementation.

c The BCBS has reviewed relevant IAS, and a joint BCBS-IASC group is further considering bank-related issues in specific IAS. IOSCO has reviewed and recommended use of 30 IAS in cross-border listings and offerings, supplemented, where necessary, to address issues at a national or regional level. The IAIS's review of relevant IAS is under way.

d The International Accounting Standards Committee (IASC) and the International Federation of Accountants (IFAC) are distinct from other standard-setting bodies in that they are private sector bodies.

Insurance products are frequently incorporated in, or sold in close conjunction with, investment products, thus increasing the channels through which disturbances affecting the market for one financial service can be transmitted to markets for another. And even such an apparently self-contained issue as money laundering has, on occasion, threatened the stability of financial firms.[2]

The list of organizations associated with the key standards in table 4.1 is not exhaustive, and the standards themselves give only a brief idea of

the many initiatives taking place under each heading. When the FSF reviewed the standards agenda in March 2000, the 12 subject areas were already only a subset of a larger group which eventually numbered 64 (FSF, 2000a, paras. 55–57 and Annex 8). The discussion in section B focuses on the main thrust and contents of the standards in table 4.1. It also aims to illustrate some omissions and some of the practical problems posed by implementation of the standards. Section C looks at the process of participation in the formulation and application of the standards initiatives. This leads naturally to the issue of bias in the official thinking which underlies the selection of the subjects covered by these initiatives and the asymmetrical way in which they are approached. To illustrate the strengths and weaknesses of this thinking, section C examines in some detail three major reports of FSF working groups. Section D deals more systematically with implementation issues and some of the problems already raised in the context of particular standards in section B. Various incentives and sanctions are discussed as well as the findings of a preliminary survey to review progress so far. As discussed in section E, the contribution of standards to the achievement of greater financial stability depends to a great extent on their incorporation into the rules and norms of business practice. This in turn is closely connected to the regulatory and supervisory regime within which these rules and norms are applied. However, improvements on this front have inherent limits, as illustrated by examples taken from the key area of banking supervision.

B. Themes of the key standards

Each of the codes discussed here is intended to accomplish improvements at both macroeconomic and microeconomic levels. A significant part of the impetus behind the initiatives discussed in subsections B.1–B.3 was furnished by particular financial crises and systemic incidents of stress – mostly recent ones. Their major objectives are macroeconomic or systemic, though particular features of the behaviour of specific economic agents are also targeted. In the case of the codes discussed in subsections B.4–B.9, the balance between macroeconomic and microeconomic objectives is different, with much less explicit emphasis given to the former. Moreover, many of the latter codes are of long-standing origin and antedate the crises of the 1990s. It is their incorporation into a global programme of financial reform that is recent.

1. *Macroeconomic policy and data transparency*

The Code of Good Practices on Transparency in Monetary and Financial Policies (IMF, 2000c) identifies desirable transparency practices in the conduct of monetary policy and of policies towards the financial sector. These practices require: clarity with respect to the roles, responsibilities and objectives of central banks and financial agencies other than central banks with responsibility for overseeing and supervising different parts of the financial sector; open processes for the formulation and reporting of decisions on monetary and financial policy; public availability of information concerning policies in both spheres; and accountability and assurances of integrity for the

central bank, other financial agencies and their staff.

The Code of Good Practices on Fiscal Transparency (IMF, 1998a) is based on four principles: first, the roles and responsibilities of and within the government should be transparent, and for this purpose there should be a clear legal and administrative framework for fiscal management; secondly, governments should commit themselves to public disclosure of comprehensive, reliable information on fiscal activities; thirdly, the process of budget preparation, execution and reporting should be open; and, fourthly, fiscal information should be subject to public and independent scrutiny.

> The new disclosure rules of the Special Data Dissemination Standard failed to serve as an effective early warning system in the case of the Asian crisis.

The Special Data Dissemination Standard was developed by the IMF in response to recognition, after the Mexican crisis, of widespread deficiencies in major categories of economic data available. It prescribes the data which countries intending to use the world's capital markets should be expected to make public concerning the real, fiscal, financial and external sectors of their economy. Moreover, it lays down minimum benchmarks to be met in terms of periodicity and timeliness in the provision of that information. Since its inception, the Special Data Dissemination Standard (SDDS) has been strengthened by the inclusion of a requirement to disclose not only reserve assets, but also reserve-related liabilities and other potential drains on reserves, such as short derivative positions and guarantees extended by the government for borrowing by the private sector in foreign currency. The SDDS is supplemented by the General Data Dissemination System (GDDS), which is designed to improve the quality of data disclosed by all member countries of the IMF.

> A common characteristic of the countries affected by recent financial crises was their openness to capital flows, while there were substantial differences in many of their macroeconomic indicators and other features of their economies.

The rationale for these codes and standards has several facets. The effectiveness of monetary, financial and fiscal policies can be enhanced if the objectives and instruments of policy in these areas are known to the public and if the government's commitment to these objectives is credible. Good governance more generally requires that central banks, other financial agencies and fiscal authorities are accountable. But an important aspect of the Codes' rationale goes beyond their benefits at the domestic level and concerns international lenders and investors. Here, the idea is that transparency should help lenders and investors to evaluate and price risk more accurately, thus contributing to policy discipline in recipient countries. Moreover, the assessment of individual countries made possible by these Codes is expected to prevent the so-called contagion effect, whereby a loss of confidence in one country spreads to others simply because they belong to the same category or region.[3]

That transparency regarding major areas of macroeconomic policy can contribute to their credibility, and to good governance more generally, seems incontrovertible. Transparency is also capable of facilitating multilateral surveillance by organizations such as the IMF. Understandably, the Codes confine themselves to process rather than substance, since codes of rules for policy would be enormously complex if they were to cover the great variety of different situations and countries. In addition, it would be much more difficult to reach consensus on such rules than on those limited to process.

Regarding the expectation that either the Codes concerning macroeconomic policy or the SDDS will lead to much improved decisions by international lenders and investors, and thus to improved resource allocation and enhanced policy

discipline for the governments of the receiving countries, there are grounds for scepticism. The new disclosure rules of the SDDS failed to serve as an effective early warning system in the case of the Asian crisis. Indeed, information was widely available concerning the balance of payments of the countries involved, the external financial flows to them, their corporate governance, trends in their domestic lending and in their banks' exposure to overvalued property sectors, and major features of external assets and liabilities (though there were gaps in what was publicly disclosed concerning the last of these items, gaps which subsequent strengthening of the SDDS was designed to fill). And if the availability of pertinent data failed to deter capital flows associated with the build-up of eventually unsustainable external financial positions in certain Asian countries, the same applied, *a fortiori,* to the behaviour of international lenders and investors in the Russian Federation prior to the crisis of mid-1998.

A more fundamental limitation of the potential contribution of transparency to the prevention of financial instability is due to the considerable variation in accompanying macroeconomic conditions and other features of policy regimes – a variation evident during recent financial crises. A common characteristic of the countries affected by these crises was their openness to capital flows, but there were substantial differences in many of their macroeconomic indicators and other features of their economies. These differences involved external deficits, the extent of currency overvaluations, the size of budget deficits, the relative importance of consumption and investment in the booms preceding the crises, the relative size of countries' external debt owed by the public and private sectors, and the coverage and effectiveness of regimes of financial regulation and supervision.

Analysis of recent international financial crises also points to other difficulties as to the extent to which improved disclosure of macroeconomic variables can contribute to greater financial stability, in particular to the avoidance of the contagion effect. National balance sheets do not always reflect the pressures on external payments that can result from the adjustment of derivative positions which are off-balance-sheet and not always adequately covered by accounting rules. Moreover, derivative positions, even if covered under these rules, are capable of blurring distinctions between different categories of exposure, such as those between short and longer term. There is now a consensus that cross-border hedging and other practices make many of the international financial system's fault lines difficult to identify in advance. As a recent report of the Financial Stability Forum states:

> Certain commonly employed risk management techniques … can have the effect of adding to the volatility of both prices and flows in the international capital market … That is, investors acquire or dispose of claims whose risk characteristics and price history resemble those of the asset being proxied but where the market is deeper, more liquid, or subject to fewer restrictions and controls. Such behaviour was one of the factors behind the large fluctuations in capital flows to South Africa and several countries in Eastern Europe around the time of the Asian crisis. (FSF, 2000b, para. 28)

In the context of more recent events, attention has been drawn to the way in which Brazilian bonds have become an instrument widely used by investors in emerging markets to hedge positions in the debt of other countries such as the Russian Federation, Morocco and the Republic of Korea.

2. Banking supervision

Weaknesses in the banking sector and inadequate banking supervision[4] have played a central role in recent financial crises in developed as well as developing countries. Recognition of the increasing potential for destabilizing the cross-border effects of banking crises – owing to the internationalization of the banking business – has led to initiatives since the 1970s that aim to improve international cooperation in banking regulation and supervision. Initially, these initiatives were directed primarily at banks in industrial countries and offshore financial centres in response to a number of events that highlighted the inadequacies in their banking regulation and supervision. These events provided much of the inspiration for subsequent efforts to improve regulatory and supervisory cooperation. The standards which emerged from these initiatives eventually

also achieved widespread acceptance among developing and transition economies. The Basel Committee on Banking Supervision (BCBS) – the most important vehicle for most of these initiatives – has increasingly assumed the role of global standard-setter in this area.[5]

A major outcome of the BCBS's extension of the focus of its activities beyond the concerns of its member countries is the *Core Principles for Effective Banking Supervision* issued in late 1997. In the development of these Principles, the BCBS collaborated with supervisors of economies outside the Group of Ten (including several developing and transition economies). They cover seven major subject areas: (i) the preconditions for effective banking supervision; (ii) the licensing and structure of banks; (iii) prudential regulations and requirements; (iv) methods of ongoing supervision; (v) information requirements; (vi) the formal powers of supervisors; and (vii) cross-border banking. In April 1998, the BCBS undertook a survey of compliance with the Core Principles in 140 economies, an effort paralleled by IMF and World Bank reviews of compliance in selected countries.[6] Subsequently a Core Principles Liaison Group (CPLG) of 22 members[7] was set up to provide feedback to the BCBS on the practical implementation of these Principles. The reviews of compliance and feedback from the CPLG led to the development by the BCBS of the *Core Principles Methodology* issued in October 1999 (BCBS, 1999a).

This document on methodology is intended to provide guidance in the form of "essential" and "additional" criteria for the assessment of compliance by the different parties to which this task may be entrusted, such as the IMF, the World Bank, regional supervisory groups, regional development banks and consulting firms, but not the BCBS itself. In addition to the specific criteria relating to banking supervision, the assessors are also required to form a view as to the presence of certain more general preconditions regarding such subjects as: (i) sound, sustainable macroeconomic policies; (ii) a well developed public infrastructure, including an adequate body of law covering, for example, contracts, bankruptcy, collateral and loan recovery, as well as accounting standards approaching those of international best practices; (iii) market discipline based on financial transparency, effective corporate governance and the absence of government intervention in banks' commercial decisions except in accordance with disclosed policies and guidelines; (iv) adequate supervisory procedures for dealing with problems in banks; and (v) adequate mechanisms for systemic protection such as a lender-of-last-resort facility or deposit insurance (or both). The parts of the assessment directed more specifically at banking supervision comprise not only the procedures of supervision but also its subject matter (which, of course, includes the standards for prudential regulation and for banks' own internal controls and risk management covered in the BCBS's own documents over the years). With respect to subjects such as accounting and auditing standards and insolvency law, the Core Principles for Effective Banking Supervision clearly overlap to some degree other key standards mentioned in table 4.1.

Internationally promulgated standards can help upgrade national rules and norms, but the objective should not be uniform rules for all countries.

Assessment of compliance with the Core Principles requires evaluation of several related requirements, including prudential regulation and other aspects of the legal framework, supervisory guidelines, on-site examinations and off-site analysis, supervisory reporting and other aspects of public disclosure, and enforcement or its absence. Assessment is also required of the supervisory authority's skills, resources and commitment, and of its actual implementation of the Core Principles. If evaluation of the preconditions for effective supervision (mentioned earlier) and assessment of the criteria relating to supervision itself are considered together, the exercise covers substantial parts of a country's commercial law, its accounting and auditing standards, and to some extent the quality of its government's macroeconomic management.

The assessment of relevant laws, regulations and supervisory procedures would appear to be

fairly straightforward, but that of supervisory capacity and the effectiveness of implementation more complex.[8] Thus, perhaps understandably, the annex to the *Core Principles Methodology,* which sets out the structure and methodology for assessment reports prepared by the IMF and the World Bank, focuses principally on the former set of subjects and not the latter. Assessment of supervisory capacity and the effectiveness of implementation is generally likely to be feasible only through extended in-depth scrutiny. This would require a lengthy presence of the assessor in the country undergoing assessment, either in the form of a permanent presence, or through a process involving several visits. If the latter option were selected for the purpose (and it seems rather more likely to be acceptable and more in accord with normal procedures for IMF surveillance), an authoritative assessment of compliance with the Core Principles may take years.

Assessment of the more general preconditions for effective supervision is not mentioned in the annex to the *Core Principles Methodology,* but here, too, a lengthy exercise is likely to be necessary. In particular, assessment of the many dimensions of a country's legal regime and of its accounting and auditing standards requires evaluation not only of laws, regulations and principles promulgated by professional bodies (such as those of accountants), but also of their implementation, and of the way in which they are incorporated into rules and norms in practice.[9] Many features of countries' legal regimes and business norms reflect differences in historical roots and in compromises among social groups. Internationally promulgated standards can help upgrade national rules and norms, but many aspects of the process will be gradual, and the objective should not be uniform rules for all countries.[10]

At the level of the countries being assessed, such exercises will often place an additional burden on a limited supply of supervisory capacity. In time, this capacity can be expanded, but the training of a bank supervisor typically requires a considerable period. And once trained, a supervisor may be faced with attractive alternative employment opportunities in the private sector, or even in the IMF or the World Bank themselves (which have recently been increasing the number of their staff with expertise in this area). There is, of course, awareness of the problem of human resources among bodies such as the BCBS, the IMF, the World Bank and the CPLG, and efforts are being made to coordinate initiatives and to ensure that scarce expert resources are used in the most efficient way. However, there remains a real danger that international assessment of countries' supervision will be at the expense of actual supervision on the ground.

3. Payments and settlement

Payment systems enable the transfer of funds between financial institutions on their own behalf and on behalf of their customers, a role which makes such systems a potential source of systemic risk. This role is evident from a consideration of four key dimensions of an economy's flow-of-funds process: (i) the activities of various economic agents; (ii) the markets for financial instruments, assets and liabilities; (iii) the supporting infrastructure, of which an integral component is the payments system; and (iv) economic conditions binding the markets together and ensuring that they clear. Failures in any of the first three dimensions are capable of disrupting links between the markets and between economic agents whose mutual interdependence is based on several different kinds of transaction and exposure. If large, such disruptions can easily take on a systemic character.[11] Moreover, payment systems also play an essential role in foreign exchange transactions, which are thus an interface between different countries' payment systems.[12] As a result of the links and similarities between systems of payment and settlement for fund transfers and for transactions in other financial assets, the main vehicle for international initiatives in this area, the BIS Committee on Payment and Settlement Systems (CPSS), has extended its purview beyond fund transfers to settlement systems for securities and foreign exchange and to clearing arrangements for exchange-traded derivatives (White, 1998:196–198). Moreover, the specific stability issues posed by securities settlement are currently the subject of a joint working group of the CPSS and the International Organization of Securities Commissions (IOSCO).[13] But the discussion here will be

limited to the key standard in the area of payment and settlement mentioned in table 4.1.

The initiative to develop an internationally agreed framework of core principles for the design, operation and oversight of payment and settlement systems reflects increased recognition of the risks associated with rapidly rising volumes of payments (CPSS, 2000a).[14] The main risks in these systems are: *credit risk*, when a counterparty is unable to meet obligations within the system currently or in future; *liquidity risk* (clearly closely related, but not identical, to credit risk), when a counterparty has insufficient funds to meet obligations within the system, though it may be able to do so at some future time; *legal risk*, when an inadequate legal framework or legal uncertainties cause or exacerbate credit or liquidity risks; and *operational risk*, when factors such as technical malfunctions or operational mistakes cause or exacerbate credit or liquidity risks. As discussed above, any of these risks can have systemic consequences, as the inability of a counterparty or counterparties to meet obligations within the system can have a domino effect on the ability of other counterparties to meet their obligations, and thus, ultimately, threaten the stability of the financial sector as a whole.[15] The task force established to develop the Core Principles was to limit itself to "systemically important payment systems", namely those capable of triggering or transmitting shocks across domestic and international financial markets.

The first Core Principle is directed at legal risk and specifies the need for a robust legal basis for the payment system, a requirement that links its rules and procedures to related areas of law such as those concerning banking, contract and insolvency. The second and third Principles concern rules and procedures for enabling participants to have a clear understanding of the system's impact on financial risks. They also recognize the need for defining how credit and liquidity risks are to be managed and for identifying responsibilities for this purpose. A system's risks can be exacerbated by the length of time required for final settlement or by the nature of the asset used to settle claims. Thus the fourth and sixth Principles specify the need for prompt settlement and for a settlement asset that is either a claim on the central bank or one carrying little or no credit risk (owing to the negligible risk of its issuer's failure). The fifth Principle requires a minimum standard of robustness for multilateral netting systems.[16] The seventh Principle is intended to minimize operational risk through ensuring a high degree of security and operational reliability. The eighth, ninth and tenth Principles address the more general issues of the system's efficiency and practicality (including the need for explicit recognition of any trade-off between safety and efficiency). They also address the need for objective and publicly disclosed criteria for participation in the system, permitting fair and open access, and effective, accountable and transparent governance arrangements. The Core Principles attribute to central banks key responsibility for ensuring that payment systems comply with the Principles.

The second part of the Report on the *Core Principles for Systemically Important Payment Systems* provides details on issues such as the identification of systemically important payment systems, the modalities of their review and reform, structural, technical and institutional factors to be considered, and the kinds of cooperation necessary with participants in the system, user groups and other parties to the reform process (CPSS, 2000b).[17] The second part also takes up certain cross-border aspects of payment systems. The Core Principles are now included in the joint IMF-World Bank Financial Sector Assessment Programme (FSAP).[18] However, experience in industrial countries suggests that the upgrading of payment systems required by the Principles is likely to entail a lengthy process owing to the many different actions required and the many different parties involved.

4. Accounting and auditing

Improvements in financial reporting and transparency are essential to most of the initiatives on codes and principles, but in the area of accounting and auditing in table 4.1 there is an explicit aim to harmonize standards. Through their impact on disclosure, these standards have an obvious bearing on counterparties' ability to assess the financial risks of transactions. The need for international harmonization is also due to the

growth in cross-border business, especially in lending and investment. The principal body with responsibility for promulgating international accounting standards is the International Accounting Standards Committee (IASC).[19] Much of the recent work of the IASC has been directed at reaching a compromise on a set of standards acceptable both to the United States and to other member countries, and which satisfies disclosure requirements for the issuance and trading of securities in the world's major financial markets. A number of the difficult problems here concerns the reconciliation of the understandably pluralistic approach of the IASC with the more specific and constraining rules of the Generally Accepted Accounting Principles (GAAP) of the United States.[20]

There is also a question as to how far the greater transparency leads to greater financial stability.

While debate on the International Accounting Standards (IAS) is concerned mainly with highly specific subjects,[21] its impact on the international financial system is likely to depend more on its success in raising standards of accounting and financial reporting worldwide. And this will also be related to accompanying initiatives to raise auditing standards. The targets of such efforts include internal auditing (i.e. assessment of the extent and effectiveness of a firm's management and accounting controls and of the safeguarding and efficient use of its assets) as well as external auditing (i.e. auditing of financial statements and supporting evidence to determine the conformity of the former with applicable standards). Internal auditing is now a legal requirement in several countries, and auditing committees have frequently acquired greater importance in countries where shifts in corporate governance have resulted in increased power for boards of directors vis-à-vis senior operating executives. But it is external auditing which is the principal subject of international initiatives. Here the problems of harmonization relate partly to differences in the accounting standards underlying financial statements but also to divergences in audit standard-setting processes themselves. These divergences result, for example, from the fact that in some countries auditing standards are set by the accounting profession whereas in others they are based on requirements mandated in laws and regulations, or they result from a process involving the joint participation of both the accounting profession and the government. The institution specified in table 4.1 as having the lead responsibility for international harmonization of auditing standards is the International Federation of Accountants (IFAC),[22] which closely collaborates with other bodies also occupying key positions in this area such as IOSCO and relevant EU institutions.

While improved standards of accounting and auditing have the potential for contributing to better decision-making by lenders and investors through enhanced transparency, recent experience cautions against exaggerated expectations in this regard, especially in the short run. There is also a question as to how far the greater transparency – which is the main ultimate objective under this heading – leads to greater financial stability. As the celebrated investment manager, Warren Buffett, warns, "the accountants' job is to record, not to evaluate", and "… the business world is simply too complex for a single set of rules to effectively describe reality for all enterprises" (Cunningham, 2000: 196, 202). In the case of financial firms, the difficulties are multiplied by the speed with which assets and liabilities can change, even in cases where high standards of reporting are observed. Moreover, as already noted, although financial reporting was poor in several of the countries involved in recent financial crises, there was no shortage of information available to lenders and investors about key macroeconomic variables and the general economic and legal environment in the countries concerned. And if the information in good financial reporting has such a beneficial ef-

If the information in good financial reporting has such a beneficial effect on decision-making, why were lenders and investors not more wary in its absence?

fect on decision-making, why were lenders and investors not more wary in its absence, especially in view of weaknesses which should have been evident from the macroeconomic information which was available?

5. Corporate governance

Corporate governance involves the relationships between the management of a business and its board of directors, its shareholders and lenders, and its other stakeholders such as employees, customers, suppliers and the community of which it is a part. The subject thus concerns the framework in which the business objectives are set and how the means of attaining them and otherwise monitoring performance are determined. The *OECD Principles of Corporate Governance* (OECD, 1999) cover five basic subjects: (i) Protection of the rights of shareholders, a heading that includes allowing the market for corporate control to function efficiently, transparently and fairly for all shareholders; (ii) Equitable treatment of shareholders, including minority and foreign shareholders, with full disclosure of material information and the prohibition of abusive self-dealing and insider trading; (iii) Recognition and protection of the exercise of the rights of stakeholders as established by law, and encouragement of cooperation between corporations and stakeholders in creating wealth, jobs and financially sound enterprises; (iv) Timely and accurate disclosure and transparency with respect to matters relevant to company performance, ownership and governance, which should include an annual audit conducted by an independent auditor; and (v) A framework of corporate governance to ensure strategic guidance for the company and effective monitoring of its management by the board of directors, as well as the board's accountability to the company and shareholders (certain key functions of the board being specified under this heading).

Corporate governance sets rules on matters where variations of approach among countries are often rooted in societal differences – for example, with respect to the relative importance of family-owned firms as opposed to corporations, or to prevalent norms regarding the primacy of sometimes conflicting business objectives, such as long-term sustainability, on the one hand, and value for shareholders, on the other. These societal differences, in turn, generally reflect differences in national histories and in the political and social consensus which has grown out of them.[23] The preamble to the OECD Principles acknowledges that there is no single model of good corporate governance and the Principles themselves are fairly general. They avoid rules for the more contentious aspects of relations between companies and their lenders and investors, such as appropriate levels of leverage. They also avoid the more detailed rules for the market for corporate control. Nevertheless, there remains a danger that the technical assistance and assessment exercises associated with the promulgation of these Principles – which will also involve other organizations such as the World Bank – will contain features that reflect biases in favour of concepts linked to particular models of corporate governance, most notably those of the United Kingdom or the United States.

Corporate governance sets rules on matters where variations of approach among countries are often rooted in societal differences that generally reflect differences in national histories and in the political and social consensus which has grown out of them.

Regarding the potential of better corporate governance to contribute to financial stability, a conclusion similar to that for auditing and accounting seems in order. Improvements in this area can be expected to lead to better decision-making on several matters, but if they are based on principles similar to those enunciated by the OECD, they are likely to be gradual. Moreover, the better decision-making achieved in this way may have only limited effects on instability, which results from forces which corporate governance can mitigate but not eliminate. These forces include the pressures on loan officers to achieve target levels of profit in financial firms (a chronic problem, but one still not satisfactorily addressed in most firms' internal controls), weakness in even state-of-the-

art techniques for controlling credit, market and other financial risks, and psychological factors conducive to imitative and herd behaviour in the financial sector.

6. Insolvency

Insolvency rules are such a substantial part of corporate governance as defined above that they have generated a separate literature on the subject. There is general recognition that existing regimes for insolvency are characterized by widespread weaknesses, or indeed by their total absence in some situations and countries.[24] At the national level (particularly in many developing and transition economies), weakness is associated with problems regarding the enforcement of contracts, ineffective modalities for the netting, clearance and settlement of outstanding obligations, poorly functioning arrangements for the collateral and security of loans, and conflicts of law. All these features can pose serious problems for certain aspects of the valuation of firms and securities, and they can be a source of increased financial risk. Their presence in emerging markets can therefore be a significant deterrent to foreign investment.

The lead role in developing globally acceptable rules for insolvency has been attributed to the World Bank, whose objective is to develop an "integrated matrix" of components and criteria for such rules, highlighting existing best practices.[25] These elements are intended to be a complement of a country's legal and commercial system with guidance provided as to how they would interact with and affect the system. Consensus on them is to be developed through a series of assessment exercises and international insolvency symposia. The principal focus of the World Bank's initiative is national regimes in developing and transition economies.

The feedback from this process has led to a Consultation Draft organized into the following three parts: (i) legal, institutional, regulatory, and restructuring and rehabilitation building blocks; (ii) different categories of insolvency conditions such as systemic insolvency and that of banks and enterprises; and (iii) an international dimension concerned with encouraging developing and transition economies to take account of both international best practices and issues with a cross-border dimension in order to facilitate their access to international financial markets.

The insolvency of a large firm with an extensive international network of entities could seriously disrupt cross-border transactions.

Improved insolvency rules have a more direct link to financial stability than many of the other subjects covered by the codes in table 4.1. Their main role under this heading is to help contain the problems due to the insolvencies of particular firms and to prevent broader contagion effects. The beneficial impact of this role obviously extends to cross-border lending and investment. However, as noted above, the focus of the initiative being led by the World Bank is on rules for developing and transition economies, even though cross-border insolvencies (i.e. insolvencies involving firms with business entities in more than one country) pose difficult problems of coordination and conflicts of law in developed countries as well. Here the danger is that the insolvency of a large firm with an extensive international network of entities could seriously disrupt cross-border transactions. A special threat is that posed by the possibility of the failure of a large multinational bank having a home jurisdiction in a developed country.[26] Most of the problems which would result from such a failure concern the cross-border dimensions of insolvency, and attempts to develop international rules are currently concentrated in other forums.[27]

7. Securities regulation

The *Objectives and Principles of Securities Regulation*, published by IOSCO in September 1998, sets out three major objectives: the protection of investors; ensuring that markets are fair,

efficient and transparent; and the reduction of systemic risk. To achieve these objectives, it lists 30 principles covering responsibilities of the regulator, self-regulation, enforcement of securities regulation, cooperation in regulation domestically and internationally, the responsibilities of issuers, rules and standards for collective investment schemes, requirements for market intermediaries, and rules and standards for the secondary market. The principles explicitly related to systemic risk are covered mainly under the last two headings, and are concerned with capital and prudential standards for market intermediaries, procedures for dealing with the failure of a market intermediary, and systems for clearing and settling securities transactions which minimize such risk. In other words, the focus of the principles for reducing systemic risk is on measures directed at firms and market infrastructure.

Unsurprisingly for a code produced by a global organization of specialist regulators, these principles are concerned mainly with the fairness and efficient functioning of markets themselves. Connections to broader issues of macroeconomic policy and to policy towards the financial sector, both of which have been associated with systemic instability in developing and transition economies, are ignored. A more comprehensive and representative set of principles for securities markets – including issues highlighted by recent crises in developing and transition economies – should arguably address some aspects of policy towards the capital account of the balance of payments (such as appropriate conditions for the access of foreign portfolio investors) and the commercial presence of foreign investment institutions.

8. Insurance

Traditionally, insurance is not regarded as a source of systemic risk. Consequently, the principal objectives of its regulation and supervision are client protection and the closely related subjects of the safety and soundness of insurance companies and their proper conduct of business. This involves such matters as disclosure, honesty, integrity and competence of firms and employees, marketing practices, and the objectivity of advice to customers. The principal grounds for downplaying the systemic risks of the insurance sector are that companies' liabilities are long term and not prone to runs, while their assets are typically liquid. Moreover, mutual linkages among insurance companies and linkages between such companies and other financial firms are limited owing to the lack of a role for the former in clearing and payments and to the extent and depth of the markets where their assets are traded (Goodhart et al., 1998:14).

However, recently questions have been raised as to the adequacy of this characterization. This is partly due to the expanding role of the insurance sector in savings and investment products stemming from the close links between many kinds of life insurance policy and personal saving or investment instruments. The recent expansion in its turn is due partly to trends in the conglomeration of financial firms that have witnessed more widespread involvement of insurance companies in the sale and management of investment funds, on the one hand, and of banks in the insurance business, on the other. These trends have increased the possibility of contagion between insurance and other forms of financial business and, where large firms are involved, the scale of the possible adverse consequences of such contagion. In the case of developing and transition economies, an additional danger should be taken into account, namely, that the failure of one or more financial firms – including those with substantial insurance interests – may trigger a run on the currency. The resulting depreciation can have adverse consequences extending well beyond the sector where the problems originate.

The focus of the *Insurance Core Principles*[28] is the organization and practice of the sector's supervision, as well as the following sector-specific subjects: the corporate governance of insurance companies, their internal controls, prudential rules, conduct-of-business issues and the supervision of cross-border business. The prudential rules cover the management of an insurance company's assets, the identification and classification of liabilities, rules for capital requirements and for the use, disclosure and monitoring of derivatives and other off-balance-sheet items, and reinsurance as an instrument for risk containment. The principle covering the supervision of cross-

border business operations is designed to ensure that no cross-border insurance entity escapes supervision, and that adequate arrangements are in place for consultations and information exchange between such an entity's home-country and host-country supervisors. Thus the focus of the *Insurance Core Principles* is functional, while issues explicitly relating to the supervision of financial conglomerates are left to other forums (IAIS, 2000a).[29]

9. Market integrity and money laundering

Money laundering is one of the most politically sensitive subjects covered by the codes and principles listed in table 4.1. It is an area where financial supervision interfaces directly with law enforcement – including some of the latter's tougher manifestations – since the activities financed with laundered money include drug dealing and terrorism. Indeed, the attention given to money laundering reflects, to a significant extent, the political difficulties in major developed countries in dealing with the problem of drug consumption. The policies adopted here have focused mainly on repression of production and consumption as opposed to alternative approaches, with the result that profits from illegal supply remain high. Money laundering is also closely connected to corrupt activities in developed and developing countries since it is used for concealing the size, sources and recipients of the money involved in such activities. Generally accepted estimates of the global scale of money laundering do not yet exist, but there is no doubt that it is very large. Money laundering has long been an important issue in relations between OECD countries and offshore financial centres. However, some recent scandals indicate that it also remains a problem for countries with traditional financial centres.[30]

Money laundering has long been an important issue in relations between OECD countries and offshore financial centres. However, some recent scandals indicate that it also remains a problem for countries with traditional financial centres.

The principal international body entrusted with the task of combating money laundering is the Financial Action Task Force on Money Laundering (FATF),[31] established after the Group of Seven summit in 1989. Its current membership consists of 29 (mainly developed) countries and two international organizations – the European Commission and the Gulf Cooperation Council. In 1990, the FATF drew up a list of 40 recommendations which members are expected to adopt. These were revised in 1996 to take account of experience gained in the meantime and of changes in money laundering practices (FATF, 1999). Implementation by member countries of these recommendations is monitored on the basis of a two-pronged approach – an annual self-assessment exercise and periodic peer reviews of a member country by teams drawn from other members. More recently, the FATF has also conducted an exercise to identify jurisdictions deemed to be non-cooperative in the combat against money laundering (FATF, 2000). It clearly hopes that identification and the attendant publicity will prompt improvements in the 15 countries it has identified so far. In addition, its members have agreed to issue advisories to regulated financial institutions within their jurisdictions, requiring them to take extra care in business undertaken with counterparties in the 15 countries – an action that is likely to impose extra costs on such business.

The FATF's 40 recommendations include the following obligations: criminalization of the laundering of the proceeds of serious crimes; the identification of all customers and the keeping of appropriate records; a requirement that financial institutions report suspicious transactions to the competent national authority and that they develop programmes to counter money laundering, including comprehensive internal controls and employee training; adequate supervision of money laundering and the sharing of expertise by supervisors with other domestic judicial and law enforcement authorities; and the strengthening of international cooperation through information exchange, mutual legal assistance and bilateral and multilateral agreements. There are relations between the FATF's initiatives and others directed at offshore financial centres.[32]

For example, the harmful tax competition techniques for evading tax through recourse to offshore financial centres that are the subject of the OECD initiative (OECD, 2000d) are often the same as or similar to those used in money laundering. Likewise, "know your client" rules – a standard part of an effective regime for financial regulation – generally cover much the same ground as the FATF's requirements concerning customer identification. However, as in the case of other codes and principles discussed in this section, the contributions of the FATF's recommendations to international financial stability are mostly indirect.

Disclosures about involvement in money laundering have sometimes been associated with the failure of financial firms. However, money laundering – like the facilities offered by offshore centres – has played, at most, a marginal role in recent financial crises. Nevertheless, by making certain types of capital flight more difficult or costly, better control of money laundering can help restrain certain potentially destabilizing capital flows and accumulation of external debt not linked to legitimate economic activity. But the effectiveness of such restraint will depend on the degree of active cooperation between countries which are sources and recipients of laundered money. Rules on money laundering are therefore an essential component of regulatory regimes for financial firms; without them such regimes could scarcely be characterized as effective or comprehensive.

C. Influence and participation in the formulation and implementation of standards

Since standards became an integral component of international financial reform, much emphasis has been placed on the importance of "ownership" of their adoption and implementation by the countries affected. Extensive consultation has taken place as part of the assessment of implementation now under way and the results can eventually be expected to affect the future development of the standards themselves. However, not all of the exercises under this heading have been free of asymmetries among the different parties involved. This has led, on occasion, to questions about fairness. Lack of symmetry, particularly in the degree to which developing countries' concerns are taken into account, is also evident in the selection of subjects to which some of the standards are to apply. This would appear, at least partly, to reflect divergences in viewpoints concerning the functioning of the international financial system and the issues appropriate for policy action.

"Ownership" is related to countries' perceptions of their national interest in the adoption and implementation of standards. Such perceptions can be assisted by the exchange of experiences in forums such as the multilateral financial institutions and the standards-setting bodies, providing the opportunity to contribute to standards setting, alignment of programmes for standards implementation with domestic agendas for financial reform, and encouraging and aiding self-assessment (FSF, 2000a: 2). The promotion of country ownership is an objective of outreach programmes on standards implementation (IMF, 2000e), which operate through vehicles such as technical assistance, workshops and regional meetings. These activities have also involved the IMF and the World Bank, institutions with relevant expertise such as supervisors from major industrial countries, and others participating in processes of peer review.

The asymmetries mentioned above are not omnipresent and are not always easily identified, since they are often woven into basic assumptions or categories underlying the standards in table 4.1. The bias in some of the Codes towards subjects likely to be of greater concern to developed countries often reflects the historical origins of the initiatives in question. Much of the cross-border business affecting the subjects covered was traditionally between parties in industrial countries, with developing countries' involvement being only fairly recent. Yet despite their increasing prominence in this context, certain concerns of developing countries appear to have been set aside during standards formulation and their interests ignored or downplayed during the follow-up. Moreover, parts of policy documents, the issuance of which has coincided with the standards initiatives – and which treat important parts of their rationale – in some cases substantially reflect official viewpoints in major developed countries, as evident from recent reports of the FSF.

Certain concerns of developing countries appear to have been set aside during standards formulation and their interests ignored or downplayed during the follow-up.

For example, the report of the FSF's Working Group on Capital Flows (FSF, 2000b) focuses mainly on improved risk-management practices and enhanced transparency on the part of private and public sectors in countries receiving international lending and investment as the principal means of countering the instability of these flows.[33] The report also identifies various biases or incentives in the policies of recipient countries that are likely to lead to excessive dependence on short-term (and thus potentially volatile) inflows. But it downplays the impact of the behaviour of lenders and investors in developed countries as well as the effects of macroeconomic policies in these countries on capital flows to developing and transition economies. The report gives considerable attention to improvements in the provision and use of official statistics and of information in financial reporting by the private sector in recipient countries. However, it shies away from endorsing a requirement for frequent disclosure of data on the large short-term positions in assets denominated in a country's currency held by foreign firms other than banks (a category that includes hedge funds), which several developing (and some developed) countries perceive as threats to the stability of their exchange rates and financial markets.

Similarly, the report of the FSF Working Group on Highly Leveraged Institutions (HLIs)[34] has tended to play down widely expressed concerns of certain countries in some of its policy recommendations (FSF, 2000c). This Working Group distinguished between two broad groups of issues posed by HLIs: systemic risks (of the kind exemplified by the collapse of Long Term Capital Management (LTCM)), on the one hand, and "market dynamics issues" (i.e. the amplification of instability and the threats to market integrity which may result from HLIs' operations in "small- and medium-sized open" economies), on the other. The systemic risks which may be caused by HLIs are naturally of concern to developing and transition economies. Like other participants in international financial markets, for example, they were affected by the increases in risk premiums and the sharply reduced availability of financing in late 1998, to which the collapse of LTCM contributed. Nevertheless, their special concerns are related more to the "market dynamics issues".

The Working Group conducted an examination of "market dynamics issues" in the experiences of six economies during 1998.[35] Its conclusions amounted to a qualified endorsement of concerns which had been expressed regarding HLIs. Thus the capacity of HLIs to establish large and concentrated positions in small- and medium-sized markets was acknowledged, and with this, their potential to exert a destabilizing influence. But there was less consensus as to the importance of their influence in comparison with other factors during particular instances of instability in the different economies during 1998. Similar conclusions were reached regarding the threat to market integrity posed by some aggressive practices attributed to HLIs, such as heavy selling of currencies in illiquid markets, dissemination of rumours about future developments, selective dis-

closure of information about firms' positions and strategies, and correlated position-taking in the markets for different assets within a country and also across currencies with the objective of achieving profitable movements in relative prices.[36] Here, too, the capacity of HLIs to engage in such practices was recognized, but there was less agreement as to its significance at different times and in different countries.

The major thrust of the Working Group's recommendations is directed at reducing the systemic risk HLIs are capable of causing rather than at "market dynamics issues". The recommendations, directed primarily at systemic risk, have many connections to those of official bodies and industry groups of major industrial countries surveyed at some length in an annex to the report. These include: stronger risk management by both HLIs and their counterparties; enhanced regulatory oversight of HLIs' credit providers; further progress in industry practices with regard to such aspects as the measurement of exposures and of liquidity risk, stress testing, collateral management and external valuation, as well as in building market infrastructure in areas such as the harmonization of documentation, valuation and bankruptcy practices. In addition, the Working Group recommended fuller public disclosures by HLIs in the context of a movement towards improved and more comparable risk-based public disclosure by financial institutions more generally.

Most of these recommendations are capable of having beneficial effects on "market dynamics issues" and of reducing systemic risk. However, the Working Group limited itself to two recommendations of particular relevance to the former subject. The first recommendation aims at strengthening some kinds of surveillance of activity in financial markets at the national level with a view to identifying rising leverage and other concerns relating to market dynamics that may require preventive measures. The second aims to promote guidelines of good practice for currency trading with the support of leading market participants who would review and, as necessary, revise existing codes and guidelines in this area in the light of concerns recently expressed about trading behaviour.

Underlying the second of these two recommendations is a recognition of the absence in most emerging financial markets of guidelines and codes of conduct for trading practices, such as are issued in most major financial centres by trade associations, industry groups and committees of market participants. The recommendation is that major financial institutions should take the initiative in preparing and promoting codes and guidelines for jurisdictions where they currently do not exist. If this recommendation is to be effective, it must not only lead to industry initiatives of the kind envisaged, but also to changes in actual behaviour, even though such guidelines and codes lack legal weight.

Regarding surveillance and transparency concerning market positions, the report on HLIs is more forthcoming than that on capital flows, though the somewhat veiled character of the exposition renders the nature of the different options considered, and the Group's view on their associated pros and cons, hard to grasp precisely. The collection of aggregate high-frequency information on positions in key markets is not accepted on the grounds of feasibility, cost and difficulties in obtaining compliance.[37] National initiatives involving proactive surveillance between monetary authorities, supervisors and market participants receive greater support from the Working Group, but subject to reservations and doubts concerning such matters as the costs and benefits of, and international participation needed for, disclosure of information on positions in major emerging-market currencies. Some surveillance of this kind (but possibly mainly of an informal nature) presumably already exists in several countries, since it would appear to have been the source of part of the information contained in the report's survey of the experience of HLIs' operations in six jurisdictions. The strongest reservations of the Report in this area concern enhanced oversight by national authorities of the provision of local currency, which is necessary for the settlement of the great majority of speculative positions against a currency. These reservations are due primarily to the Working Group's view that formal procedures for this purpose constitute capital controls.

The unavoidable conclusion regarding the Working Group's recommendations on "market dynamics issues" is that they fall well short of symmetry. Although they recognize the concerns recently expressed about HLIs' practices in this

area as legitimate, they devote much more attention to the obligations for transparency sought from economic actors in developing and transition economies as part of international financial reform.

Asymmetries in the assessment procedures associated with the standards initiatives are also exemplified in another report of the FSF (2000d), that of its Working Group on Offshore Centres (OFCs).[38] In the context of international financial reform, there is concern that, although OFCs do not seem to have been a major cause of systemic problems so far, they might become so in the future. This is because of the growth in the assets, liabilities and off-balance-sheet activities of institutions based in OFCs, as well as growing interbank relations. In particular, the fear is that OFCs could prove an important source of contagion. The terms of reference of the Working Group included a general stock-taking of the use made of OFCs, and, more particularly, a review of their progress in enforcing international prudential and disclosure standards, and in complying with international agreements on the exchange of supervisory information and other information relevant to combating financial fraud and money laundering.

Smooth progress in global initiatives on standards requires a perception of even-handedness regarding different aspects of their application among all the parties involved.

For this purpose, the Working Group organized a survey of OFCs that aimed at assessing compliance with the international standards of supervision established by the BCBS, the IAIS and IOSCO (i.e. with standards for the banking, insurance and securities business). The survey was conducted through two questionnaires – one for onshore supervisors in 30 major financial centres and the other for 37 OFCs. The first questionnaire was designed to elicit views on the quality of regulation and supervision in those OFCs with which the onshore supervisors had some degree of familiarity, and on the quality of cooperation they had experienced with OFC supervisors. The second questionnaire was intended to provide information on how these OFCs interacted with the home supervisors of suppliers of financial services operating in or from their jurisdictions (i.e. branches, subsidiaries or affiliates of suppliers incorporated in an onshore jurisdiction). The survey was the basis of a classification of OFCs into three groups: (i) those generally viewed as cooperative, with a high quality of supervision, which largely adhered to international standards; (ii) those generally seen as having procedures for supervision and cooperation in place, but where actual performance fell below international standards and there was substantial room for improvement; (iii) those generally seen as having a low quality of supervision and being non-cooperative with onshore supervisors (or both), and as making little or no attempt to adhere to international standards. However, several supervisors in OFCs considered that the procedures followed in this exercise had provided them with an inadequate opportunity for self-assessment of their regulatory regimes and of the quality of their supervision. Providing OFCs with such an opportunity would have been in better accord with the spirit of the report's proposals concerning the future programme for assessment of standards implementation on the part of OFCs. One of the stages specified is self-assessment assisted by external supervisory expertise (FSF, 2000d: 56–60). As a class, OFCs do not arouse much sympathy within the international community. However, smooth progress in global initiatives on standards requires a perception of even-handedness regarding different aspects of their application among all the parties involved.[39]

D. Implementation, sanctions and incentives

Implementation of standards is a process with several dimensions and stages. The first step specified in the strategy of the FSF Task Force (FSF, 2000a, sect. III) is to identify and achieve international consensus on standards. This is followed by a prioritization exercise so that the process of implementation becomes manageable – an exercise which has led to the list of key standards in table 4.1. Action plans at the national level then need to be drawn up. The primary agents involved here are national governments, which consult multilateral financial institutions and standard-setting bodies as necessary and can receive technical assistance of various kinds. Once implementation of plans is under way, it is subject to assessment, partly by the relevant national authorities themselves, but also by multilateral financial institutions, standard-setting bodies, and possibly other parties; technical assistance is also provided under this heading. Another integral part of the process of implementation is the dissemination of information on progress, in particular, to market participants such as lenders and investors.

Implementation is also to be promoted by official and market sanctions and incentives, which have many mutual links.[40] One important example on the official side is the technical assistance already mentioned. Others might involve the inclusion of standards implementation in policy surveillance (closely linked to assessment exercises), conditions attached to official financing (especially that of multilateral financial institutions), and taking into account the observance of standards in decisions on eligibility for membership of international bodies and in regulatory and supervisory decisions in host countries with respect to a country's financial firms abroad. In some of these cases the FSF Task Force is endorsing actions already taken or is advocating further steps in the direction of such actions. But in others the sanctions and incentives put forward have not yet been the subject of official decisions and the Task Force itself has expressed its awareness of possible drawbacks.

In terms of actions already taken, implementation of financial standards is now included in the IMF's policy surveillance under Article IV (which takes account of the conclusions of the FSAP mentioned in subsection B.2). One of the conditions for a country's eligibility for financing through the IMF's Contingency Credit Line (CCL)[41] is a positive assessment during the most recent Article IV consultations of its progress in adhering to internationally accepted standards. There are also indications of pressure to link standards implementation to the conditions associated with other IMF facilities. In particular, steps to implement and observe specific standards have been included in some IMF country programmes. Finally, the granting of market access to a foreign financial firm in several countries is already conditional on the standard of supervision in its home country, and the incentive put forward by the Task

> One of the conditions for a country's eligibility for financing through the IMF's Contingency Credit Line is a positive assessment of its progress in adhering to internationally accepted standards.

Force would presumably reinforce such conditions.

Possible official sanctions and incentives which are not currently in place and would not represent extension or reinforcement of existing policies include various measures. Membership of bodies such as IOSCO, the Basel-based bodies concerned with financial regulation and supervision, or the OECD might be linked to progress in standards implementation. But this, as the FSF Task Force notes, could actually have the perverse effect of removing a source of peer pressure. Risk weights in setting prudential capital requirements for borrowing counterparties could be differentiated in accordance with the observance of standards in the jurisdictions where they operate. This presupposes effective assessment of compliance, which is not yet in place and may prove difficult to achieve in some cases. Nonetheless, steps in this direction are part of some proposals currently under consideration (see box 4.1).[42] Supervision could be tightened and other regulatory actions taken regarding the subsidiaries or branches of foreign financial firms whose home supervisors are in countries where implementation of standards is weak. Such actions might include restricting inter-affiliate transactions and increasing scrutiny of customer identification, for example. As the FSF notes, this would require disclosure to supervisors in host countries of all pertinent information concerning compliance with the standards in question. Another challenge would be to achieve a level of coordination sufficient to avoid regulatory arbitrage among financial centres.

Market participants considered observance of the standards less important than the adequacy of a country's legal and judicial framework, political risk, and economic and financial fundamentals.

Assessment of the effectiveness and appropriateness of official and market sanctions and incentives in standards implementation has now commenced. The FSAP[43] and IMF Article IV surveillance will inevitably play a key role in the former. Among the subjects of surveillance would be progress in standards implementation under the heading of the strength of the financial sector more generally. The extensive – and thus resource-consuming – process of assessment should itself be subject to continuing evaluation by a body which needs to keep a certain distance from the assessors. This may prove to be one of the key roles for the FSF, though one possibly complicated by membership in it of important institutions responsible for this assessment.

Market sanctions and incentives are to depend most importantly on market participants' use of information on an economy's observance of standards in their risk assessment. Such information is then reflected in differentiated credit ratings, spreads for borrowers, exposure limits and other lending and investment decisions. If these sanctions and incentives are to work, the key requirements are: (i) that market participants be familiar with international standards; (ii) that they judge them to be relevant to their risk assessments; (iii) that they have access to information on their observance; and (iv) that this information be deployed as an input in their risk assessments (FSF, 2000a). Official assistance to the operation of market sanctions and incentives can take the form of promoting disclosure of relevant information as well as pressures on, and encouragement to, market participants to take account of standards observance in their decisions.

The effectiveness of market sanctions and incentives depends on their incorporation into market practices. Although experience so far has been of a short duration, the FSF has sought feedback from market participants to enable preliminary conclusions on the effectiveness of such sanctions and incentives, most importantly in the form of an informal dialogue with participants from 100 financial firms in 11 jurisdictions (FSF, 2000e, sect. III).[44] This outreach exercise revealed only limited awareness of the 12 key standards in table 4.1, though the degree of awareness varied, being greatest for the Special Data Dissemination Standard (SDDS) and International Accounting Standards (IAS). Few market participants took account of an economy's observance of the standards in their lending and investment decisions, although observance of the SDDS was found to

Box 4.1

BASEL CAPITAL STANDARDS

The Basel Capital Accord of 1988 was the result of an initiative to develop more internationally uniform prudential standards for the capital required for banks' credit risks. The objectives of the Accord were to strengthen the international banking system and to promote convergence of national capital standards, thus removing competitive inequalities among banks resulting from differences on this front. The key features of this Accord were a common measure of qualifying capital, a common framework for the valuation of bank assets in accordance with their associated credit risks (including those classified as off-balance-sheet), and a minimum level of capital determined by a ratio of 8 per cent of qualifying capital to aggregate risk-weighted assets. In subsequent years, a series of amendments and interpretations were issued concerning various parts of the Accord. These extended the definition and purview of qualifying capital, recognized the reductions in risk exposure which could be achieved by bilateral netting meeting certain conditions, interpreted the Accord's application to multilateral netting schemes, allowed for the effects on risk exposure of collateralization with securities issued by selected OECD public-sector entities, and reduced the risk weights for exposures to regulated securities firms. Simultaneously, the Basel Committee continued its work on other banking risks, of which the main practical outcome so far has been the amendment of the 1988 Accord to cover market risk, which was adopted in 1996. The 1988 Basel Accord was designed to apply to the internationally active banks of member countries of the Basel Committee on Banking Supervision, but its impact was rapidly felt more widely; by 1999 it formed part of the regime of prudential regulation not only for international, but also for strictly domestic banks, in more than 100 countries.

From its inception, the 1988 Basel Accord was the subject of criticism directed at such features as its failure to make adequate allowance for the degree of reduction in risk exposure achievable through diversification, the possibility that it would lead banks to restrict their lending, and its arbitrary and undifferentiated calibration of certain credit risks. In the case of country risk, with very limited exceptions this calibration distinguished only between OECD and non-OECD countries – a feature of the Accord which some developing countries considered unjustifiably discriminatory. In the aftermath of the financial crises of the 1990s, the Accord's contribution to financial stability more generally became a focus of attention. There was special concern here with regard to the incentives which the Accord's risk weighting was capable of providing to short-term interbank lending – a significant element of the volatile capital movements during these crises.

The Basel Committee responded by initiating a comprehensive overhaul of the 1988 Accord. Its first proposal for this purpose (*A New Capital Adequacy Framework* – henceforth New Framework), published in June 1999 (BCBS, 1999b), incorporates three main elements or "pillars": (i) minimum capital rules based on weights that are intended to be more closely connected to credit risk than those of the 1988 Accord; (ii) supervisory review of capital adequacy in accordance with specified qualitative principles; and (iii) market discipline based on the provision of reliable and timely information. In early 2001 (as this *TDR* was completed), a revised set of proposals was issued that is designed to take account of comments by the banking industry and supervisors around the world.

The New Framework contains two basic approaches to the numerical standards for capital adequacy: the standardized and the internal-ratings-based approaches. A major feature of the standardized approach is the proposal for recourse to the ratings of credit rating agencies in setting weights for credit risk. The New Framework's proposal regarding the internal-ratings-based approach is still tentative and will require adequate safeguards concerning such matters as the calibration of risk and comparability. However, the approach is likely to be an option in the revised proposals for banks with sufficiently sophisticated systems for handling credit risk.

The New Framework's proposal for recourse to the ratings of credit rating agencies in setting weights for credit risk has proved highly contentious. Perhaps most importantly, there is a widespread view that the track record of the major agencies, especially with respect to identifying the probability of serious threats to the debt-service capacity of, or defaults by, sovereign borrowers,

Box 4.1 (concluded)

is not good enough to justify reliance on them for setting weights for credit risk. Much recent criticism has focused on the agencies' performance during the Asian debt crisis. A notable feature of this crisis was the large and swift downgrading of some of the countries affected. Thus a major concern here is that, if credit rating agencies' announcements simply parallel changes in market sentiment or, still worse, actually follow such changes, they are capable of exacerbating fluctuations in the conditions in credit markets and thus financial crises. Recourse to agencies' ratings for credit-risk weighting might result in the new capital standards, on occasion, actually exacerbating the instability of bank lending.

Statistical studies[1] of the effects of rating agencies' announcements concerning creditworthiness on countries' borrowing costs show a strong correlation between such announcements and the spreads on dollar-denominated bonds above the yields of United States Treasury bonds of the same maturity. But mere correlation does not settle questions regarding the nature of the role of agencies during fluctuations in credit conditions. Only if the announcements of credit agencies concerning changes in creditworthiness preceded changes in market conditions would it seem reasonable to attribute to them an effective *ex-ante* capacity to rate credit risk. However, the results of research on the subject provide weak support for this proposition. Indeed, the findings of this research help to explain widespread opposition in official circles to major agencies' ratings for setting banks' minimum capital levels (and not only those in developing and transition economies), an opposition which, it should be noted, is apparently matched by some reluctance among the agencies themselves to assume such a responsibility.

There is also concern about the expansion in the use of agencies' ratings for the purposes of economic policy. The ratings of major rating agencies already have a role in the regulatory framework of a number of countries. In the United States, for example, they are used to distinguish investment grade from speculative securities for various purposes such as rules governing the securities holdings of banks and insurance companies. Nonetheless, the proposals of the New Framework would substantially extend the influence of major rating agencies and could easily lead to increased official regulation and oversight.

Other questions have focused on the coverage of major agencies' ratings in the context of their use of credit-risk weighting. Even in the European Union, according to provisional estimates of the European Commission, coverage of the major credit rating agencies is limited to less than 1,000 corporates. In India, to take a developing-country example, in early 1999, out of 9,640 borrowers enjoying fund-based working capital facilities from banks, only 300 had been rated by any of the major agencies (Reserve Bank of India, 2000: 13–14). Of course, as noted above, the New Framework envisages internal-ratings-based approaches to the setting of banks' credit-risk weights as an alternative to recourse to the ratings of credit rating agencies for sufficiently sophisticated banks. But other banks might still need to make extensive use of the New Framework's proposed risk weightings for unrated exposures. In view of the unsatisfactory character of this alternative, there have been calls for greater emphasis in the Basel Committee's revised proposals on recourse to the ratings of domestic (as opposed to major international) rating agencies – a proposal not in fact excluded from the New Framework so long as the agencies in question meet certain minimum criteria.

As for the promotion of greater stability in international bank lending through incentives to tighter control over short-term interbank exposures, the proposals of the New Framework are widely regarded as still inadequate. This is because, under one of the options for credit-risk weighting, exposures with an original maturity of up to six months to banks within a broad range of credit ratings would be attributed a weighting more favourable than those with longer maturities (subject to a floor). In the light of recent experience, a more restrictive approach to short-term interbank claims may indeed be required.

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[1] These studies are summarized in Cornford (2000b, sect. VI.A).

influence economies' credit ratings. Generally, market participants considered observance of the standards less important than the adequacy of a country's legal and judicial framework, political risk (often rated as more important than regulatory or supervisory risk), and economic and financial fundamentals. Rating agencies, which tend to be better acquainted with both the standards and the assessment exercises undertaken so far, nonetheless considered that their direct access to national authorities provided them with a better understanding of the quality of regulation and supervision, of policy and data transparency, and of market infrastructure.[45]

It is too early to make more than a highly preliminary evaluation of standards implementation and of the effectiveness of incentives. The large potential costs of the administrative burden associated with implementation and assessment are widely acknowledged. But the effectiveness of measures proposed to alleviate this burden has yet to be proved. In the case of the official sanctions and incentives mentioned above, many are still only being considered and not all will necessarily be adopted. The inclusion of standards implementation in IMF conditionality is still at an early stage, and its extension in this area remains highly contentious. The impact of market sanctions and incentives on standards is likely to take time. This is indeed reflected in the feedback from market participants concerning factors that override standards observance in their decisions. For example, market participants' reference to the overriding significance of the quality of the legal and judicial framework – one of the targets of the standards – should be viewed in the light of the length of time required for the standards to have an impact. Similar considerations apply in varying degrees to political risk (where market participants cited the threat of nationalization and policy reversals) and economic and financial fundamentals. Regarding incorporation of standards observance as a factor in the decision-making processes of market participants, there is a chicken-and-egg problem, at least in the medium term. By taking account of standards observance in their lending and investment decisions, market participants are supposed to make an important contribution to such observance. However, during the early stage of standards observance, its impact on the determinants of creditworthiness and the investment climate is at most still superficial. This means that market participants will continue to rate this subject as being of limited importance, and it will, therefore, have a correspondingly low weight in their lending and investment decisions.

E. Standards, financial regimes and financial stability

As already mentioned, the improvements described in previous sections will entail extensive changes for many countries, and their implementation could be lengthy. This is particularly true of the required reforms in the legal and regulatory framework and of their incorporation into the norms of business practice, which is a prerequisite for receiving the full benefit of these reforms. The gradual and difficult nature of this process for developing and transition economies should not be taken as a reflection on their legislative and administrative competence or their political will. For example, the process of deregulating financial sectors in OECD countries or of putting in place a single-market regime in the European Union for the banking and securities business – both processes involving obstacles and constraints similar to those confronting the global regimes of financial standards – took decades.[46]

The limits on the efficacy of enhanced standards and associated legal and regulatory reforms reflect various factors. One of these is the rootedness of standards in past experience, which makes them less than perfect for dealing with the consequences of innovation. Moreover, many of the standards covered by recent initiatives are directed at the behaviour of economic agents and the functioning of firms and markets. Stronger foundations at this level can reduce – but not eliminate – the likelihood and magnitude of systemic instability. Malpractice and fraud may become easier to detect as standards are enhanced, but they will not disappear. The collapse of Barings in early 1995 is an example of the broader destabilizing potential of events originating in malpractice within a single firm. More importantly, systemic crises in the financial sector are often closely linked to macroeconomic dynamics and to developments at the international level – or regional level within a country – which transcend particular national financial sectors. A Utopian vision of standards might include standards for macroeconomic policy designed to put an end to phenomena such as boom-bust cycles, which historically have frequently proved to be the financial sector's nemesis. But, as already noted in subsection B.1, the codes of good practices regarding various aspects of macroeconomic policy in table 4.1 concern transparency and procedural issues, and not the contents of such policy itself.

The crucial field of banking supervision illustrates the limitations of standards. A natural starting-point here is the licensing of banks. In some countries the relevant criteria were long designed primarily to ensure adequate levels of competence and integrity among those owning and controlling a bank. But licensing is often also used to serve less limited objectives, such as the avoidance of "overbanking", limitation of financial conglomeration, and (in the case of foreign entities) restricting foreign ownership of the banking sector, or ensuring that the parent institution is adequately supervised in its home country. The objectives of licensing may have (usually proximate) relations to banking stability, but they cannot prevent serious banking instability or banking crises. Another major subject of banking supervision is implementation of prudential regulation, much of which is concerned with ensuring adequate management and internal controls, but which also includes prudential capital requirements.[47] A key purpose of capital here is to pro-

vide a stable resource to absorb any losses incurred by an institution, and thus protect the interests of its depositors. Capital requirements for credit and market risks are also clearly intended to contribute to financial risk management of assets and liabilities, as well as to appropriate pricing of the different products and services which a bank offers. Prudential capital, by strengthening financial firms, reduces the likelihood of major financial instability originating in the failure of a single firm. It also increases such firms' defences against instability originating elsewhere. However, its contribution to restraining financial instability stops here. Other prudential guidelines or rules are directed at subjects such as exposure to foreign-exchange risks, risks due to large exposures to single counterparties or groups of related counterparties, adequate liquidity, loan-loss provisions, consolidated financial reporting and country exposures. These guidelines and rules serve the same objectives as prudential capital, and their efficacy is subject to the same limitations.

These limitations are explicable, at least in part, in terms of the considerations raised above concerning standards more generally. Financial regulation is constantly struggling to keep up with financial innovation, and in this struggle it is not always successful. There is thus a continuing danger that new practices or transactions, not yet adequately covered by the regulatory framework, may prove a source of financial instability. Closely related in many ways to financial innovation, are difficulties – which have become more important in recent years – regarding the transparency required for regulation and supervision. The balance sheets of many financial firms have an increasingly chameleon-like quality which reduces the value of their financial returns to regulators. Consequently, the tensions between financial innovation and effective regulation in modern financial markets are unlikely to disappear. In principle, one can envisage a tightening of regulation sufficiently drastic as to come close to eliminating the dangers due to innovation. However, the tightening would be too stifling to be politically acceptable in any country that values dynamism in its financial sector.

Financial regulation is constantly struggling to keep up with financial innovation, and in this struggle it is not always successful.

Probably the most important determinant of the intrinsic limitations of regulation and supervision is the unavoidable dependence of financial stability on macroeconomic stability more generally.[48] Most assets of banks are susceptible to changes in their quality resulting from broader changes in economic conditions. So long as cycles of financial boom and bust are features of the economic system, so also will be unforeseeable deteriorations in the status of many bank assets.[49] Where banking crises are combined with currency crises, and cross-border as well as domestic financing contributes to the boom (as in many recent instances involving developing economies), the process is fuelled by forces similar to those that characterize purely domestic credit cycles. These include herd behaviour of lenders and investors, driven partly by the very conditions their lending and investment have helped to create, but also by competition within the financial sector. Other forces include the all too ready acceptance, for example, of benchmarks resulting from collective behaviour, poor credit evaluation (often exacerbated in the case of cross-border financing by less familiarity with the borrowers and their economies), and the pressures on loan officers resulting from target returns on capital. An important distinctive feature of boom-bust cycles with a cross-border dimension is another macroeconomic factor – the exchange rate. Capital inflows generally come in the first place in response to exchange-rate adjusted returns, and thus on assumptions about the stability of the exchange rate. The outflows are in most cases associated with movements in contradiction with these assumptions, in the form of a large depreciation of the currency. This often has devastating effects on the net indebtedness and income of many domestic economic actors.

In thinking about the interaction between broader types of financial instability and difficulty in controlling financial risks, as experienced in the internal controls of banks as well as in their supervision, the concept of "latent concentration risk" (used in some recent literature on credit risk to denote problems due to unpredictable correla-

tions between defaults) can be an illuminating one. This concept also serves to pinpoint relations between uncertainty, on the one hand, and the limitations of banking supervision, on the other.[50] Concentration risk is traditionally handled in the context of banking regulation and supervision through limits on the size of exposures to particular borrowers. For this purpose, "borrower" is typically defined to include groups of counterparties characterized by links due to common ownership, common directors, cross-guarantees, or forms of short-term commercial interdependency. But boom-bust cycles bring into focus risks due to latent concentration, as they lead to deterioration in the economic positions of counterparties apparently unconnected in other, more normal, times. Indeed, a common feature of the boom-bust cycle would appear to be exacerbation of the risk of latent concentration as lenders move into an area or sector *en masse* prior to attempts to exit similarly. To some extent, the risks of latent concentration can be handled through prudential measures, such as banks' general loan-loss reserves and capital requirements for credit risk, but there are limits to the efficiency of such measures. ■

Notes

1 The Financial Stability Forum was established by the finance ministers and central bank governors of the Group of Seven in February 1999 to promote international financial stability through improved exchange of information and cooperation with respect to financial supervision and surveillance. Its membership consists of the national authorities responsible for financial stability in selected OECD countries, Hong Kong (China) and Singapore, and major international financial institutions, international supervisory and regulatory bodies and central-bank expert groupings.

2 An example of such dangers was furnished by the large-scale withdrawal of funds from and subsequent bankruptcy of two Deak and Co. subsidiaries (Deak Perera Wall Street and Deak Perera International Banking Corporation) in response to information in a 1984 report of the United States Presidential Commission on Organized Crime concerning Deak Perera's involvement in money laundering.

3 This part of the rationale for standards is particularly emphasized in Drage, Mann and Michael (1998:77–78).

4 The distinction between banking regulation and supervision in the literature is not particularly clearcut. But regulation can be taken roughly to refer to rules, both those set out in banking legislation and those referring to the instruments and procedures of the competent authorities. Supervision refers to implementation including licensing, ongoing off-site and on-site supervision of institutions, enforcement and sanctioning, crisis management, the operation of deposit insurance, and procedures for handling bank insolvencies. These distinctions follow closely those in Lastra (1996: 108).

5 The BCBS comprises representatives of the central banks and supervisory authorities of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and United States. For an account of the acceptance of the BCBS's standards beyond its membership, primarily in relation to prudential standards for bank capital, see Cornford (2000b, sect. III).

6 For a discussion of these assessments of compliance, see IMF (2000d).

7 The members of the CPLG are from Argentina, Australia, Brazil, Chile, China, Czech Republic, Commission Bancaire de l'Union Monétaire Ouest Africain, France, Germany, Hong Kong (China), India, Italy, Japan, Mexico, Netherlands, Republic of Korea, Russian Federation, Saudi Arabia, Singa-

pore, South Africa, United Kingdom and United States. In addition, the CPLG has representatives from the European Commission, the Financial Stability Institute, the IMF and the World Bank.

8 This is recognized in the IMF paper cited above concerning the experience of the early assessment exercises as follows: “Due to lack of manpower and time, the assessments are not always as in-depth as warranted to identify all the underlying weaknesses. It is also difficult to obtain a thorough understanding of the adequacy of supervisory staff numbers and skills, as well as the skills of commercial bankers. A genuine assessment of bank supervision requires in-depth on-site review – including interviews with supervisors and bankers – resulting in well-researched judgements on institutional capacity and supervisors’ concrete achievements” (IMF, 2000d, para. 57).

9 In 1996, for example, before the outbreak of the East Asian financial crisis, the ratio of capital to risk-weighted assets in the Republic of Korea, according to official estimates, was above 9 per cent. However, if accounting rules closer to international norms had been used, non-performing loans for the sector as a whole would have exceeded its combined capital funds (Delhaise, 1998: 115). By the mid-1990s, in a number of countries affected by the crisis, the capital standards of the 1988 Basel Accord were part of the legal regime for banks (*TDR 1998*, Part One, chap. III, box 3). But in the absence of proper rules for the valuation of banks’ assets, this standard had little meaning for many of the institutions to which it was supposed to apply.

10 For a survey of banks’ accounting practices and other financial reporting under regulatory regimes in 23 mainly industrial countries that highlights the prevalence and extent of shortfalls from international best practice in the first half of the 1990s, see Cornford (1999, sect. III).

11 This framework for analysing policies aimed at the stability of the financial sector is frequently deployed by William White of the BIS (White, 1996: 23).

12 Traditionally, such transactions have depended on national payment systems for the transfer of funds between correspondent banks of the countries whose currencies are involved. For example, in the case of a cross-border payments order transmitted between banks through SWIFT (Society for Worldwide Interbank Financial Telecommunication – a private company which transmits financial messages for the benefit of its shareholding member banks and of other approved categories of financial institutions in 88 countries), the banks must arrange the clearing and settlement themselves, either relying on mutual bilateral correspondent relationships or forwarding the orders to domestic systems for interbank fund transfers. Many major banks have introduced “straight-through processing”, in which there is an automated linkage between their SWIFT connection and their computers linked to the domestic payments system (BIS, 1997: 482–485). More recently there has been growth in the direct settlement of foreign exchange transactions between parties in different jurisdictions through systems processing payments in more than one currency.

13 IOSCO is a grouping of securities regulators (both governmental and self-regulatory bodies) from more than 90 countries. Created in 1984, it is a private, non-profit organization whose main objectives are cooperation for better market regulation, information exchange, standard setting, and mutual assistance in the interest of protecting market integrity.

14 For a commentary on the Core Principles and discussion of the initiative’s background, see Sawyer and Trundle (2000). (John Trundle of the Bank of England was chairman of the Task Force which drew up the Core Principles.)

15 More specifically, the initiative was a response to the conclusion in the report of an ad hoc working party on financial stability in emerging market economies, set up after the 1996 summit of the Group of Seven, concerning the essential role of sound payment systems in the smooth operation of market economies, as well as to growing concern regarding the subject among emerging market economies themselves. See mimeograph document of the Working Party on Financial Stability in Emerging Market Economies, *Financial stability in emerging market economies: A strategy for the formulation, adoption and implementation of sound principles and practices to strengthen financial systems* (April 1997, chap. II).

16 In a multilateral netting arrangement a participant nets obligations vis-à-vis other participants as a group throughout a specified period (typically a day), and then settles the debit or credit balance outstanding at the end of this period through the arrangement’s common agent.

17 Part 2 was a response to widespread comments elicited by Part 1 that more detail on interpretation and implementation was needed.

18 This Programme is aimed at assessing the vulnerabilities of countries’ financial sectors and identifying priorities for action, partly in the light of internationally agreed standards for these sectors.

19 The IASC was created in 1973 by major professional accounting bodies and now includes more than 130 such bodies from more than 100 countries. The entities concerned with international accounting standards include not only professional accounting bodies, international accounting firms, transnational corporations and other international lenders and investors, but also other bodies such as international

trade unions concerned with cross-border business activities.

20 A 1997 study of the United States Financial Accounting Standards Board (FASB) identified 255 variations between United States and international standards, many of which were judged as significant. See Scott and Wellons (2000: 67). For a more extended discussion of the *IASC-US Comparison Project*, which was the source of this finding, see Grossfeld (2000).

21 Specific topics identified as the most difficult for the achievement of reconciliation and understanding among countries in a survey of institutional investors, firms, underwriters and regulators in the first half of the 1990s (quoted in Iqbal, Melcher and Elmallah, 1997: 34) were the following: accounting for goodwill, deferred taxes, inventory valuation, depreciation methods, discretionary reserves, fixed-asset valuation, pensions, foreign currency transactions, leases, financial statement consolidation and financial disclosure requirements.

22 IFAC was established in 1977 to promulgate international standards in auditing and closely related subjects. IFAC and IASC have an agreement of "mutual commitments" for close cooperation and mutual consultations, and membership in one automatically entails membership in the other.

23 This point is forcefully made with the support of a wealth of case studies from the business history of the United States in Kennedy (2000, part 1).

24 The arrangements proposed below, in chap. VI, sect. B, for orderly workouts in the case of cross-border debt depend, for their functioning, on adequate national insolvency regimes.

25 The account which follows relies heavily on the Group of Thirty (2000, chap. 2, sect. 1).

26 This point was made recently in an OECD publication: "The incidence of banking crises, and the costs these have imposed on countries, is quite large and the systemic consequences of the failure of a large institution are of a different order of magnitude from those associated with the failure of smaller institutions. In particular, the costs of bailing out a very big institution might be large relative to the resources of the country in which the institution resides. … it is not clear that an increase in size and perhaps geographic scope of an institution makes the risk of its failure any greater than before. Accidents do happen, however, and it is likely that the systemic consequences of bank failures grow as institutions become larger and larger. The situation is also more complex in the case of internationally operating banks" (OECD, 2000c: 138–139).

27 See Group of Thirty (2000, especially chaps. 4–6). The policy issues are surveyed in Group of Thirty (1998).

28 For more detailed guidelines for the Principles' application, see International Association of Insurance Supervisors (IAIS, 2000b). The IAIS is an association of insurance supervisors established in 1994 and now includes supervisors from more than 100 countries.

29 The main forum dealing explicitly with these issues is the Joint Forum on Financial Conglomerates, which was founded in 1996 and brings together developed-country representatives from the BCBS, IOSCO and IAIS. The Joint Forum has reviewed various means of facilitating the exchange of information among supervisors within their own sectors and among supervisors in different sectors, and has investigated legal and other barriers that impede the exchange of information among supervisors within their own sectors and between supervisors in different sectors. It has also examined other ways to enhance supervisory coordination, and is working on developing principles for the more effective supervision of regulated firms within financial conglomerates.

30 See, for example, the coverage of recent events of money laundering in London in the *Financial Times*, 20 October 2000, and of a report of the subcommittee of the United States Senate concerning use of correspondent services provided by the country's banks for the purpose of money laundering in the *International Herald Tribune*, 6 February 2001. A *New York Times* editorial reproduced in the latter commented as follows: "Banks are undoubtedly wary of legal restrictions that raise costs and discourage depositors, particularly in their lucrative private banking divisions. But America cannot condemn corruption abroad while allowing its own banks to make fortunes off it."

31 Various other regional or international bodies, either exclusively or as part of their work, also participate in combating money laundering. These include the Asia/Pacific Group on Money Laundering (APG), the Caribbean Financial Action Task Force (CFATF), the PC-R-EV Committee of the Council of Europe, and the Offshore Group of Banking Supervisors.

32 Attention is drawn to such connections between different international initiatives concerning offshore financial centres by José Roldan, President of the FATF during the period July 2000–2001, in an interview (Roldan, 2000: 21–22).

33 For a more detailed commentary on this report, see Cornford (2000a).

34 This FSF report focuses mainly on large, substantially unregulated institutions characterized by low transparency, primarily hedge funds. But, as the report notes, a clear distinction cannot always be drawn between the practices of these institutions and others subjected to greater regulation.

35 The six economies were Australia, Hong Kong (China), Malaysia, New Zealand, Singapore and South Africa.

36 One instance of such activity, which attracted much attention in 1998, was the "double play" in which some financial institutions are believed to have engaged in Hong Kong (China). This operation is described as follows in the Working Group's report (FSF, 2000c: 117): "Some market participants suggested that there were attempts to carry out a 'double play' involving the equity and currency markets, whereby short positions would be first established in the equity (or equity futures) market, and sales of Hong Kong dollars would then be used to drive up interest rates and thereby depress equity prices. Some other market participants questioned whether such a strategy was pursued. Any double play would have been facilitated at that time by institutional factors in the linked exchange rate arrangement which made short-term interest rates very sensitive to changes in the monetary base, and also by reduced market liquidity as a result of the Asian crisis. Among those taking short positions in the equity market were four large hedge funds, whose futures and options positions were equivalent to around 40 percent of all outstanding equity futures contracts as of early August, prior to the HKMA [Hong Kong Monetary Authority] intervention (there were no limits or reporting requirements on large equity futures positions at this time). Position data suggest a correlation, albeit far from perfect, in the timing of the establishment of the short positions." See also Yam (1998).

37 A working group of the Committee on the Global Financial System on Transparence Regarding Aggregate Positions (the Patat Group), whose mandate was to look at what aggregate data on financial markets could be collected to enhance their efficient operation, was abolished because of its finding that "it would not be possible to obtain adequately comprehensive and timely information on a voluntary basis, and legislative solutions were deemed impractical" (see White, 2000: 22).

38 As the report notes (FSF, 2000d: 9), OFCs are not easily defined, but can be characterized as jurisdictions that attract a high level of non-resident activity. Traditionally, the term has implied some or all of the following: low or no taxes on business or investment income; no withholding taxes; light and flexible incorporation and licensing regimes; light and flexible supervisory regimes; flexible use of trusts and other special corporate vehicles; no requirement for financial institutions and/or corporate structures to have a physical presence; an inappropriately high level of client confidentiality based on impenetrable secrecy laws; and unavailability of similar incentives to residents. Since OFCs generally target non-residents, their business substantially exceeds domestic business. The funds on the books of most OFC are invested in the major international money-centre markets.

39 The point was eloquently expressed in a recent editorial in the periodical, *The Financial Regulator,* as follows: " The interconnection of the world financial system has created … problematic externalities, with … small countries now able to do a lot of damage. With world government some way off, these externalities are likely to prove tricky to manage. For the foreseeable future there is no better solution than international cooperation. When big countries push little countries around, even for the best of reasons, they give this crucial cooperation a bad name. The challenge for those interested in global financial stability is to find some way of negotiating better regulation while avoiding … the heavy-handedness characterizing the current drive against offshore centres." See "Justice for offshore centres", *The Financial Regulator*, September 2000.

40 The term "incentive" is used by the FSF in this context to cover measures which include sanctions as well as incentives.

41 For a description of the CCL, see chap. VI, box 6.3.

42 BCBS has proposed in its *A New Capital Adequacy Framework* (see box 4.1) the following incentives with regard to observance of standards: (i) to be eligible for claims on it to receive a risk weighting below 100 per cent, a country would have to subscribe to the SDDS; (ii) claims on a bank will only receive a risk weighting of less than 100 per cent if the banking supervisor in that country has implemented – or has endorsed and is in the process of implementing – the BCBS' *Core Principles for Effective Banking Supervision*; and (iii) claims on a securities firm will only receive a risk weighting of less than 100 per cent if that firm's supervisor has endorsed – and is in the process of implementing – IOSCO's *Objectives and Principles of Securities Regulation* (1998).

43 See note 18 (sect. B.3) above.

44 The jurisdictions covered by the outreach exercise were Argentina, Australia, Canada, France, Germany, Hong Kong (China), Italy, Japan, Sweden, United Kingdom and United States.

45 Nevertheless, as discussed in box 4.1 (on proposals for reform of the Basel Capital Accord), how effectively the agencies have used this understanding is still open to question.

46 Deregulation of interest rates in major OECD countries, for example, has taken from seven to more than 20 years in all but a small minority of cases. The establishment of a single market for financial services in the EU took more than 30 years (see Cornford and Brandon, 1999: 11–13).

47 Capital requirements are attributed a central role in countries' regimes of prudential regulation and supervision. They have also been the subject of major international initiatives, of which the most important is the Basel Capital Accord that is currently

undergoing a major revision . See box 4.1 on Basel Capital Standards.

48 This dependence, of course, provides the link between sectoral policies aimed at financial stability and macroeconomic policies, including those directed at the balance of payments (amongst which, especially for developing and transition economies, should be counted controls on capital transactions).

49 The argument here follows closely that of Akyüz and Cornford (1999: 30–31). See also *TDR 1998* (Part One, chap. IV, sect. C.3).

50 See, for example, Caouette, Altman and Narayanan (1998: 91, 240). The limitations of credit risk models in handling correlations among defaults are reviewed in BCBS (1999c, Part II, sect. 6, and Part III, sect. 3).

Chapter V

EXCHANGE RATE REGIMES AND THE SCOPE FOR REGIONAL COOPERATION

A. Introduction

Exchange rate regimes in developing countries and transition economies have attracted increased attention in the recent debate on the reform of the international financial architecture in view of their contribution to external vulnerability, and currency and financial crises. In countries that are closely integrated into international financial markets, adjustable peg regimes (the so-called soft pegs) are increasingly seen as the major cause of boom-bust cycles in financial flows. Consequently, the mainstream advice is that they either adopt a regime of freely floating exchange rates or that they make a credible commitment to defend a fixed exchange rate by locking into a reserve currency through currency boards or by adopting a reserve currency as their national currency (dollarization); in other words, they are advised to go for one of the so-called "corner" solutions as opposed to the intermediate regimes of adjustable pegs.[1] According to some estimates, almost two thirds of emerging-market economies were using intermediate exchange rate regimes in 1991, but by 1999 this proportion had fallen to 42 per cent, and the proportion using hard pegs or some variant of floating had risen to 58 per cent (Fischer, 2001, fig. 2). However, while many countries afflicted by financial crisis in the past decade have subsequently adopted floating rates, the increased volatility associated with such regimes has become a source of concern. As a result, there now appears to be a greater interest among developing countries and transition economies in hard pegs. And increasingly, in a closely integrated global financial system, the existence of many independent currencies is being called into question (Hausmann, 1999).

For emerging-market economies, adjustable peg regimes are problematic under free capital mobility as they lead to boom-bust cycles and overshooting of exchange rates. However, neither free floating nor hard pegs constitute viable alternatives. Currency misalignments and gyrations associated with floating regimes can have serious consequences for developing countries with small and open economies and a relatively large stock of external debt denominated in reserve currencies. On the other hand, for most developing countries and transition economies, a policy of locking into a reserve currency and surrendering monetary policy autonomy can entail considerable costs in terms of growth, employment and inter-

national competitiveness – costs that far exceed the benefits such a regime may yield in terms of price and exchange rate stability. These conclusions are shared in a paper on exchange rate regimes for emerging-market economies jointly prepared by staff of the French and Japanese Ministries of Finance, on the occasion of the meeting of European and Asian finance ministers in Kobe, Japan, in January 2001:

> There is no guarantee that currency board arrangements escape from the same drawbacks as pegged regimes. … Free-floating strategies have their own costs of possible excessive volatility and free riding risks. (Ministry of Finance, Japan, 2001: 3–4)

A consequence of the mainstream advice is that developing countries with similar foreign trade structures and market orientation could end up at opposite ends of the spectrum of exchange rates – some with floating and others with fixed exchange rates against the dollar – even if there is a considerable amount of trade amongst them. Consequently, not only would their currencies be floating against each other, but also their bilateral exchange rates would be greatly influenced by the overall movement of the dollar against other currencies. Given the misalignments and fluctuations that characterize the currency markets, this would imply erratic, unexpected shifts in the competitive position of developing countries vis-à-vis each other. When there is considerable bilateral trade, as between Brazil and Argentina, such shifts can have an important impact on their economies, leading to tensions in trade relations. Briefly stated, unilateral corner solutions may result in inconsistent outcomes for the developing countries taken together.

The key question is whether there exists a viable and appropriate exchange rate regime for developing economies when major reserve currencies are subject to frequent gyrations and misalignments, and when international capital movements are extremely unstable.

The key question is whether there exists a viable and appropriate exchange rate regime for developing and transition economies that are closely integrated into global financial markets when major reserve currencies are subject to frequent gyrations and misalignments, and when the size and speed of international capital movements can very quickly overwhelm the authorities in such countries and narrow their policy options. Can these countries be expected to solve their exchange rate problems unilaterally when the magnitude, direction and terms and conditions of capital flows are greatly influenced by policies in major reserve currency countries, and when international currency and financial markets are dominated by speculative and herd behaviour? Certainly, controls over capital flows can facilitate the prudent management of their exchange rates. Indeed, a few countries, such as China, have so far been able to pursue adjustable peg regimes without running into serious problems. However, several emerging markets have already made a political choice in favour of close integration into the global financial system and are unwilling to control capital flows. Furthermore, it may be very difficult for any single country to resist the strong trend towards liberalization of capital movements, particularly if it has close links with international markets through FDI and trade flows.

While all this implies that the solution should, in principle, be sought at the global level, the prospects for this are not very promising, given the stance of the major powers on the question of exchange rates. Since global arrangements for a stable system of exchange rates are not foreseeable in the near future, the question arises as to whether viable solutions can be found at the regional level. In this respect, the post-Bretton Woods experience of Europe in establishing mechanisms to achieve a stable pattern of intraregional exchange rates, and eventually move to a currency union, may hold useful lessons for developing regions, particularly East Asia and South America. However, while regional currency arrangements and monetary cooperation among developing countries could bring some benefits, they do not resolve the problem of what currency regime to adopt and how to achieve exchange rate stability vis-à-vis G-3 currencies. Even if they could achieve greater integration, developing countries could not neglect their exchange rates

vis-à-vis such currencies. It thus appears that regional arrangements among developing countries may need to involve major reserve-currency countries or rely on a common regime of capital controls in order to achieve stability and avoid costly crises.

B. Exchange rate regimes

1. Soft pegs

It has long been established that an economy which is fully committed to free movement of capital (or which does not succeed in effectively controlling capital movements) cannot both fix its exchange rate (at a given value or within a narrow band) and pursue an independent monetary policy. Any attempt to do so will eventually run into inconsistencies that will force the country to abandon one of the objectives. One option would be to adhere to fixed exchange rates through currency boards or outright dollarization at the expense of autonomy in monetary policy. Another would be to move to floating exchange rates, thereby freeing monetary policy from defending a particular exchange rate (or a narrow band). The breakdown of the Bretton Woods system of adjustable pegs, the 1992–1993 crisis in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) and the recent episodes of crisis in emerging markets are all seen as the outcome of the inconsistency between capital account openness, exchange rate targeting and independent monetary policy.

The Bretton Woods system of adjustable pegs operated with widespread controls over international capital movements. However, inconsistencies between the pattern of exchange rates and the domestic policy stances of major countries created serious payments imbalances and incentives for capital to move across borders, circumventing the controls. This eventually led to the breakdown of the system and the adoption of floating rates. Even though the adjustable pegs in the EMS constituted a step towards monetary union (hard pegs) and were supported by extensive intraregional monetary cooperation, inconsistencies between macroeconomic fundamentals and exchange rates led to a crisis and breakdown of the ERM in 1992–1993.The adoption of soft pegs is also considered to be one of the root causes of recent financial crises in emerging-market economies such as Mexico, Thailand, Indonesia, the Republic of Korea, the Russian Federation and Brazil. The subsequent move by these countries to floating rates is often interpreted as the recognition that soft pegs are not viable for countries closely integrated into the global financial markets.

The role of soft pegs in contributing to external fragility and the outbreak of financial crises in emerging markets is well established.[2] Most emerging-market economies offer higher nominal interest rates than the industrialized world, in large part because of higher inflation rates. These create short-term arbitrage opportunities for international investors and lenders, as well as incentives for domestic firms to reduce their costs of finance by borrowing abroad. On the other hand, by providing implicit guarantees to international debtors and creditors, currency pegs can encourage imprudent lending and borrowing. The risk of depreciation

is discounted owing to the stability of the nominal exchange rate and the confidence created by rapid liberalization and opening up of the economy. The credibility of the peg as well as arbitrage opportunities are enhanced when the country pursues a tight monetary policy in order to bring down inflation or prevent overheating of the economy.

However, a nominal peg with a higher inflation rate also causes an appreciation of the currency in real terms and a widening of the current-account deficit. If external deficits and liabilities are allowed to mount, the currency risk will rise rapidly. Since there is no firm commitment to defend the peg, the worsening fundamentals eventually give rise to expectations of a devaluation and a rapid exit of capital. Not only does this cause liquidity shortages; it also forces the monetary authorities to tighten monetary policy and restrict liquidity even further. Sooner or later, the exchange rate peg is abandoned, leading to a free fall which, together with the hike in interest rates, causes enormous dislocation in the economy.

Despite the risk of costly currency swings and crises, many countries with relatively high rates of inflation have often favoured stabilizing the internal value of their currencies by stabilizing their external value through anchoring to a reserve currency with a good record of stability. This is true not only for the small and open European economies such as Austria, the Netherlands and Belgium, but even for a large economy such as Italy, which faced several speculative attacks against its currency and experienced disruptions throughout the process of convergence towards the inflation rates of its larger trading partners in the EU. Many emerging-market economies, notably in Latin America, have also used soft pegs for disinflation. Although it proved difficult to achieve an orderly exit from such pegs in order to realign their currencies, it is notable that these countries managed to avoid the return of rapid inflation in the aftermath of crises, despite sharp declines in their currencies. For instance, after the introduction of an exchange-based stabilization plan (*Plano Real*) in 1994, Brazil succeeded in bringing down its inflation rate from a four-digit level to a single-digit level by 1998. Despite various adjustments in the value of the *real* and a relatively rapid decline in inflation, the Brazilian currency had appreciated by some 20 per cent at the end of the disinflation process. However, it was not possible to engineer an orderly realignment of the exchange rate, which came under severe pressure at the end of 1998, partly due to spillovers from the Russian crisis. But after an initial hike, inflation stabilized at low levels despite a sharp drop in the value of the *real* against the dollar (see *TDR 1999*, Part One, chap. III, sect. B).

Appreciation is generally unavoidable in exchange-based stabilization programmes because of stickiness of domestic prices. More fundamentally, it is part of the rationale of successful disinflation, since greater exposure to international trade – resulting in lower import prices and increased competition in export markets – helps to discipline domestic producers and acts as a break on income claims. However, such programmes are often launched without adequate attention to the potential problems of real currency appreciation and without a clear exit strategy (i.e. when and how to alter the peg and/or the regime and realign the exchange rate). Although economically it may appear simple to restore international competitiveness by a one-off adjustment in the exchange rate, this solution may be politically difficult. Indeed, problems in finding a political solution tend to be underestimated. Governments are often unwilling to abandon the peg and devalue after exerting considerable effort in attempting to convince people that the fixed rate has brought them more good than harm. They are also afraid of losing markets' confidence and facing a sharp reversal of capital flows and a collapse of their currency.

Exchange-rate-based stabilization programmes are often launched without adequate attention to the potential problems of real currency appreciation and without a clear exit strategy.

Given the herd behaviour of financial markets, such fears of a hard landing are not always unfounded, even though, as noted above, sharp currency declines rarely result in the return of

rapid inflation. Forewarning an exit strategy is risky, since it is not always easy to judge how rapidly inflation will decline. The Turkish exchange-based stabilization programme of December 1999 had such a strategy. However, it failed to meet its inflation target and, after a series of economic and political crises, the Government was obliged to abandon the peg and move to the other corner, floating, before the preannounced exit date (see chapter II, box 2.1). In Europe, institutional arrangements in the context of the EMS that involved assistance from anchor countries have helped, on several occasions, to engineer necessary adjustments in the currencies of the pegging countries without leading to instability and contagion (see below). However, such arrangements are not easily replicable for emerging markets that peg unilaterally. Support from international financial institutions could help achieve orderly exits, but the experience so far has not been very encouraging.[3]

A large majority of developing countries have been unwilling to impose controls on capital inflows during the boom phase of the financial cycle.

Soft pegs are not used only for disinflation. In East Asia, for example, exchange rate stability was an important ingredient of the export-oriented development strategy of the individual economies and was intended to support the regional division of labour in the context of the “flying-geese” process. Because of the concentration of Asian exports in dollar-denominated markets, nominal exchange rates in the region, although not fixed, had been kept generally stable within a band of around 10 per cent in relation to the dollar since the late 1980s. Given their low inflation rates, in most East Asian economies the appreciation of the currency was moderate or negligible. The combination of stable nominal exchange rates, rapid economic growth and relatively high nominal interest rates inspired confidence and attracted international investors and lenders. However, this led to a build-up of considerable currency risks and external financial fragility, resulting eventually in a rapid exit of capital, with spillover effects throughout the region through herd behaviour. Even in Indonesia, orderly currency adjustment was not possible despite sound macroeconomic fundamentals and the timely action taken by the Government to widen the currency band in order to stop contagious speculation (*TDR 1998*, Part One, chap. III; Akyüz, 2000b).

One way out of these problems is to use controls over capital flows while maintaining a soft peg. Taxes and reserve requirements on inflows designed to remove short-term arbitrage opportunities can help preserve monetary autonomy, and a policy of high interest rates can be pursued without encouraging speculative capital inflows and a build-up of excessive currency risk. However, as long as domestic inflation is high, currency appreciation cannot be avoided. This is particularly serious when currency pegs are used for disinflation. In any case, a large majority of developing countries have been unwilling to impose controls on capital inflows during the boom phase of the financial cycle, as a means of deterring short-term arbitrage flows, for the same reasons that they were unwilling to exit from pegged exchange rates after successful disinflation. Again, as explained in the next chapter, they are even less willing to impose controls over capital outflows in order to stabilize exchange rates and free monetary policy from pressures in the currency markets at times of speculative attacks and crisis.

2. *Floating*

Does free floating constitute a viable alternative for developing countries and transition economies? Can such countries really leave the external value of their currencies to the whims of international capital flows and dedicate monetary policy entirely to domestic objectives such as price stability or full employment? To what extent would such objectives be undermined by excessive volatility and misalignments associated with free floating?

Quite apart from how appropriate such a regime might be, for a number of reasons it is particularly unsuitable for developing countries and transition economies, as well as for smaller in-

dustrial countries. Compared to the major industrial economies, developing and emerging-market economies are much more dependent on foreign trade, which is typically invoiced in foreign currencies. On average, the share of international trade in their domestic production is twice as large as in the United States, the EU or Japan, so that the impact of exchange rate movements on their domestic economic conditions – including prices, production and employment – is much greater. Moreover, these economies have higher net external indebtedness, a larger proportion of which is denominated in foreign currencies. Consequently, sharp changes in their exchange rate tend to generate debt servicing difficulties, liquidity and solvency problems. In sharp contrast, a country such as the United States can borrow in its own currency, therefore effectively passing the exchange rate risk onto creditors.[4]

It is also argued that most developing and transition economies lack credible institutions, and this in itself is a cause of greater volatility in market sentiment and exchange rates, which is believed to have led to a widespread "fear of floating" among emerging markets. Consequently, a large number of those countries which claim to allow their exchange rates to float actually pursue intermediate regimes, and use interest rates and currency-market intervention to influence exchange rates. This finding also contradicts the claim that emerging markets have been moving away from adjustable peg regimes (Calvo and Reinhart, 2000; Fischer, 2001; Reinhart, 2000).

The experience of major industrial countries with floating rates suggests that volatility, gyrations and misalignments in exchange rates cannot simply be attributed to lack of credible institutions.

The experience of major industrial countries with floating rates during the interwar years as well as since the breakdown of the Bretton Woods system suggests that volatility, gyrations and misalignments in exchange rates cannot simply be attributed to lack of credible institutions. Rather, they are systemic features of currency markets dominated by short-term arbitrage flows. The French experience in the 1920s, for example, was lucidly described in a report of the League of Nations in 1944:

> The dangers of such cumulative and self-aggravating movements under a regime of freely fluctuating exchanges are clearly demonstrated by the French experience of 1922–26. Exchange rates in such circumstances are bound to become highly unstable, and the influence of psychological factors may at times be overwhelming. French economists were so much impressed by this experience that they developed a special "psychological theory" of exchange fluctuations, stressing the indeterminate character of exchange rates when left to find their own level in a market swayed by speculative anticipations … The experience of the French franc from 1922 to 1926 and of such interludes of uncontrolled fluctuations as occurred in certain currencies in the 'thirties demonstrates not only the difficulty of maintaining a freely fluctuating exchange on an even keel, … it also shows how difficult it may be for a country's trade balance to adjust itself to wide and violent variations. (League of Nations, 1944: 118, 119)

Writing in 1937 about the same experience, von Hayek explained gyrations not only in terms of short-term capital flows; he also argued that floating rates encouraged such capital flows:

> It is because … the movements of short term funds are frequently due, not to changes in the demand for capital for investment, but to changes in the demand for cash as liquidity reserves, that short term international capital movements have such a bad reputation as causes of monetary disturbances. And this reputation is not altogether undeserved. … I am altogether unable to see why under a regime of variable exchanges the volume of short term capital movements should be anything but greater. Every suspicion that exchange rates were likely to change in the near future would create an additional powerful motive for shifting funds from the country whose currency was likely to fall or to the country whose currency was likely to rise … This means that if the original cause is already a short-term capital movement, the variability of exchanges will tend to multiply its magnitude

> and may turn what originally might have been a minor inconvenience into a major disturbance. (von Hayek, 1937: 62–64)

As discussed in some detail in earlier UNCTAD reports, since the breakdown of the Bretton Woods arrangements, volatility, persistent misalignments and gyrations have also been the dominant features of the exchange rates of the major reserve currencies.[5] Despite a significant convergence of inflation rates and trends in unit labour costs during the past decade, the G-3 exchange rates have continued to show persistent misalignments and large gyrations. Such disorderly behaviour has caused serious problems for developing countries in the management of their currencies and external debt, and has often been an important factor in major emerging-market crises. But these problems have generally been ignored by the major industrial countries which, for the most part, have geared their monetary policy to domestic objectives, notably combating inflation. Only on a few occasions have the United States and Japan, for example, which are committed to free floating, resorted to intervention and ad hoc policy coordination when currency instability and misalignments posed serious threats to their economic prospects – in the second half of the 1980s, in order to realign and stabilize the dollar in the face of mounting protectionist pressures associated with large trade imbalances, and again in the mid-1990s, when the yen rose to unprecedented levels against the dollar.

> Despite a significant convergence of inflation rates and trends in unit labour costs during the past decade, the G-3 exchange rates have continued to show persistent misalignments and large gyrations.

Developing countries are encouraged to adopt floating on the grounds that the resulting exchange rate uncertainty would remove implicit guarantees and discourage imprudent lending and borrowing. However, experience shows that crises are as likely to occur under floating rates as under adjustable pegs (World Bank, 1998). Under financial liberalization and free capital mobility, nominal exchange rates fail to move in an orderly way to adjust to differences in inflation rates (i.e. the purchasing power parity is not preserved), while adjustment of interest rates to inflation is quite rapid. As a result, currencies of high-inflation countries tend to appreciate over the short term. Under soft pegs, excessive capital inflows (i.e. inflows in excess of current-account needs) attracted by arbitrage opportunities would increase international reserves, while under floating, they would lead to nominal appreciations, which reinforce – rather than temper – capital inflows and aggravate the loss of competitiveness caused by high inflation. Although appreciations also heighten currency risks, markets can ignore them when they are driven by herd behaviour. For instance, if the currencies in East Asia had been allowed to float in the early 1990s, when inflows were in excess of current-account needs, the result could have been further appreciations and widening payments imbalances. Indeed, in the face of such large capital inflows during the early 1990s, many governments in East Asia generally chose to intervene in order to prevent appreciation (*TDR 1998*, box 2).

As already noted, the post-war experience of emerging markets with floating is rather limited; it is largely concentrated in the aftermath of recent episodes of financial crisis. Nevertheless, it reveals a number of features that belie the promises of its advocates. In Latin America, for instance, domestic interest rates have been more sensitive to changes in United States rates, and more variable in countries with floating regimes than those with fixed or pegged rates, implying less – rather than more – monetary autonomy and greater risk to the financial system (Hausmann, 1999). Floating appears to promote pro-cyclical monetary policies as interest rates tend to rise during recession. It also leads to the shrinking of domestic financial markets and to high interest rates by increasing the risk of holding domestic assets.

> Crises are as likely to occur under floating rates as under adjustable pegs.

3. Hard pegs

It thus appears that emerging-market economies with open capital accounts cannot achieve sustained economic and financial stability by either pegging or floating their currencies. There remain the options of hard pegs, currency boards or outright dollarization. At the end of the 1990s, the currencies of 45 economies, members of the IMF, had hard pegs, of which 37 (including the then 11 euro-currency countries) had no independent legal tender, and the remainder (including Argentina, Hong Kong (China) and the transition economies of Bulgaria, Estonia and Lithuania) had currency boards(Fischer, 2001). With the exception of EMU, most economies without an independent legal tender were small. More recently, Ecuador and El Salvador have adopted the dollar as their national currency and Guatemala is in the process of doing so.

Not only do hard pegs remove the nominal exchange rate as an instrument of external adjustment, but also they subordinate all other policy objectives to that of maintaining a fixed nominal exchange rate or dollarization.

Such regimes are considered particularly appropriate for countries with a long history of monetary disorder, rapid inflation and lack of fiscal discipline (i.e. where there is "exceptional distrust of discretionary monetary policy") (Eichengreen, 1999: 109). They effectively imply abolishing the central bank and discarding discretionary monetary policy and the function of lender of last resort. Not only do they remove the nominal exchange rate as an instrument of external adjustment, but also they subordinate all other policy objectives to that of maintaining a fixed nominal exchange rate or dollarization. However, these same features also provide the credibility needed for the success of such regimes since they imply that governments are prepared to be disciplined by external forces, particularly by a foreign central bank with a record of credible monetary policy. The expected economic benefits include low inflation, low and stable interest rates, low cost of external borrowing and, if there is outright dollarization, the ability to borrow abroad in the currency circulating domestically. Furthermore, dollarization is expected to deepen the financial sector, extend the maturities of domestic financial assets and encourage long-term financing. It is often favoured by private business in emerging markets because it increases predictability and reduces the cost of transactions.

Some of these benefits can be significant. For a small economy which is closely integrated with, and dependent on, a large reserve-currency country such benefits may also offset the potential costs of no longer being able to use interest and exchange rates in response to domestic and external shocks, and to manage business cycles as well as the loss of seigniorage from printing money. However, for most developing countries, currency boards and dollarization are not viable alternatives over the long term, even though they may help to quickly restore credibility after a long history of monetary disorder, fiscal indiscipline and rapid inflation. In particular, large and unpredictable movements in the exchange rates of major reserve currencies make the option of unilaterally locking into and floating with them especially unattractive.[6]

Hard pegs do not insulate economies from external financial and real shocks, any more than did the gold standard. Unless the anchor country experiences very similar shocks and responds in a manner that is also appropriate to the anchoring country, the costs of giving up an independent monetary policy and defending a hard peg can be very high in terms of lost output and employment. But for obvious structural and institutional reasons, a combination of developing and industrial countries does not constitute an optimal currency area, and they are often subject to asymmetric shocks, especially if the developing countries are highly dependent on primary exports. Furthermore, in the absence of close economic integration, the business cycles of anchor and anchoring countries are unlikely to be synchronized, so that a particular monetary policy stance pursued by the former may be unsuitable for the latter. Thus, a country with a hard peg may find its currency and interest rates rising at a time when its economy is

already suffering from recession and loss of competitiveness in international markets, as Argentina has over the past two years (see chapter II, box 2.2).

It is often suggested that asymmetric shocks and asynchronous cycles do not matter as long as wages and prices are fully flexible. In this respect, there is a certain degree of ambivalence in the orthodox thinking on exchange rate policy, since one of the original arguments in favour of floating rates was that sticky wages and prices prevented rapid adjustment to internal and external shocks without sacrificing growth and employment (Friedman, 1953). Even when wages and prices are reasonably flexible, the adjustment process can entail large costs because it is not instantaneous. With an absolutely fixed exchange rate, the only instrument at hand to correct real appreciation is a cut in nominal wages, but that cannot be achieved without reducing aggregate domestic demand and increasing unemployment. Furthermore, for the reasons explained by Keynes more than 60 years ago, such cuts, will, in turn, reduce aggregate demand and add to deflationary pressures when they result in lower real wages. Thus it would be very difficult to restore competitiveness without deflation. Fiscal austerity designed to reduce external deficits would only deepen the crisis, leading to what Robert McKinnon described nearly 40 years ago as a situation of the "tail wagging the dog" (McKinnon, 1963: 720). It is therefore surprising that the most important argument advanced in favour of flexible exchange rates, namely the sluggishness of nominal wage and price adjustment, is overlooked by the advocates of currency boards or dollarization.

Nor can currency boards ensure that domestic interest rates remain at the level of the country to which the currency is pegged. When the economy suffers from loss of competitiveness and large payments deficits, the resulting decline in reserves leads to a reduction in liquidity, pushing up interest rates and threatening to destabilize the banking system. It has indeed been shown that a currency board regime makes payments crises less likely only by making bank crises more likely (Chang and Velasco, 1998). International investors may not take the hard peg for granted and may demand a large risk premium, as demonstrated by the large spreads that most currency board countries have had to pay over the past few years. Speculative attacks against a currency can occur in a currency board system as in any other exchange rate regime, and costs incurred in defending a hard peg may exceed those incurred by countries experiencing a collapse of soft pegs. For instance, in terms of loss of output and employment, Argentina and Hong Kong (China) suffered as much as or even more than their neighbours which experienced sharp declines in their currencies during recent emerging-market crises. For financially open economies, differences among such regimes are due less to their capacity to prevent damage to the real economy and more to the way damage is inflicted.

> A currency board regime makes payments crises less likely only by making bank crises more likely, and costs incurred in defending a hard peg may exceed those incurred by countries experiencing a collapse of soft pegs.

Historically, exits from currency boards have occurred in the context of decolonization, when the pound sterling was often the anchor currency. Unlike their modern counterparts, the rationale for establishing such regimes was not to gain credibility; rather, they were imposed by the colonial power with a view to reinforcing trade ties with its colonies. In principle, by retaining a national currency, currency board regimes – as distinct from dollarization – allow for devaluation and even exit. However, there is no modern currency board regime with a known exit strategy; indeed, making such a strategy known would defeat its very purpose. For this reason, an orderly exit from a currency board regime is unlikely to be possible, especially when the economic costs of adhesion militate in favour of change. By contrast, when the regime works well, governments feel no need for exit.

C. Regional arrangements: the European experience

Given the difficulties that developing countries have been facing in finding unilateral solutions to the problem of managing their currencies and preventing financial crises, and given the resistance of the major powers to genuine reform of the international financial architecture, attention has increasingly focused on regional solutions (Chang, 2000; Mistry, 1999; Park and Wang, 2000). In this context, there is growing interest in the lessons provided by the European experience with regional monetary cooperation and currency arrangements in the post-Bretton Woods era, which culminated in a monetary union at the end of the 1990s.

> Although the smaller European countries sacrificed part of their monetary autonomy, they were considerably strengthened vis-à-vis currency markets and became less dependent on international financial institutions.

The first response of Europe to the collapse of the Bretton Woods system in the early 1970s consisted of "snake" and "snake in the tunnel" arrangements that were designed to stabilize the intra-European exchange rates within relatively narrow bands in an environment of extreme volatility. This was followed by the creation of the EMS in 1979 with the participation of the members of the European Economic Community (EEC), and eventually by the introduction of the euro and the establishment of the European Monetary Union (EMU) in 1999.[7] Thus it took some 30 years to pass from soft pegs to hard pegs.

After the collapse of the Bretton Woods system, European countries were able to avoid inflationary spillovers from the United States by appreciation of their currencies vis-à-vis the dollar, and floating against the dollar was seen as consistent with their objective of stabilizing the internal value of their currencies. However, given the relatively high degree of regional integration, a move towards free floating among the European currencies posed a potential threat of instability and disruptions to intraregional trade and resource allocation, particularly for small and open economies. A policy of establishing a stable pattern of intraregional exchange rates and collectively floating against the dollar was seen as an appropriate solution, since the trade of the region as a whole with the rest of the world was relatively small. In effect, regional integration and monetary cooperation was designed to establish Europe as a single large economy – like that of the United States – with limited dependence on international (extra-European) trade.

Although the decision to join such arrangements (or, in the Austrian view, to "tie their own hands" in monetary affairs) was taken unilaterally by each country, the system that emerged involved multilateral commitments at the regional level. Since the deutsche mark had been the most stable currency after the war and Germany was the largest market in the region, the German currency provided a natural anchor for many European countries following the collapse of the Bretton Woods arrangements. Given the political will of the participating countries to move towards

greater integration, Germany did not simply provide an anchor currency; it also assumed responsibilities vis-à-vis the anchoring countries in securing the stability of the arrangements through such means as intervention in the currency markets and provision of lender-of-last-resort financing, although the latter role has never been explicitly stated. As for the smaller countries, although they sacrificed part of their monetary autonomy, they were considerably strengthened vis-à-vis currency markets and became less dependent on international financial institutions.

Currency arrangements were also supported by a European Community regime for capital movements, which, until a directive in 1988, provided governments with some leeway for restricting different categories of transaction.

In the process leading to a common currency, the adjustable pegs adopted were crucially different from the unilateral soft pegs used by emerging markets in recent years in that both anchoring and anchor countries shared the common objective of achieving monetary convergence and internal and external stability for their currencies. The system was also designed to reduce one-way bets, which might have been encouraged by inflation and interest rate differentials, by establishing bands around the so-called "parity grids". It established obligations for symmetric interventions as well as unlimited short-term credit facilities among central banks designed to maintain bilateral exchange rates within the band. It also made available to member countries various types of external payments support to enable ERM participants both to keep their currencies within prescribed fluctuation limits and to cope with circumstances that might threaten orderly conditions in the market for a member country's currency.[8] In addition, it stipulated concrete procedures for realignment of the bands. Furthermore, European integration allowed special arrangements in the ERM for the less advanced countries – Greece, Ireland, Portugal and Spain – including the provision of considerable fiscal compensation, which did much to enable them to achieve monetary and fiscal convergence and meet the EMU stability criteria.

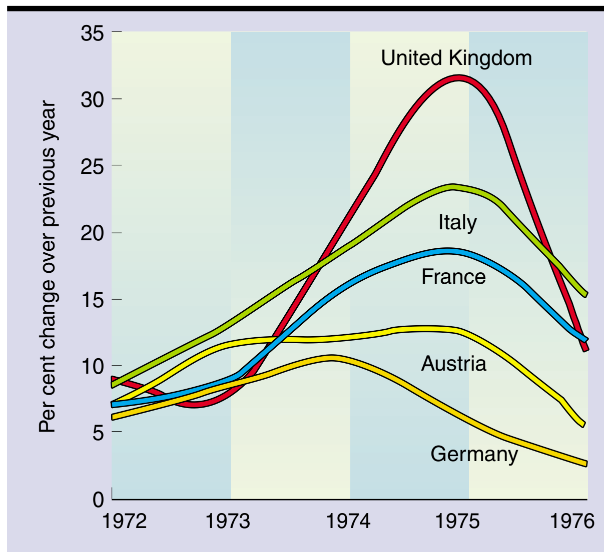
These arrangements were also supported by a European Community regime for capital movements, which, until a directive in 1988, provided governments with some leeway for restricting different categories of transaction, along with some liberalization obligations which were less stringent for short-term and potentially speculative transactions. The 1988 directive abolished restrictions on capital movements between residents of European Community countries, subject to provisos concerning the right to control short-term movements during periods of financial strain.[9] The directive also stated that European Community countries should endeavour to attain the same degree of liberalization of capital movements vis-à-vis third countries as among themselves. However, governments retained the right to take protective measures with regard to certain capital transactions in response to disruptive short-term capital movements. Upon adoption of the single currency, such measures could be taken only in respect of capital movements to or from third countries.

Despite the establishment of institutions to support the exchange rate arrangements and integration, the path to monetary union has not been smooth; it has often been disrupted by shocks and policy mistakes. In some instances disruptions were similar to currency crises experienced by emerging markets under soft pegs. As in emerging markets, occasionally pressures developed as a result of differences in the underlying inflation rates: at the high end of the inflation spectrum was Italy (and subsequently the United Kingdom), followed by France with moderate inflation, while Germany and Austria were at the lower end. For high-inflation countries, therefore, currency realignments were needed from time to time until their inflation rates converged towards that of the anchor country. On many occasions inflation differentials were widened by external or internal shocks which, in effect, tested the resilience of the system and the commitments of the participating countries to internal and external stability. The first shock came soon after the collapse of the Bretton Woods arrangements in the form of a hike in oil prices. In the United Kingdom and Italy unit labour costs rose much faster, and inflation

Chart 5.1

UNIT LABOUR COSTS IN SELECTED EUROPEAN COUNTRIES AFTER A NEGATIVE SUPPLY SHOCK, 1972–1976

(Per cent change over previous year)

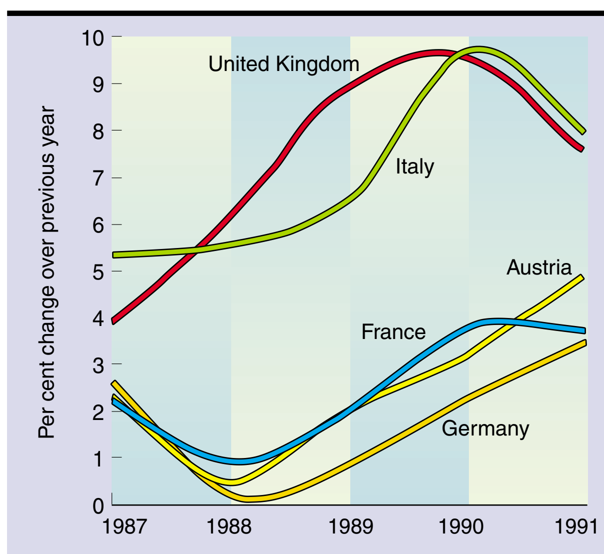


Source: AMECO database, European Commission, 2000.

Chart 5.2

UNIT LABOUR COSTS AFTER A POSITIVE DEMAND SHOCK, 1987–1991

(Per cent change over previous year)



Source: See chart 5.1.

persisted longer than in France, Austria and Germany (chart 5.1). In consequence, the parities between the currencies of these countries became unsustainable, necessitating realignments.

However, such realignments have not always been an orderly process. The events leading to the 1992–1993 EMS crisis provide useful lessons on how regional currency arrangements, even with supporting institutions, can break down when exchange rates are inconsistent with underlying inflation and interest rates. The beginning of this crisis originated from the policy response to the 1987 global stock market crash, when central banks in the United States and Europe lowered interest rates to historical lows. This provided a strong monetary stimulus at a rather late stage of recovery, pushing up growth rates in Europe to 4 per cent or higher, with the United Kingdom leading in the late 1980s and Germany in the early 1990s (owing also to the impact of unification). Acceleration in growth, however, was associated with greater divergence of inflation rates; unit labour costs went up drastically in Italy and the United Kingdom, compared to Germany and France (chart 5.2). However, the nominal exchange rate of the lira against the deutsche mark was kept virtually stable from 1987 until 1992, implying a real appreciation of 23 per cent. For the United Kingdom, which had entered the ERM in 1990 with an already overvalued currency, the rate of appreciation was even higher. In both countries, loss of competitiveness was reflected in a sharp swing in the current account from a surplus to a deficit. Until the outbreak of the crisis, these deficits were sustained by large inflows of capital, notably from Germany, on account of sizeable interest rate differentials. Thus the EMS crisis that forced Italy and the United Kingdom to leave ERM and devalue in September 1992 was similar in many respects to emerging-market crises. For these two countries, such an adjustment in nominal rates was certainly preferable to maintaining the grids and trying to restore competitiveness through a deflationary adjustment. By contrast, as discussed in *TDR 1993* (Part Two, chap. I, sect. B), the attack on the French franc could not be depicted as a case of the market eventually imposing discipline, because the underlying fundamentals of the French economy were as strong as those in Germany.

This experience shows that, just as with unilateral pegging or fixing, regional currency arrangements, even with supporting institutions, can run into trouble in the absence of appropriate policy actions to bring exchange rates into conformity with underlying fundamentals. Again, while it is true that the hegemony of an anchor country in regional arrangements is balanced by responsibilities that are not present in unilateral pegging or fixing, policies pursued by such a country may still turn out to be too restrictive for other members. Indeed, tight German monetary policy appears to have been a factor in the speculative attack on the French franc during the EMS crisis.

With the move to a single currency, smaller members of the EMU are expected to exert a somewhat greater influence on the common monetary policy. Furthermore, strong trade linkages can be a force for stability and convergence, with expanding economies providing additional demand and export markets for those members experiencing a downturn. Even though asymmetric shocks and structural differences may still produce significant divergence of economic performance among countries at different levels of development, such differences do not need to cause serious policy dilemmas if countries are prepared to use the various instruments they still have at their disposal. However, under certain circumstances, the constraints imposed on fiscal policy by the Stability and Growth Pact could impair the ability to smooth out intraregional differences in economic performance.

D. Options for developing countries: dollarization or regionalization?

Despite the temporary setbacks in 1992–1993, and shortcomings in the design of policies and institutional arrangements which constrained policy options, European monetary cooperation has been successful in securing stability in intraregional exchange rates, containing financial contagion and dealing with fluctuations vis-à-vis the dollar and the yen. To what extent can such arrangements be replicated by developing countries as a means of collective defence against systemic instability? Is it feasible for developing countries to establish regional arrangements among themselves without involving G-3 countries, and to follow a path similar to that pursued by Europe – from a regionally secured exchange rate band to a currency union? Alternatively, could they go directly to currency union by adopting a regional currency?

Interest in regional monetary arrangements and cooperation in the developing world has increased rapidly since the outbreak of the Asian crisis. For example, at the 1997 Annual Meetings of the IMF and the World Bank, soon after the outbreak of the crisis, a proposal was made to establish an Asian Monetary Fund. Subsequently, an initiative was launched in May 2000 involving swap and repurchase arrangements among member countries of the Association of South-East Asian Nations (ASEAN), China, Japan and the Republic of Korea (see box 5.1). More recently, the joint French-Japanese paper cited in section A above (Ministry of Finance, Japan, 2001: 5–6) has given support to the strengthening of regional cooperation in East Asia, drawing on the European experience:

Box 5.1

REGIONAL MONETARY AND FINANCIAL COOPERATION AMONG DEVELOPING COUNTRIES

At present there are few regional financial and monetary arrangements among developing countries, apart from those in East Asia described in box 5.2. Such arrangements as do exist range from agreements to pool foreign exchange reserves, such as the Andean Reserve Fund and the Arab Monetary Fund, to currency pegging (Rand Monetary Area) and a regional currency (Eastern Caribbean Monetary Union). The Communauté financière africaine (CFA) also has a common currency, but is unique in that it involves an agreement between its members and a major European country on cooperation in monetary and exchange-rate policy.

The *Andean Reserve Fund* was established in 1976 by the members of the Andean Community – Bolivia, Colombia, Ecuador, Peru and Venezuela – and has a subscribed capital of $2 billion. The Fund provides financial support to its members in the form of loans or guarantees for balance-of-payments support, short-term (liquidity) loans, emergency loans, loans to support public external debt restructuring, and export credit. Conditionality for drawing on these facilities is softer than that of IMF. The Fund also aims at contributing to the harmonization of the exchange-rate, monetary and financial policies of member countries. It is thus intended to promote economic and financial stability in the region and to further the integration process in Latin America.[1]

The *Arab Monetary Fund* was established in 1976 with a structure similar to that of IMF and comprises all members of the League of Arab States (except the Comoros). It has a subscribed capital of 326,500 Arab accounting dinars, equivalent to about $1.3 billion. The Fund aims at promoting exchange-rate stability among Arab currencies and at rendering them mutually convertible, and it provides financial support for members that encounter balance-of-payments problems. It is also intended to serve as an instrument to enhance monetary policy cooperation among members and to coordinate their policies in dealing with international financial and economic problems. Its final aim is to promote the establishment of a common currency.

In the *Rand Monetary Area*, Lesotho and Swaziland, both economically closely integrated with South Africa, peg their currencies to the South African rand without formally engaging in coordination of monetary policy.

The *Eastern Caribbean Monetary Union* is an arrangement for a common currency among the members of the Organization of Eastern Caribbean States, a group of small island developing countries.[2] The currency is pegged to the dollar, but in contrast to France with respect to the CFA (see below), the United States does not play an active role in the pegging arrangement.

The creation of the *Communauté financière africaine* goes back to 1948, but the agreements governing the current operation of the CFA-zone were signed in 1973. There are two regional groups, each with its own central bank: the Economic and Monetary Union of West Africa, and the Central African Economic and Monetary Community.[3] The 14 countries involved have a common currency, the CFA franc, that is not traded on the foreign exchange markets but is convertible with the French franc at a fixed parity. There is free capital mobility within the CFA-zone, and between these countries and France, and the foreign exchange reserves of its members are pooled. The French Treasury guarantees the convertibility of the CFA franc into French francs at a fixed parity and assumes the role of lender of last resort. On the other hand, the arrangement includes a mechanism that limits the independence of the two regional central banks, and the French Treasury can influence monetary policy in the CFA zone as well as determination of the parity with the French franc.

Each of the two central banks has an operations account with the French Treasury into which they have to deposit 65 per cent of their foreign exchange reserves, but which also provides an overdraft facility (at market-related interest) that is, in principle, unlimited. On the other hand, in their operations the central banks have to observe two rules that are designed to check the supply of CFA francs: (i) their sight liabilities are required to have a foreign exchange cover of at least 20 per

Box 5.1 (concluded)

cent, and (ii) their lending to each member Government is limited to 20 per cent of that Government's revenue of the previous year. Moreover, France has seats on the Boards of both central banks.[4]

It appears that membership in the CFA has helped to keep inflation in the CFA countries concerned considerably below the average of other African countries; between 1975 and 1985, per capita income also grew faster. However, the system came under increasing strain after 1985 due to external shocks and weakening macroeconomic fundamentals (Hadjimichael and Galy, 1997). The CFA countries suffered from severe terms-of-trade losses as world market prices for some of their major export commodities (cocoa, coffee, cotton and oil) dropped sharply and the French franc appreciated markedly against the dollar following the Plaza Accord of 1985. Consequently, the nominal effective exchange rate of the CFA franc rose by almost 7 per cent annually between 1986 and 1993. CFA countries' exports lost competitiveness in world markets as domestic costs could not be reined in; both the combined current-account and the fiscal deficit of the CFA zone increased by 6.5 per cent of GDP, and the 20 per cent limit of monetization of government debt was substantially exceeded by several countries.

In 1994 it was decided to adjust the parity of the CFA franc with the French franc, from 50 CFA francs to 100 CFA francs to one French franc (see also *TDR 1995*, chap. 1, box 1; Clément, 1996). This was the first – and so far only – devaluation since 1948, but it demonstrated the vulnerability of the arrangement, especially in the absence of a mechanism that would allow for a gradual adjustment of the nominal exchange rate in the light of macroeconomic and balance-of-payments developments. The probability that these developments diverge between commodity-dependent developing countries and the developed country whose currency serves as an anchor is relatively high, given the difference in their exposure to external shocks.

The stability and proper alignment of exchange rates of the CFA countries vis-à-vis their trade partners and competitors exert a major influence on their overall economic performance. First, trade in these countries accounts for a very high share of GDP. Second, intra-CFA trade is limited, accounting, on average, for only 8 per cent of its members' total trade.[5] Third, because of structural differences, CFA and EU countries do not constitute an optimal currency area. Even though half of the total trade of CFA countries is with the EU, their export and import structures are very different and the CFA countries face competition from third parties in commodity exports both to the EU and elsewhere. Thus, while bringing a certain amount of monetary discipline and protection against speculative attacks, a policy of locking into the French franc (and, hence, subsequently into the euro) and floating with it against other currencies poses problems for trade and international competitiveness.

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1 For more detailed information, see FLAR (2000).

2 The member States are Antigua and Barbuda; Dominica; Grenada; Montserrat; St. Kitts and Nevis; Saint Lucia; and St Vincent and the Grenadines. The British Virgin Islands and Anguilla are associate members.

3 The Economic and Monetary Union of West Africa comprises Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo; and the Central African Economic and Monetary Community comprises Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon. The two groups maintain separate currencies, but since both have the same parity with the French franc, they are subject to the same regulatory framework. And because there is free capital mobility between each of the two regions, the CFA franc zone can be considered as a single currency area. The Comoros has a similar arrangement but maintains its own central bank.

4 For a detailed treatment of the institutional aspects of the CFA, see Banque de France (1997).

5 Trade with countries within the CFA franc zone ranges from 1.5 per cent of total trade in Congo to 23.3 per cent in Mali. By contrast, trade links with Europe are very close. They are slightly closer for the member States of the Central African Economic and Monetary Community (50 per cent of exports and 66 per cent of imports) than for the members of the Economic and Monetary Union of West Africa (49.3 and 46.3 per cent, respectively).

> Strengthened regional co-operation is a way of ensuring both stability and flexibility … The European Monetary Union process provides a useful example of how further integration can be achieved … In this regard, an important step was taken in Chiang Mai on 6 May 2000 to establish a regional financial arrangement to supplement existing international facilities … Regional co-operation frameworks should be fully integrated into the overall monetary and financial system.

Interest has also been expressed in establishing regional currencies, as opposed to dollarization, in Latin America. A recent statement made by the President of the Inter-American Development Bank stated:

> The issue (of dollarization) is very controversial and has both its defenders and detractors, but we do not think the conditions are appropriate in most countries for taking that route … We believe, however, that the important conditions are in place for thinking about sub-regional currencies. (Reported in *SUNS*, 11 January 2000.)

If established and sustained, regional currencies among developing country groupings can bring considerable benefits, similar to those expected from the introduction of the euro. They can reduce transaction costs of doing business within a region and eliminate exchange rate spreads and commissions in currency trading associated with intraregional trade and investment. For example, such effects are estimated to raise the combined GDP of the euro area by some 0.5 per cent. The adoption of the euro is also expected to raise intraregional trade, primarily through trade diversion (*TDR 1999,* Part One, chap. III). Furthermore, a supranational central bank can reduce the influence of populist national politics on monetary policy, while nevertheless being accountable to member countries. Unlike dollarization, such an arrangement would also bring benefits in terms of seigniorage (Sachs and Larrain, 1999: 89).

Establishing regional arrangements – including regional currencies – among developing countries would also reduce the likelihood of synchronous cycles and asymmetric shocks to the extent that there are similarities in their economic structures and institutions. In other words, a grouping of developing countries alone is more likely to meet the conditions of an optimal currency area than one which also involves developed countries.

However, in drawing lessons from Europe for developing countries, it is necessary to take into account certain differences between the two. The European experience shows that small and highly open economies with close regional trade links can establish and sustain a system of stable exchange rates around a major reserve currency so long as there are clear guidelines regarding the maintenance and alteration of members' currency bands, appropriate allocation of responsibilities and supporting institutions and policies. Such arrangements can be operated for quite a long time without major disruptions and can help to deepen integration (see box 5.2). For larger groups and for countries of equal size or economic power, however, there could be significant difficulties in establishing and sustaining such systems. There would be an additional difficulty when the group does not contain a major reserve-currency country.

> Is it feasible for developing countries to establish regional currency arrangements among themselves without involving G-3 countries, and to follow a path similar to that pursued by Europe?

Consequently, unless they are organized around a major reserve-currency country, developing countries of comparable size may find it difficult to form a group to establish and sustain ERM-type currency grids and ensure that the monetary and financial policies pursued independently by each country are mutually compatible and consistent with the stability of exchange rates. Moreover, without the involvement of a large reserve-currency country, it could be difficult to put in place effective defence mechanisms against speculative attacks on individual currencies. Under these conditions, while a rapid move to monetary union through the adoption of a regional currency might be considered desirable, it would face similar problems of implementation as the introduction of an exchange

Box 5.2

THE CHIANG MAI INITIATIVE

Even before the financial crisis of 1997, there had been a growing interest in East Asia in pursuing regional policy coordination and monetary cooperation. Various swap arrangements and repurchase agreements had been introduced, and these initiatives intensified during the Mexican crisis in the mid-1990s. However, none of these moves prepared the region for the currency runs of 1997 and 1998.

In a Joint Statement on East Asia Cooperation issued at the summit of "ASEAN plus 3" (the 10 members of ASEAN plus China, Japan, and the Republic of Korea) in November 1999, it was agreed to "strengthen policy dialogue, coordination and collaboration on the financial, monetary and fiscal issues of common interest" (Ministry of Finance, Japan, 2000a: 8). Against this background, the region's Finance Ministers launched the so-called "Chiang Mai Initiative" in May 2000, aimed at building networks for multilayered financial cooperation to match the growing economic interdependence of Asian countries and the consequently greater risk that financial shocks could lead to regional contagion.[1] The Initiative envisages the use of the ASEAN+3 framework to improve exchange of information on capital flows and to launch moves towards the establishment of a regional economic and financial monitoring system. The core of the Initiative is a financing arrangement among the 13 countries that would strengthen the mechanism of intraregional support against currency runs. This arrangement, building on the previous ASEAN Swap Arrangement (ASA), is intended to supplement existing international financial cooperation mechanisms. It is also expected to contribute to the stability of exchange rates within the region.

The previous ASA, which dates back to 1977, comprised only five countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand). Total funds committed under the arrangement were $200 million – a negligible amount compared to the combined loss of foreign exchange reserves of $17 billion that the five countries experienced between June and August 1997.

The new ASA envisaged under the Chiang Mai Initative includes Brunei Darussalam and allows for the gradual accession of the four remaining ASEAN countries (Cambodia, Lao People's Democratic Republic, Myanmar and Viet Nam). But its most important element is the inclusion of bilateral swap and repurchase arrangements between the ASEAN countries and China, Japan, and the Republic of Korea. Funds available under the new ASA total $1 billion. However, the commitments of the three non-ASEAN countries to the bilateral swap arrangements are likely to be substantially greater than this; they will be determined by the level of their foreign currency reserves and the amounts that were involved in earlier agreements between Japan and the Republic of Korea ($5 billion) and Japan and Malaysia ($2.5 billion). The conditions for drawing on the facilities and a number of technicalities remain to be agreed in negotiations among the countries concerned, but it appears that assistance under the bilateral swap arrangements will, in principle, be linked to IMF support (Ministry of Finance, Japan, 2000b).

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1 For further information on the Initiative, see Ministry of Foreign Affairs of the Kingdom of Thailand (2000); Ministry of Finance, Japan (2000a and 2000b); "Asia finance: Central banks swap notes", *The Economist*, 16 May 2000.

rate mechanism. Recognition of such difficulties and adoption of appropriate mechanisms to overcome them are essential if developing countries are to succeed in their attempts to form regional monetary groupings aimed at attaining greater exchange rate and financial stability.

The absence of a major reserve-currency country in regional arrangements also poses problems of credibility. It may be especially difficult for countries with a long history of monetary disorder and inflation to form a credible monetary union without involving a major reserve-currency country with a good record of monetary discipline and stability. In this regard, Latin America is clearly less favourably placed than East Asia.

More fundamentally, for developing countries to manage on their own regional exchange rates vis-à-vis the G-3 currencies is a daunting task, whether it is undertaken within the framework of a monetary union or under ERM-type arrangements. They cannot simply float their currencies and adopt an attitude of benign neglect towards the value of their currencies vis-à-vis the rest of the world, even under conditions of deep regional integration. For instance, in East Asia, while intraregional trade among the countries of the region (ASEAN, first-tier NIEs and China) is important and constantly growing, it still accounts for less than half of their total trade (*TDR 1996,* Part Two, chap. I, sect. E), compared to two thirds in the EU. Furthermore, as a proportion of GDP, the trade of East Asian developing countries with the rest of the world is more than twice as large as that of the United States, the EU or Japan. Accordingly, their exchange rates vis-à-vis G-3 currencies can exert a considerable influence on their economic performance. Furthermore, regional arrangements would not protect them against financial shocks, since they carry large stocks of external debt in G-3 currencies.

For developing countries to manage on their own regional exchange rates vis-à-vis the G-3 currencies is a daunting task, whether it is undertaken within the framework of a monetary union or under ERM-type arrangements.

These factors thus render floating against G-3 currencies unattractive and raise the question of what constitutes an appropriate exchange rate regime at the regional level. One option is to establish a crawling band, with the central rate defined in terms of a basket of G-3 currencies.[10] The joint French-Japanese paper cited above suggested that such an intermediate regime could be a possible step towards monetary union:

> A possible solution for many emerging market economies could be a managed floating exchange-rate regime whereby the currency moves within a given implicit or explicit band with its centre targeted to a basket of currencies. … managed free-floating exchange rate regimes may be accompanied for some time, in certain circumstances, by market-based regulatory measures to curb excessive capital inflows. (Ministry of Finance, Japan, 2001:3–4)

The paper went on to argue that a "group of countries with close trade and financial links should adopt a mechanism that automatically moves the region's exchange rates in the same direction by similar percentages". This would imply fixed bands for currencies of members, as in the ERM. But as the European experience shows, there would also be a need to alter such bands in line with changes in inflation rates, for example. Such a regime, pursued collectively, may need to be supported by a collective system of control over capital movements. For reasons already mentioned, control over capital flows – both inward and outward – can be more easily agreed upon when countries act together rather than separately. In such an arrangement, intraregional capital flows may be deregulated – as in the EMU – but capital flows to and from nonmember countries would have to be controlled – as in the formative years of the EMS – in order to restrict short-term, potentially destabilizing movements.

Any regional monetary arrangement would need to include mechanisms to support the regional currency, or currencies, in order to keep exchange rates in line with targets and stem specu-

lative attacks. Since the East Asian crisis, various proposals have been put forward to establish regional support mechanisms for intervention in currency markets and for the provision of international liquidity to countries facing a rapid exit of capital. The 1997 proposal to establish an Asian facility of $100 billion was "derailed quickly by the United States Treasury and IMF for fear that it would detract from the role (and power) of the latter and make it even more difficult to get the United States' contribution to the IMF's latest quota increase authorized by the United States Congress" (Mistry, 1999: 108).[11] Another proposal made was to pool and deploy national reserves to defend currencies facing speculative attacks and to provide international liquidity to countries without the stringent conditions typically attached to such lending by international financial institutions. For instance on the eve of the Thai crisis in 1997, the combined net reserves of East Asia – including Japan – exceeded $500 billion, and by 2000 had risen to about $800 billion (Park and Wang, 2000). Pooling of reserves can also be supplemented by regional agreements to borrow among regional central banks, modelled on the IMF's General Arrangements to Borrow (GAB), as recently proposed by Singapore as a form of mutual assistance.

> Any regional monetary arrangement would need to include mechanisms to support the regional currencies in order to keep exchange rates in line with targets and stem speculative attacks.

Arrangements such as pooling of national reserves or swap facilities among central banks can undoubtedly do much to stabilize exchange rates, even when they involve only developing countries of the region. However, they are likely to be more effective in smoothing out short-term volatility and responding to isolated currency pressures than in stalling systemic crises. Given the herd behaviour of financial markets, the speed of spillovers and extent of contagion, it may be impossible to sustain an ERM-type currency band at times of crisis simply by drawing on a pool of national reserves, if there is no possibility of recourse to a regional lender of last resort. Besides, maintaining a high level of reserves for this purpose would be a very expensive way of securing insurance against financial panics. As discussed in the next chapter, a more viable alternative would be to resort to unilateral standstills and exchange and capital controls at times of speculative attacks.

> As European experience has shown, progress towards a currency union can be a long and drawn-out process, requiring political will and a "culture" of regionalism. Recent initiatives and proposals in East Asia, however modest they may be, constitute an important step forward.

In a world of systemic and global financial instability, any regional arrangement designed to achieve exchange rate stability in order to prevent crises, and manage them better if they nonetheless occur, should also incorporate a number of other mechanisms, with the aim of ensuring enhanced regional surveillance, information-sharing and early warning. Domestic reforms would still be needed in many of the areas discussed in the previous chapter in order to provide a sound basis for regional cooperation. Just as domestic policy actions without appropriate global arrangements would not be sufficient to ensure greater financial stability, regional arrangements could fail in the absence of sound domestic institutions and policies.

As European experience has shown, progress towards a currency union can be a long and drawn-out process, requiring political will and a "culture" of regionalism. Regional monetary arrangements linking several national currencies through exchange rate bands can encounter serious problems even when there are supporting institutions. It would not be easy for developing countries to replicate the European experience, with or without the help of G-3 countries. However, the threat of virulent financial crises, together with the lack of genuine progress in the reform of the international financial architecture, has created a sense of urgency in emerging markets, notably in East Asia, for building col-

lective defence mechanisms at the regional level. In this context, recent initiatives and proposals, however modest they may be, constitute an important step forward. ■

Notes

1 For instance, the report of the International Financial Institutions Advisory Commission set up by the United States Congress (commonly referred to as the "*Meltzer Report*"), recommended "that countries avoid pegged or adjustable rates. The IMF should use its policy consultations to recommend either firmly fixed rates (currency board or dollarization) or fluctuating rates" (IFIC, 2000: 8).Similar views have been expressed by the former Treasury Secretary of the United States concerning the choice of an appropriate exchange rate regime, "... which, for economies with access to international capital markets, increasingly means a move away from the middle ground of pegged but adjustable fixed exchange rates towards the two corner regimes of either flexible exchange rates or a fixed exchange rate supported, if necessary, by a commitment to give up altogether an independent monetary policy" (Summers, 2000b: 8).

2 For an earlier account of this process, before the recent surge in capital flows to emerging markets, see *TDR 1991* (Part Two, chap. III, sect. F); *TDR 1998* (Part One, chap. III, sect. B); and *TDR 1999* (Part Two, chap. VI).

3 For instance, the 1998 Brazilian programme with the IMF had stipulated an orderly exit from the peg through gradual devaluations throughout 1999, as well as emergency financing, but this did not prevent the crisis.

4 This inability of a country to borrow in its own currency has been coined the "original sin hypothesis" (Hausmann, 1999; Eichengreen and Hausmann, 1999). A corollary of this hypothesis is that "... the country's aggregate net foreign exposure must be unhedged, by definition. To assume the ability to hedge is equivalent to assume that countries can borrow abroad in their own currencies but choose not to do so, in spite of the fact that the market does not appear to exist" (Eichengreen and Hausmann, 1999: 25).

5 For an assessment of the experience in the 1980s, see UNCTAD secretariat (1987); Akyüz and Dell (1987); and also *TDR 1990* (Part Two, chap. I). For the more recent experience, see previous *TDR 1993* (Part Two, chap. I); *TDR 1994* (Part Two, chap. II); *TDR 1995* (Part Two, chap. I); *TDR 1996* (Part Two, chap. I); and *TDR 1999* (chap. III).

6 For a debate on the relative costs and benefits of hard pegs and floating rates, see Hausmann (1999) and Sachs and Larrain (1999).

7 The first major political initiative for a European monetary union was taken in 1969 with the adoption of the Werner Report, which proposed: for the first stage, a reduction of the fluctuation margins between the currencies of the member States of the Community; for the second stage, the achievement of complete freedom of capital movements, with integration of financial markets; and for the final stage, an irrevocable fixing of exchange rates between the currencies. In its first effort at creating a zone of currency stability, the EEC attempted in 1971 to fix European parities closer to each other than to the dollar, but with some flexibility ("the snake"). The "snake" rapidly died with the collapse of the dollar-based Bretton Woods system, but was reborn in 1972 as the "snake in the tunnel", a system which narrowed the fluctuation margins between the Community currencies (the snake) in relation to those operating between these currencies and the dollar (the tunnel). During the currency turmoil that accompanied the 1973 oil crisis, this arrangement could not function well, leading to various exits and floating, until the establishment of the EMS in 1979. The United Kingdom was a member of the EMS but did not participate in the ERM until 1990. For the history of European monetary integration and

the functioning of the EMS, see Bofinger and Flassbeck (2000).

8 For a useful survey of mechanisms for external payments support in the EEC, see Edwards (1985: 326–346). As part of the establishment of the Economic and Monetary Union, the European Monetary Cooperation Fund – the body which administered short-term facilities under the heading of mutual external financial support – was dissolved and its functions taken over by the European Monetary Institute (EMI).

9 In addition, there was an obligation to take the measures necessary for the proper functioning of systems of taxation, prudential supervision, etc. For more details, see Akyüz and Cornford (1995).

10 Such a regime is coined BBC (basket, band and crawl) (Williamson, 2000).

11 This source also provides a detailed discussion of other proposals for regional arrangements.

Chapter VI

CRISIS MANAGEMENT AND BURDEN SHARING

A. Introduction

There is a growing body of opinion that effective management of financial crises in emerging markets requires a judicious combination of action on three fronts: a domestic macroeconomic policy response, particularly through monetary and fiscal measures and exchange rate adjustment; timely and adequate provision of international liquidity with appropriate conditionality; and the involvement of the private sector, especially international creditors. With benefit of hindsight, it is now agreed that the international policy response to the Asian crisis was far from optimal, at least during the initial phase. An undue burden was placed on domestic policies; rather than restoring confidence and stabilizing markets, hikes in interest rates and fiscal austerity served to deepen the recession and aggravate the financial problems of private debtors. The international rescue packages were designed not so much to protect currencies against speculative attacks or finance imports as to meet the demands of creditors and maintain an open capital account. Rather than involving private creditors in the management and resolution of the crises, international intervention, coordinated by the IMF, in effect served to bail them out.[1]

This form of intervention is increasingly considered objectionable on grounds of moral hazard and equity. It is seen as preventing market discipline and encouraging imprudent lending, since private creditors are paid off with official money and not made to bear the consequences of the risks they take. Even when the external debt is owed by the private sector, the burden ultimately falls on taxpayers in the debtor country, because governments are often obliged to serve as guarantors. At the same time, the funds required for such interventions have been getting ever larger and are now reaching the limits of political acceptability. Thus, a major objective of private sector involvement in crisis resolution is to redress the balance of burden sharing between official and private creditors as well as between debtors and creditors.

For these reasons, the issues of private sector involvement and provision of official assistance in crisis management and resolution have been high on the agenda in the debate on reform of the international financial architecture since the outbreak of the East Asian crisis. However, despite prolonged deliberations and a proliferation of meetings and forums, the international commu-

nity has not been able to reach agreement on how to involve the private sector and how best to design official lending in financial crises. As acknowledged by the IMF, "While some success has been achieved in securing concerted private sector involvement, it has become increasingly clear that the international community does not have at its disposal the full range of tools that would be needed to assure a reasonably orderly – and timely – involvement of the private sector" (IMF, 2000f: 10). This chapter seeks to address this problem by defining the state of play, examining the issues that remain to be resolved and assessing various options proposed.

B. Private sector involvement and orderly debt workouts

Private sector involvement in financial crisis resolution refers to the continued or increased exposure of international creditors to a debtor country facing serious difficulties in meeting its external financial obligations, as well as to arrangements that alter the terms and conditions of such exposure, including maturity rollovers and debt write-offs.[2] In this context, it is useful to make a distinction between mechanisms designed to prevent panics and self-fulfilling debt runs, on the one hand, and those designed to share the burden of a crisis between debtors and creditors, on the other. To the extent that private sector involvement would help restrain asset grabbing, it would also reduce the burden to be shared. For instance, debt standstills and rollovers can prevent a liquidity crisis from translating into widespread insolvencies and defaults by helping to stabilize the currency and interest rates. In this sense, private sector involvement in financial crises is not always a zero sum game. It can also help resolve conflict of interest among creditors themselves by ensuring more equitable treatment.

Market protagonists often argue that foreign investors almost always pay their fair share of the burden of financial crises in emerging markets. According to this view, international banks incur losses as a result of arrears and bankruptcies, while holders of international bonds suffer because the financial difficulties of the debtors affect the market value of bonds, and most private investors mark their positions to market (Buchheit, 1999: 6). Losses incurred in domestic bond and equity markets are also cited as examples of burden sharing by private investors.[3]

A major objective of private sector involvement in crisis resolution is to redress the balance of burden sharing between official and private creditors as well as between debtors and creditors.

In assessing creditor losses, it is important to bear in mind that, so long as the value of claims on the debtor remains unchanged, mark-to-market losses may involve only a redistribution among investors. On the other hand, net losses by creditors are often compensated by risk spreads on lending to emerging markets. For instance, on the eve of the Asian crisis, the total bank debt of emerging markets was close to $800 billion. Applying a modest 300 basis points as the average spread on these loans would yield a sum of more than $20 billion per annum in risk premium, compared to the estimated total mark-to-market losses[4] of foreign banks of some $60 billion incurred in emerging-market crises since 1997.

Foreign investors are directly involved in burden sharing when their claims are denominated in the currency of the debtor country and they rush to exit. This hurts them twice, by triggering sharp drops both in asset prices and in the value of the domestic currency. For this reason, countries that borrow in their own currencies (or adopt a reserve currency as their own) are expected to be less prone to currency and debt crises since potential losses would deter rapid exit and speculative attacks.

> While debtor countries have the option to impose unilateral payment suspension, without a statutory basis such action can create considerable uncertainties, thereby reducing the likelihood of orderly debt workouts.

However, the denomination of external debt in the currency of the debtor country does not eliminate the so-called collective action problem which underlines self-fulfilling debt runs and provides the principal rationale for debt standstills; even though creditors as a group are better off if they maintain their exposure, individual investors have an incentive to exit quickly for fear of others doing so before them. The consequent declines in domestic asset prices and in the value of the currency not only hurt creditors, but also have serious repercussions for the debtor economy. In some cases, there could be a run for the strong foreign-owned domestic banks as well, placing a particular burden on locally-owned and smaller banks and other financial institutions. It is for these reasons that governments of debtor countries are often compelled to take action to prevent a rapid exit of foreign investors from domestic capital markets. Such actions may go beyond monetary tightening. In Mexico, for instance, market pressures in 1994 forced the Government to shift from peso-denominated *cetes* to dollar-indexed *tesebonos* in the hope that removing the currency risks would persuade foreign creditors to stay. However, this did not prevent the eventual rush to exit, the collapse of the peso and hikes in interest rates. Thus, even when external debt is denominated in domestic currency, arrangements to involve private creditors through standstills and rollovers can play an important role in efforts to achieve greater financial stability.

As discussed in detail in *TDR 1998*, the rationale and key principles for an orderly debt workout can be found in domestic bankruptcy procedures. Although chapter 11 of the United States Bankruptcy Code is the most cited reference, other major industrial countries apply similar principles. These principles combine three key elements: (i) provisions for an automatic standstill on debt servicing that prevents a "grab race" for assets among the creditors; (ii) maintaining the debtor's access to the working capital required for the continuation of its operations (i.e. lending into arrears); and (iii) an arrangement for the reorganization of the debtor's assets and liabilities, including debt rollover, extension of existing loans, and debt write-off or conversion. The way these elements are combined depends on the particularities of each case, but the aim is to share the adjustment burden between debtor and creditors and to assure an equitable distribution of the costs among creditors.

Under these procedures, standstills give the debtor the "breathing space" required to formulate a debt reorganization plan. While, in principle, agreement is sought from creditors for restructuring debt, the procedures also make provisions to discourage holdouts by allowing for majority – rather than unanimous – approval of the creditors for the reorganization plan. The bankruptcy court acts as a neutral umpire and facilitator, and when necessary has the authority to impose a binding settlement on the competing claims of the creditors and debtor under so-called "cramdown" provisions.

Naturally, the application of national bankruptcy procedures to cross-border debt involves a number of complex issues. However, fully-fledged international bankruptcy procedures would not be needed to ensure an orderly workout of international debt. The key element is internationally sanctioned mandatory standstills. Under certain circumstances, it might be possible to reach agreement on voluntary standstills with creditors but, as recognized by the IMF, "… in the face of a broad-based outflow of capital, it may be difficult to reach agreement with the relevant resident

and nonresident investors ...” (IMF, 2000f: 10). On the other hand, while debtor countries have the option to impose unilateral payment suspension, without a statutory basis such action can create considerable uncertainties, thereby reducing the likelihood of orderly debt workouts. Furthermore, debtors could be deterred from applying temporary payment standstills for fear of litigation and asset seizure by creditors, as well as of lasting adverse effects on their reputation.

Standstills on sovereign debt involve suspension of payments by governments themselves, while on private external debt they require an imposition of temporary exchange controls which restrict payments abroad on specified transactions, including interest payments. Further restrictions may also be needed on capital transactions of residents and non-residents (such as acquisition of assets abroad or repatriation of foreign capital). Clearly, the extent to which standstills would need to be combined with such measures depends on the degree of restrictiveness of the capital account regime already in place.

> While the international community has increasingly come to recognize that market discipline will only work if creditors bear the consequences of the risks they take, it has been unable to reach agreement on how to bring this about.

Since standstills and exchange controls need to be imposed and implemented rapidly, the decision should rest with the country concerned, subject to a subsequent review by an international body. According to one proposal, the decision would need to be sanctioned by the IMF. Clearly, for the debtor to enjoy insolvency protection, it would be necessary for such a ruling to be legally enforceable in national courts. This would require a broad interpretation of Article VIII(2)(b) of the Articles of Agreement of the IMF, which could be provided either by the IMF Executive Board or through an amendment of these Articles so as to cover debt standstills. In this context, Canada has proposed an Emergency Standstill Clause to be mandated by IMF members (Department of Finance, Canada, 1998).

However, as argued in *TDR 1998,* the IMF Board is not a neutral body and cannot, therefore, be expected to act as an independent arbiter, because countries affected by its decisions are also among its shareholders. Moreover, since the Fund itself is a creditor, and acts as the authority for imposing conditionality on the borrowing countries, there can be conflicts of interest vis-à-vis both debtors and other creditors. An appropriate procedure would thus be to establish an independent panel for sanctioning such decisions. Such a procedure would, in important respects, be similar to GATT/WTO safeguard provisions that allow developing countries to take emergency actions when faced with balance-of-payments difficulties (see box 6.1).

For private borrowers the restructuring of debts should, in principle, be left to national bankruptcy procedures. However, these remain highly inadequate in most developing countries (see chapter IV, subsection B.6). Promoting an orderly workout of private debt, therefore, crucially depends on establishing and developing appropriate procedures. Ordinary procedures for handling individual bankruptcies may be inappropriate and difficult to apply under a more widespread crisis, and there may be a need to provide general protection to debtors when bankruptcies are of a systemic nature. One proposal that has been put forward is “… to provide quasi automatic protection to debtors from debt increases due to a devaluation beyond a margin …” (Miller and Stiglitz, 1999: 4). Clearly, the need for such protection will depend on the extent to which standstills and exchange controls succeed in preventing sharp declines in currencies. For sovereign debtors, it is difficult to envisage formal bankruptcy procedures at the international level, but they too could be given a certain degree of protection against debt increases brought about by currency collapses. Beyond that, negotiations between debtors and creditors appear to be the only feasible solution. As discussed below, these may be facilitated by the inclusion of various provisions in debt contracts, as well as by appropriate intervention of multilateral financial institutions.

Box 6.1

GATT AND GATS BALANCE-OF-PAYMENTS PROVISIONS AND EXCHANGE RESTRICTIONS

The balance-of-payments provisions of Articles XII and XVIIIB of GATT 1994 allow a Member to suspend its obligations under the Agreement, and to impose import restrictions in order to forestall a serious decline in, or otherwise protect the level of, its foreign exchange reserves, or to ensure a level of reserves adequate for implementation of its programme of economic development.[1] The provisions of Article XVIIIB (part of Article XVIII dealing with governmental assistance to economic development) are directed particularly at payments difficulties arising mainly from a country's efforts to expand its internal market or from instability in its terms of trade. Permissible actions include quantitative restrictions as well as price-based measures. In applying such restrictions, the Member may select particular products or product groups. The decision is taken unilaterally, with notification to the WTO Secretariat and subsequent consultations with other Members in the Committee on Balance-of-Payments Restrictions. Restrictions are imposed on a temporary basis, and are expected to be lifted as conditions improve. However, the Member cannot be required to remove restrictions by altering its development policy.

Similar provisions are to be found in Article XII of the General Agreement on Trade in Services (GATS), which stipulates that, in the event of serious difficulties in the balance of payments and in external finance, or a threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. Again, such restrictions are allowed to ensure, inter alia, the maintenance of a level of financial reserves adequate for implementation of the Member's programme of economic development or economic transition. The conditions and modalities related to the application of such restrictions are similar to those in the GATT 1994 balance-of-payments provisions.

Clearly, these provisions are designed to avoid conditions in which countries are forced to sacrifice economic growth and development as a result of temporary difficulties originating in the current account of the balance of payments, particularly trade deficits. Even though they may not be invoked directly for the restriction of foreign exchange transactions and the imposition of temporary standstills on debt payments at times of severe payments difficulties arising from the rapid exit of capital – and a consequent capital-account crisis – resort to such action in those circumstances would be entirely in harmony with the provisions' underlying rationale.

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[1] For more detailed discussion, see Jackson (1997, chap. 7); and Das (1999, chap. III.3).

C. Recent debate within the IMF

Despite its potential benefits to both debtors and creditors, private sector involvement in crisis resolution has proved to be one of the most contentious issues in the debate on reform of the international financial architecture. While the international community has increasingly come to recognize that market discipline will only work if creditors bear the consequences of the risks they take, it has been unable to reach agreement on how to bring this about. According to one view, a voluntary and case-by-case approach would constitute the most effective way of involving the private sector in crisis resolution. Another view is that, for greater financial stability and equitable burden sharing, a rules-based mandatory approach is preferable. This divergence of views is not simply between debtor and creditor countries, but also among the major creditor countries.

> Current practices leave too much discretion to the Fund and its major shareholders in decisions regarding the timing and extent of the official financing it should provide, and under what conditions.

The main argument in favour of a rules-based system is that a case-by-case approach could lead to asymmetric treatment – not only between debtors and creditors, but also among different creditors. It would also leave considerable discretion to some major industrial powers, which have significant leverage in international financial institutions, to decide on the kind of intervention to be made in emerging-market crises. Private market actors, as well as some major industrial countries, are generally opposed to involuntary mechanisms on the grounds that they create moral hazard for debtors, that they alter the balance of negotiating strength in favour of the latter, that they delay the restoration of market access, and that they can be used to postpone the adjustments needed.[5]

The recent debate within the IMF on private sector involvement in crisis resolution appears to have focused on three mechanisms. First, it is agreed that the Fund should try, where appropriate, to act as a catalyst for lending by other creditors to a country facing payments difficulties. If this is inappropriate, or if it fails to bring in the private sector, the debtor country should seek to reach an agreement with its creditors on a voluntary standstill. Finally, it is recognized that, as a last resort, the debtor country may find it necessary to impose a unilateral standstill when voluntary agreement is not feasible. All these measures should also be accompanied by appropriate monetary and fiscal tightening and exchange rate adjustment. A report of the meeting of the IMF Executive Board concerning the involvement of the private sector in the resolution of financial crises stated:

> Directors agreed that, under the suggested framework for involving the private sector, the Fund's approach would need to be a flexible one, and the complex issues involved would require the exercise of considerable judgement. … In cases where the member's financing needs are relatively small or where,

> despite large financing needs, the member has good prospects of gaining market access in the near future, the combination of strong adjustment policies and Fund support should be expected to catalyze private sector involvement. In other cases, however, when an early restoration of market access on terms consistent with medium-term external sustainability is judged to be unrealistic, or where the debt burden is unsustainable, more concerted support from private creditors may be necessary, possibly including debt restructuring …
>
> Directors noted that the term “standstill” covers a range of techniques for reducing net payment of debt service or net outflows of capital after a country has lost spontaneous access to international capital markets. These range from voluntary arrangements with creditors limiting net outflows of capital, to various concerted means of achieving this objective.
>
> Directors underscored that the approach to crisis resolution must not undermine the obligation of countries to meet their debt in full and on time. Nevertheless, they noted that, in extreme circumstances, if it is not feasible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally. Directors noted that … there could be a risk that this action would trigger capital outflows. They recognized that if a tightening of financial policies and appropriate exchange rate flexibility were not successful in stanching such outflows, a member would need to consider whether it might be necessary to resort to the introduction of more comprehensive exchange or capital controls. (IMF, 2000h)[6]

Clearly, there still remains the possibility of large-scale bailout operations. Some countries apparently attempted to exclude this possibility, but could not secure consensus:

> A number of Directors favoured linking a strong presumption of a requirement for concerted private sector involvement to the level of the member’s access to Fund resources. These Directors noted that a rules-based approach would give more predictability to the suggested framework for private sector involvement, while limiting the risk that large-scale financing could be used to allow the private sector to exit. Many other Directors, however, stressed that the introduction of a threshold level of access to Fund resources, above which concerted private sector involvement would be automatically required, could in some cases hinder the resumption of market access for a member with good prospects for the successful use of the catalytic approach to securing private sector involvement.

Nor has there been agreement over empowering the IMF to impose stay on creditor litigation in order to provide statutory protection to debtors that impose temporary standstills:

> Most Directors considered that the appropriate mechanism for signalling the Fund’s acceptance of a standstill imposed by a member was through a decision for the Fund to lend into arrears to private creditors … Some Directors favored an amendment to Article VIII, section 2(b), that would allow the Fund to provide a member with some protection against the risk of litigation through a temporary stay on creditor litigation. Other Directors did not favor such an approach, and noted that in recent cases members’ ability to reach cooperative agreements with private creditors had not been hampered by litigation.

Considerable flexibility is undoubtedly needed in handling financial crises since their form and severity can vary from country to country. However, current practices leave too much discretion to the Fund and its major shareholders in decisions regarding the timing and extent of the official financing it should provide, and under what conditions; how much private sector involvement it should require; and under what circumstances it should give support to unilateral payment standstills and capital controls. The suggested framework generally fails to meet the main concerns of debtor countries regarding burden sharing in crisis resolution and the modalities of IMF support and conditionality. Nor does it provide clear guidelines to influence the expectations and behaviours of debtors and creditors with the aim of securing greater stability.

D. Official assistance, moral hazard and burden sharing

The above discussion suggests that there is now a greater emphasis on private sector involvement when designing official assistance to countries facing financial difficulties. The elements of this strategy include the use of official money as a catalyst for private financing, lending into arrears to precipitate agreement between debtors and creditors, and making official assistance conditional on prior private sector participation. Some of these policies were, in fact, used for the resolution of the debt crisis in the 1980s, although their objectives were not always fully met. For instance, under the so-called Baker Plan, official lending to highly-indebted developing countries sought to play a catalytic role, but faced stiff opposition from commercial banks, which refused to lend to these countries. The practice of IMF lending to debtors that are in arrears on payments owed to private creditors dates back to the Brady Plan of 1989, when commercial banks were no longer willing to cooperate in restructuring third world debt as they had made sufficient provisions and reduced their exposure to developing country borrowers. A decision by the IMF Board in September 1998 formally acknowledged lending into arrears as part of the Fund's lending policy and extended this practice to bonds and non-bank credits in the expectation that it would help countries with Fund-approved adjustment programmes to restructure their private debt.[7]

The current emphasis on official assistance being made conditional on private sector participation includes a commitment not to lend or grant official debt relief unless private markets similarly roll over their maturing claims, lend new money or restructure their claims. This strategy, which has come to be known as "comparability of treatment", aims not only at preventing moral hazard as it pertains to private creditors, but also at ensuring an acceptable form of burden sharing between the private and official creditors. Its underlying principle is that public assistance should not be made available unless debtors get some relief from private creditors, and no class of private creditors should be exempt from burden sharing.[8] In 1999, Paris Club creditors specifically advised Pakistan to seek comparable treatment from its private bondholders by rescheduling its eurobond obligations. However, this policy does not seem to have been implemented in the case of recent official assistance to Ecuador, when the IMF did not insist that the country reach an agreement on restructuring with the holders of its Brady bonds as a precondition for official assistance (see box 6.2; and Eichengreen and Ruhl, 2000: 19).

Certainly, the emphasis on burden sharing and comparable treatment between private and official creditors constitutes a major advance over the debt strategies adopted in the 1980s and in the more recent emerging-market crises. During these episodes, official intervention was designed primarily to keep sovereign debtors current on debt servicing to private creditors and the seniority accorded to multilateral debt went unchallenged. However, the emphasis on burden sharing among creditors does not necessarily lead to improved outcomes regarding the more important question of burden sharing between debtors and creditors.

In this respect, a key issue is whether a strategy that makes official assistance conditional on private sector participation could succeed in pro-

Box 6.2

RECENT BOND RESTRUCTURING AGREEMENTS

A number of recent sovereign bond restructuring agreements have been widely hailed by the international community for their success "... in puncturing unsustainable expectations of some investors that international sovereign bonds were, in effect, immune from restructuring ..." (IMF, 2000f: 10). However, they also show that, under current institutional arrangements, there are no established mechanisms for an orderly restructuring of sovereign bonds, and that the process can be complex and tedious.[1] Success in bringing bondholders to the negotiating table does not depend on the presence of CACs in bond documents alone. A credible threat of default could be just as effective. However, even then, the debtors are not guaranteed to receive significant debt relief, particularly on a mark-to-market basis.

Pakistan restructured its international bonds at the end of 1999 without invoking the CACs present in its bonds, preferring a voluntary offer to exchange its outstanding eurobonds for a new six-year instrument, which was accepted by a majority of the bondholders. Communication problems were not serious because the bonds were held by only a few Pakistani investors. It is believed that the presence of CACs and a trustee, as well as the request of the Paris Club to extend "comparability of treatment" to eurobonds, along with a credible threat of default, played an important role in discouraging holdouts.[2] However, the terms of restructuring were quite favourable to bondholders compared to the prevailing market price, and the new bonds offered were more liquid. According to the IMF, there was a "haircut" for the creditors compared to the relative listing price but not to the relative market value, and although the initial impact of the restructuring on the debt profile of the country was somewhat positive, "by 2001 market estimates suggest that debt-service payments will be back to levels before restructuring and will be higher for the remaining life of the exchange bond" (IMF, 2000g: 137 and table 5.2).

By contrast, **Ukraine** made use of the CACs present in four of its outstanding bonds in a restructuring concluded in April 2000. Unlike Pakistan, the bonds were spread widely among retail holders, particularly in Germany, but the country managed to obtain the agreement of more than 95 per cent of the holders on the outstanding value of debt. As in Pakistan, however, this involved only the extension of principal maturities rather than relief, since reorganization was undertaken on a mark-to-market basis. Indeed, there was a net gain for creditors relative to market value (IMF, 2000g, table 5.2).

From mid-1999 **Ecuador** started having serious difficulties in making interest payments on its Brady bonds, ending up in a default in the second half of the year. As rolling over maturities would not have provided a solution, the country sought a large amount of debt reduction by offering an exchange for global bonds issued at market rates, but with a 20-year maturity period. This was rejected by the bondholders, who furthermore, voted for acceleration. After a number of failed attempts, Ecuador invited eight of the larger institutional holders of its bonds to join a Consultative Group, with the aim of providing a formal mechanism of communication with bondholders rather than negotiating terms for an exchange offer. In mid-August, bondholders accepted Ecuador's offer to exchange defaulted Brady bonds for 30-year global bonds at a 40 per cent reduction in principal, while the market discount was over 60 per cent. This resulted in a net gain for the creditors relative to market value.[3]

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1 On these restructuring exercises, see De la Cruz (2000); Eichengreen and Ruhl (2000); Buchheit (1999); and IMF (2000g, box 5.3).
2 For a different view on the impact of the Paris Club's request, see Eichengreen and Ruhl (2000: 26–28).
3 For an assessment of the Ecuadorian restructuring, see Acosta (2000).

moting orderly debt workouts with private creditors. The rationale for this strategy is that, if the Fund were to stand aside and refuse to lend to a country under financial stress unless the markets rolled over their claims first, private creditors would be confronted with the prospect of default, which would encourage them to negotiate and reach agreement with the debtor. The main weakness of this strategy is that, if the default is not very costly, creditors will have little incentive for restructuring their claims. On the other hand, if it is costly, the IMF will not be able to stand by and let it happen, since the threat to international financial stability, as well as to the country concerned, would be serious. The insistence on IMF non-intervention would be no more credible than an announcement by a government that it will not intervene to save citizens who have built houses in a flood plain.[9] This dilemma provides a strong case for explicit rules prohibiting the building of houses in flood plains or a "grab race" for assets.[10]

A credible strategy for involving the private sector in crisis resolution should combine temporary standstills with strict limits on access to Fund resources.

Thus it appears that a credible strategy for involving the private sector in crisis resolution should combine temporary standstills with strict limits on access to Fund resources. Indeed, such a strategy has received increased support in recent years.[11] According to one view, access could be limited by charging penalty rates. However, since such price-based measures are unlikely to succeed in checking distress borrowing under crisis conditions, quantitative limits will be needed. A recent report by the United States Council on Foreign Relations (CFR) on reform of the international financial architecture argued that the IMF should adhere consistently to normal access limits of 100 per cent of quota annually and 300 per cent on a cumulative basis, and that countries should be able to resort to unilateral standstills when such financing proves inadequate to stabilize markets and their balance of payments. The amounts committed in recent interventions in emerging-market crises, beginning with the one in Mexico in 1995, far exceeded these limits, being in the range of 500 per cent to 1,900 per cent of quota.

However, in setting such access limits, it should be recognized that IMF quotas have lagged behind growth of global output, trade and financial flows, and their current levels may not provide appropriate yardsticks to evaluate the size of IMF packages. According to one estimate, adjusting quotas for the growth in world output and trade since 1945 would require them to be raised by three and nine times, respectively (Fischer, 1999). In an earlier proposal – made in an IMF paper on the eve of the Mexican crisis – to create a short-term financing facility for intervention in financial crises, 300 per cent of quota was considered a possible upper limit (see *TDR 1998*, chap. IV, sect. B.4). Such amounts appear to be more realistic than current normal access limits.

Fund resources are not the only source of rescue packages, and in many cases bailouts rely even more on the money provided by some major creditor countries. This practice has often increased the scope for these countries to pursue their own national interests in the design of rescue packages, including the conditionalities attached to lending. It is highly probable that major creditor countries will continue to act in this manner whenever and wherever they see their interests involved, and some debtor countries may even prefer to strike bilateral deals with them rather than going through multilateral channels. However, limits on access to Fund resources should be observed independently of bilateral lending under crisis. Furthermore, it is desirable to keep such ad hoc bilateral arrangements separate from multilateral lending in order to reduce the scope for undue influence over Fund policies by some of its major shareholders.

A key question is whether such access limits should be exceeded under certain circumstances. For instance, while arguing for strict limits, the CFR report suggested, "In the unusual case in which there appears to be a systemic crisis (that is, a multicountry crisis where failure to intervene threatens the performance of the world economy and where there is widespread failure in the abil-

Box 6.3

RECENT INITIATIVES IN IMF CRISIS LENDING

The IMF has recently taken steps to strengthen its capacity to provide financing in crises, though this capacity still falls short of that of a genuine international lender of last resort.[1] The Supplemental Reserve Facility (SRF), approved by the IMF's Executive Board in response to the deepening of the East Asian crisis in December 1997, was designed to provide financing without limits to countries experiencing exceptional payments difficulties, but under a highly conditional stand-by or Extended Arrangement (IMF, 1998b: 7). However, the SRF depends on the existing resources of the Fund which, recent experience suggests, are likely to be inadequate on their own to meet the costs of large interventions.

The Contingency Credit Line (CCL), created in Spring 1999, is intended to provide a precautionary line of defence in the form of short-term financing, which would be available to meet balance-of-payments problems arising from international financial contagion (IMF, 1999). Thus, unlike the SRF, which is available to countries in crisis, the CCL is a preventive measure. Countries can prequalify for the CCL if they comply with conditions related to macroeconomic and external financial indicators and with international standards in areas such as transparency, banking supervision and the quality of banks' relations and financing arrangements with the private sector. The pressures on the capital account and international reserves of a qualifying country must result from a sudden loss of confidence amongst investors triggered largely by external factors. Moreover, although no limits on the scale of available funds are specified, like the SRF, the CCL depends on the existing resources of the Fund. Originally, it was expected that the precautionary nature of the CCL would restrict the level of actual drawings. However, in the event, no country has applied for this facility. It is suggested that, under the initial terms, countries had no incentive to pre-qualification because fees and interest charges on the CCL were the same as under the SRF. In addition, access was not automatic, but subject to the Board's assessment of policies and risks of contagion effects. The IMF Board took steps in September 2000 to lower charges as well as to allow some automatic access with a view to enhancing the potential use of the CCL (IMF, 2000j), but there appear to be more serious design problems. In particular, countries seem to avoid recourse to it for fear that it will have the effect of a tocsin in international financial markets, thus stifling access to credit.[2]

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1 For a discussion of these facilities, see IMF (2000i). For a discussion of the issues involved in establishing an international lender of last resort, see *TDR 1998* (chap. IV, sect. B.4), and Akyüz and Cornford (1999).

2 For an earlier assessment along these lines, see Akyüz and Cornford (1999: 36). For a more recent assessment, see Goldstein (2000: 12–13).

ity of private capital markets to distinguish creditworthy from less creditworthy borrowers), the IMF would return to its 'systemic' backup facilities …" (CFRTF, 1999: 63). It proposed the creation of a facility to help prevent contagion, to be funded by a one-off allocation of special drawing rights (SDRs),[12] which would replace the existing IMF facilities for crisis lending (see box 6.3).

While the concerns underlying different lending policies for systemic and non-systemic crises may be justified, in practice exceptions to normal lending limits could leave considerable room for large-scale bailout operations and excessive IMF discretion. One possible implication is that countries not considered systemically important could face strict limits in access to Fund resources, but

would have the option of imposing unilateral standstills. However, for larger emerging markets bailouts would still be preferred to standstills. Recent events involving defaults by Pakistan and Ecuador (see box 6.2), but rescue operations for Argentina and Turkey (see chapter II) bear this out. In the latter cases, difficulties experienced were largely due to the currency regimes pursued rather than to financial contagion from abroad. However, there is wide concern that if these crises had been allowed to deepen, they could have spread to other emerging markets.

E. Voluntary and contractual arrangements

As noted above, considerable emphasis is now being placed on voluntary mechanisms for the involvement of the private sector in crisis management and resolution. However, certain features of the external debt of developing countries render it extremely difficult to rely on such mechanisms, particularly for securing rapid debt standstills and rollovers. These include a wider dispersion of creditors and debtors and the existence of a larger variety of debt contracts associated with the growing spread and integration of international capital markets, as well as innovations in sourcing foreign capital. As a result, the scope of some of the voluntary mechanisms used in the past has greatly diminished.

Perhaps the most important development, often cited in this context, is the shift from syndicated bank loans to bonds in sovereign borrowing, since, for reasons examined below, bond restructuring is inherently more difficult. Sovereign bond issues were a common practice in the interwar years when emerging markets had relatively easy access to bond markets. During the global financial turmoil of the late 1920s and early 1930s, many of these bond issues ended up in defaults. There was little recourse to bond financing by emerging-market governments prior to the 1990s. The share of bonds in the public and publicly guaranteed long-term debt of developing countries stood at some 6.5 per cent in 1980, but rose rapidly over the past two decades, reaching about 21 per cent in 1990 and almost 50 per cent in 1999 (World Bank, 2000). This ratio is lower for private, non-guaranteed debt, but the increase in the share of bonds in private external debt is equally impressive – from about 1 per cent in 1990 to some 24 per cent in 1999. According to the Institute of International Finance (IIF), from 1992 to 1998, of a total of about $1,400 billion net capital flows to 29 major emerging markets, 23 per cent came from commercial banks and 27 per cent from other private creditors, mainly through bonds (IIF, 1999, table 1).

A second important development is that international lending to emerging markets has been increasingly to private sector borrowers. The share of public and publicly guaranteed debt in the total long-term debt of developing countries exceeded 75 per cent in the 1980s, but stood at less than 60 per cent in 1999. The increased importance of private sector borrowing has meant a rapid increase in the dispersion of debtors. While an important part of private borrowing consists of interbank loans, direct lending to corporations is also important in some emerging markets. In Indonesia, for example, such borrowing accounted for more than three quarters of the total private debt. Furthermore, in developing countries, an

increasing proportion of the private sector's external bank debt is in the form of bilateral rather than syndicated lending, implying also a greater dispersion of creditors. The creditor base is further broadened as a result of repackaging arrangements and credit derivatives, whereby economic interest in the original loan is passed on to third parties (Yianni, 1999: 81–84).

Various developments regarding emerging-market debt have also increased the scope for rapid exit and creditor runs, thereby reducing the room for cooperative solutions. Perhaps the most important of these is the shift in bank lending towards more short-term loans. In the mid-1980s, bank loans with a maturity of less than one year accounted for around 43 per cent of total bank loans, but they increased to almost 60 per cent on the eve of the Asian crisis, and dropped to about 50 per cent thereafter. Similarly, the widespread use of acceleration and cross-default clauses and put options in credit contracts has increased the scope for dissident holdouts, making it difficult for debtors and creditors to reach rapid agreement on voluntary standstills and workouts.[13]

A number of proposals have been made for designing mechanisms to facilitate voluntary involvement of the private sector in crisis resolution. In discussing these mechanisms, it is useful to make a distinction between bond covenants and other contractual and cooperative arrangements designed to "bind in" and "bail in" the private sector.

1. Bond restructuring and collective action clauses

As already noted, the notion that sovereign bonds as well as bank loans may need to be restructured has only recently been accepted by the international community (though not necessarily by all segments of financial markets). The emerging-market sovereign debtors that had issued bonds in the 1970s and 1980s generally remained current on such obligations during the debt crisis of the 1980s while rescheduling and restructuring their commercial bank debt – a factor that appears to have played an important role in the rapid expansion of bond financing in the 1990s relative to bank lending. As a result of this rapid increase, together with the increased frequency of virulent financial crises, bond restructuring has gained in importance, particularly for sovereign borrowers.

However, there are serious difficulties in bond restructuring compared to rescheduling and restructuring of syndicated credits. First of all, there are collective representation and collective action problems, which are more acute with bonds than with loan contracts. These arise from communication difficulties between the bond issuer and holders; in general bondholders are anonymous and more diverse and include a variety of investors, both individual and institutional. The communication problem is further aggravated by trading in secondary markets. Moreover, there are legal impediments to the establishment of communication mechanisms between issuers and holders, as well as to dealing with non-participating holders, that vary according to the legislation governing bonds. Again, as legislation for bond contracts varies, it becomes difficult to apply uniform procedures in restructuring. Current arrangements also encourage holdouts and litigation by bondholders since, unlike the practice during the interwar years, sovereign issuers are often required to include a waiver of sovereign immunity. Thus, sovereign debtors do not enjoy the protection accorded to private debtors under domestic bankruptcy and insolvency procedures that often overrule holdouts and eliminate free riders.

Quite independently of the contractual and legal provisions governing a bond, a sovereign issuer facing serious financial difficulties always has the option of making an offer to exchange its existing bonds with new instruments containing new terms of payment. However, the problems of communication and holdouts render such exchange offers difficult to implement effectively. Thus, since the Mexican crisis, emerging-market borrowers have been increasingly urged to include so-called collective action clauses (CACs) in bond contracts in order to improve communication with bondholders and facilitate bond restructuring.[14] Such clauses appear to be particularly desirable for sovereign borrowers, who do not benefit from national bankruptcy codes. There are basically three types of CACs:

- *collective representation clauses,* designed to establish a representative forum (e.g. a trustee) for coordinating negotiations between the issuer and bondholders;
- *majority action clauses,* designed to empower a qualified majority (often 75 per cent) of bondholders to agree to a change in payment terms in a manner which is binding on all bondholders, thereby preventing holdouts; and
- *sharing clauses,* designed to ensure that all payments by the debtor are shared among bondholders on a pro-rated basis, and to prevent maverick litigation.

It should be noted that the inclusion of CACs in bond contracts, where allowed by law, is optional – not mandatory – and often depends on market convention. Issuers generally adopt the documentation practices prevailing in the jurisdiction of the governing law. In general, collective representation clauses are not contained in bonds governed either by English law or New York law. Majority action clauses are routinely included in bond contracts governed by English law, but not in those issued under New York law, even though the latter does not preclude them from sovereign issues. Similarly, bonds governed by German and Japanese laws do not generally contain majority action clauses. In these cases, any change to the terms of payment requires a unanimous decision by the bondholders. This is also true for Brady bonds, even when governed by English law. It appears that the inclusion of a unanimity rule was a major reason for the Brady process to be implemented through loan-for-bond exchanges rather than through amendments to the existing loan contracts (Buchheit, 1999: 9). Sharing clauses are routinely included in syndicated bank loans, but are uncommon in publicly issued bonds since they are often viewed by markets as a threat to the legal right of creditors to enforce their claims.[15] The absence of sharing clauses, together with the waiver of sovereign immunity, leaves considerable room for bondholders to hold out against restructuring and to enter into a “grab race” for assets through litigation.

According to available data, about one third of total bonds issued by emerging markets during the 1990s were governed by English law; the share of bonds issued under New York law was lower, but still exceeded a quarter, followed by those issued under German law (just under one fifth) and Japanese law (around 13 per cent). It appears that Asian, and particularly Latin American, emerging markets have made greater use of New York law than English law in their issues. Japanese law is seldom used in Latin American issues but governs about a quarter of Asian issues, while the opposite is true concerning the use of German law. Between 1995 and 2000, there was an increase in the proportion of bonds governed by New York law, but it is not clear if this is linked to the increased frequency of financial crises in emerging markets (Dixon and Wall, 2000: 145–146; Eichengreen and Mody, 2000a, table 1).

It is estimated that about half of all outstanding international bond issues – including those issued by industrial countries – do not include CACs, and this proportion is even greater for emerging-market bonds. A major concern of emerging markets is that the inclusion of CACs would curtail their access to markets and raise the cost of borrowing because it would signal a greater likelihood of default. They thus insist that such clauses be introduced first in sovereign bonds of industrial countries. Some industrial countries, such as Canada and the United Kingdom, have recently decided to include or extend CACs in their international bond and note issues in order to encourage a wider use of such clauses, particularly by emerging markets. International private sector groups find majority voting acceptable, subject to a threshold in the order of 90–95 per cent, but they prefer voluntary exchange offers, and are opposed

A major concern of emerging markets is that the inclusion of collective action clauses would curtail their access to markets and raise the cost of borrowing because it would signal a greater likelihood of default, but the empirical evidence on the impact of such clauses on the cost of international bond financing is inconclusive.

to making CACs mandatory in bond contracts (IMF, 2000g: table 5.2; Dixon and Wall, 2000: table 2).

The empirical evidence on the impact of CACs on the cost of international bond financing is inconclusive (BIS, 1999; Eichengreen and Mody, 2000b; Dixon and Wall, 2000). Indeed, CACs can have two opposite effects. On the one hand, their inclusion can raise the default probability in the eyes of investors since they may create moral hazard for the debtor, leading to a higher risk premium. On the other hand, in the event of a default, such clauses help recover the claims of investors by facilitating bond restructuring. The net effect depends on how CACs affect the perceived default probability and the expected recovery rate. For countries with high credit ratings, the latter effect could dominate, so that the inclusion of CACs may, in fact, lower the cost of bond financing. For lower-rated bonds, however, such clauses may well lead to sharp increases in the perceived risk of default, thereby raising the spread on new issues.

It is not clear if the introduction of CACs in bond contracts could make a major impact on debt restructuring, since experience in this respect is highly limited.[16] In any case, even if such clauses were rapidly introduced by emerging-market borrowers in their new bond issues, the initial impact would be limited because of the existence of a large stock of outstanding bonds without CACs. On the other hand, CACs have been rarely used by emerging markets for bond restructuring even when they are present in bond contracts, partly because of the fear that bondholders' meetings could be used to mobilize opposition against attempts to restructure bonds and to take a decision for acceleration (which typically requires the consent of 25 per cent of bondholders). Clearly, such risks can be serious, since the ultimate decision on restructuring lies with bondholders, and the sovereign debtor does not have the means of obtaining court approval for its restructuring plan, as provided, for instance, under the "cramdown" provisions of the United States Bankruptcy Code for corporate borrowers.

In assessing the potential role of CACs in involving the private sector in crisis resolution, it is important to distinguish between standstills and financial restructuring. The existing practice regarding bond issues leaves little scope for securing a rapid standstill on a voluntary basis.[17] Such a standstill requires representational bodies, such as trustees or bondholder committees, as well as prohibition of litigation by individual bondholders and/or sharing clauses. As already noted, there is strong resistance by private investors to the inclusion of such clauses across almost all jurisdictions, and they are not likely to be introduced on a voluntary basis. Majority action clauses alone cannot secure rapid voluntary standstill and "cramdown" on dissident bondholders, because invoking such clauses is a tedious process and leaves ample time and opportunities for rogue bondholders to impose a financial stranglehold over the debtor.

The existing practice regarding bond issues leaves little scope for securing a rapid standstill on a voluntary basis.

Private investors often point out that the major financial crises in emerging markets were not precipitated by a rapid exit of holders of sovereign bonds through litigation and a "grab race" for assets, but by short-term hot money (Buchheit, 1999: 7). This is certainly true for East Asia, where sovereign bond debt was generally negligible. However, with the rapid growth of the bond market, granting bondholders unmitigated power of litigation and asset attachment is potentially a serious source of instability. As already discussed, the current emphasis in official lending on private sector participation is unlikely to generate adequate incentives for voluntary standstill and rollover of private debt at times of crisis.

The consequences of unilateral suspension of payments on bonds could be more serious than defaults on bank debt because the effect would be immediately transmitted to secondary markets. A sharp increase in the risk premium and a decline in bond prices would then create considerable opportunities for profit-making by litigious investors (the so called "vultures"), who could acquire distressed debt at substantial discounts and pursue a "grab race" for assets.[18] On the other hand, as some recent bond restructuring exercises show,

even when unilateral defaults lead to an agreement on restructuring, the process tends to be disorderly and does not always guarantee significant relief for the debtor (see box 6.2).

Thus a possible solution would be to combine internationally sanctioned mandatory standstills with majority action clauses in order to prevent a "grab race" for assets and facilitate voluntary restructuring. One proposal (Buiter and Silbert, 1999) favours a contractually-based approach to standstill, which would require all international loan agreements to include an automatic universal debt rollover option with a penalty (UDROP). However, such a clause is unlikely to be introduced voluntarily and would need an international mandate. Another proposal is to empower the Fund to impose or sanction standstills on bondholders at the outbreak of a crisis (see, for example, Miller and Zhang, 1998). This could be combined with IMF lending into arrears, when needed, in order to alleviate the liquidity squeeze on the debtor country and encourage a rapid restructuring. Debt restructuring should be left to a voluntary agreement between the bondholders and the issuer, subject to provisions in the bond contracts. It is neither feasible nor desirable to empower the IMF or any other international authority to impose restructuring of sovereign debt, such as the one practised under the "cramdown" provisions of chapter 11 of the United States Bankruptcy Code. Nevertheless, the Fund could still exert considerable influence on the process through its policy of conditionality on lending.

A possible solution would be to combine internationally sanctioned mandatory standstills with majority action clauses in order to prevent a "grab race" for assets and facilitate voluntary restructuring.

It has been argued that proposals such as CACs and standing committees "... are appropriate if it is one's judgement that most countries that experience crises have problems with fundamentals that require debts to be restructured in the absence of a bailout. ... UDROPs and internationally sanctioned standstills are appropriate if one instead believes that most crises are caused by creditor panic, and that all that is required to restore order to financial markets is a cooling-off period" (Eichengreen and Ruhl, 2000: 4, footnote 4). However, the considerations above suggest that both instruments are needed in the arsenal of measures since resolution of most crises requires both a cooling-off period and debt-restructuring. Even when the underlying fundamentals are responsible for a crisis, debtors need breathing space, as markets have a tendency to overreact, and this leads to overshooting of asset prices and exchange rates, thereby aggravating the financial difficulties of the debtors. Under such circumstances, standstills would allow time to design and implement cooperative solutions to debt crises.

2. Restructuring bank loans

For the reasons already discussed, it is generally believed that debt workouts are easier for international bank loans than for sovereign bonds, as they allow greater scope for voluntary and concerted mechanisms. Furthermore, the experience in the 1980s with restructuring of syndicated credits, and the more recent negotiations and rollover of bank loans in the Republic of Korea and Brazil, are often cited as successful examples of debt workouts with banks.[19] However, a closer look at these experiences shows that there are considerable weaknesses in the procedures followed, and the outcomes reached appear to bail out – rather than bail in – the private sector.

A main factor, which facilitated negotiations with commercial banks in the 1980s, was the existence of advisory or steering committees consisting of representatives of banks selected mainly on the basis of their exposure to the debtor country concerned. Clearly, this helped solve the representation problem by providing a forum for negotiations. Furthermore, the presence of sharing clauses in syndicated loan contracts, together with sovereign immunity, deterred litigation against debtor countries. However, agreement required the unanimous consent of committee members, who were also expected to strike a deal that would be

acceptable to non-participating banks. This, in effect, allowed considerable room for holdouts by individual banks, in much the same way as bond contracts without majority action clauses. Such holdouts resulted in protracted negotiations, leading to frictions not only between debtors and creditors but also among creditors themselves. As noted by an observer of sovereign debt reschedulings in the 1980s: "From the borrower's perspective, the unanimous consent method translated into always being negotiated down to the minimum common denominator, one acceptable to all members of the committee based on consultation with their respective constituencies. Namely, one bank had the ability to prevent an entire package from being adopted if it disagreed with any one of its features" (De la Cruz, 2000: 12).

The primary strategy of these negotiations was to avoid default and to ensure that the debtor had enough liquidity to stay current (i.e. to continue servicing its debt). The money needed was provided by the creditor banks as part of the rescheduling process as well as through official lending. In this way banks could keep these assets in their balance sheets without violating regulatory norms regarding credit performance. Maturities were rolled over as they became due, but concessional interest rates and debt cancellation were not among the guiding principles of commercial debt workouts.

Thus, as described in *TDR 1988*, the process involved "concerted lending", whereby each bank rescheduled its loans and contributed new money in proportion to its existing exposure, the aggregate amount being the minimum considered necessary to avoid arrears. The IMF also made its provision of resources to debtor countries – to keep them current on interest payments to commercial banks – contingent upon the banks' making the contributions required of them. Thus, official intervention amounted to using public money to pay creditor banks even though it was designed to bind the banks in. Developing countries saw their debt growing, not only to commercial banks, but also to the official creditors, as they borrowed to remain current on their interest payments (*TDR 1988*, Part One, chap. V).

The negotiated settlements also resulted in the socialization of private debt in developing countries when governments were forced to assume loan losses, thereby, in effect shifting the burden to the tax payers. For example, in the case of Chile, it was noted that "private debts have been included in debt rescheduling being negotiated between the Chilean State and the foreign bank advisory committee for Chile. Apparently the Chilean Government caved in under pressure from the bank advisory committee … To make their viewpoint absolutely clear, foreign banks apparently tightened up their granting of very short-term commercial credits to Chile during the first quarter of 1983, a technique reportedly used with some success 10 years earlier vis-à-vis the same country. The International Monetary Fund, also active in the debt rescheduling exercise, has not publicly objected to this threat" (Diaz Alejandro, 1985: 12). For Latin America as a whole, before the outbreak of the crisis in 1982, around two thirds of the lending by United States banks was to private sector borrowers. In 1983, the first year of debt restructuring, the share of publicly guaranteed debt rose to two thirds, and eventually reached 85 per cent in 1985 (UNCTC, 1991).

This process of protracted negotiations between banks and debtors, with the intermediation of international financial institutions (a strategy widely described at the time as "muddling through"), continued for several years without making a dent in resolving the problem and removing the debt overhang. Highly-indebted developing countries increasingly questioned the rationale of engaging in such Ponzi financing – whereby they had to keep on borrowing in order to service their debt – which eventually pushed some of them into default on interest payments and led to legal battles with the banks. On the other hand, creditors too became highly sceptical of the merits of "putting good money after bad", and started to dispose of such debt in secondary markets as they accumulated adequate provisions. Through the Brady Plan, the resolution of the crisis eventually involved the private sector, but only after costing the debtors a lost development decade.

In more recent episodes of financial crisis in emerging markets, creditor banks were again able to organize themselves into groups to conduct negotiations with the debtors – with the Republic of Korea in January 1998, and with Brazil in March 1999. Again, in both cases negotiations and

agreements came only after the deepening of the crisis. In the case of Brazil, banks were unwilling to roll over debt in late 1998 and agreement was reached only after the collapse of the currency. The Government of the Republic of Korea had already suspended payments at the end of December 1997 and, as recognized by the IMF, "… the agreement to stabilize interbank exposure to Korea was struck … when it was generally recognized that reserves were almost exhausted and that, absent an agreement, a default was inevitable" (IMF, 2000f: footnote 26). A number of banks had already left, which contributed to the turmoil in the foreign exchange market.

While the rescheduling of debt provided some breathing space in both cases, the impact was far less than what could have been achieved with timely standstills. As the Government of the Republic of Korea noted in its subsequent report to the G-20, "Many of those who have analysed Korea's 1997–1998 crisis contend that Korea could have solved its liquidity problems sooner had a standstill mechanism been in place at the time it requested IMF assistance" (Ministry of Finance and Economy, Republic of Korea, 1999: 13), that is, at the end of November 1997.[20] In Indonesia, restructuring came even later than in the Republic of Korea (eight months after the first IMF programme) and made very little impact on stabilizing the economy.[21]

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More significantly, such debt restructuring exercises can hardly be portrayed as examples of the private sector bearing the consequences of the risks it had taken. In the restructuring in the Republic of Korea, private debts were effectively nationalized via a government guarantee. This was also the case for subsequent reschedulings by Thailand and Indonesia. Moreover, creditors ended up better after the rescheduling; there was no debt write-off but simply a maturity extension, with new loans carrying higher spreads than the original loans. Although the maturity extension spreads were considered to be relatively low, particularly compared to the IMF's Supplemental Reserve Facility (SRF), such a comparison overlooks the fact that the original bank loans already carried a risk premium.[22]

Problematic as they are, it is found that such restructuring exercises cannot be replicated in many other countries. According to the IMF, "the success of the Korean operation reflected two specific features, which are unlikely to apply to other cases. First, Korea maintained a restrictive capital account regime that forced a high proportion of imported foreign saving to be channelled through domestic banks … Second, at the onset of the crisis, the sovereign external debt burden was very low. As a result, the extension of a sovereign guarantee … did not place excessive burden on the sovereign" (IMF, 1999: 41–42). It is thus recognized that debt restructuring with foreign banks can run into serious difficulties when debtors are widely dispersed and the capital account is wide open. The latter feature could indeed discourage creditor banks from entering into restructuring since it would allow other investors to exit at their expense. It is also recognized that a concerted rescheduling of international private bank debt in emerging markets would require sovereign guarantees – a practice inherited, as noted above, from the 1980s – though this is not consistent with the established principles of orderly workouts of private debt.

A further difficulty with such concerted rescheduling operations is that they require the exertion of moral suasion by the supervisory authorities of creditor banks. This gives considerable discretionary power to major industrial countries, that may not apply it in a predictable and equitable manner to different episodes of crisis. As recognized by the IMF, "supervisory authorities are likely to be reluctant to exert moral suasion over the commercial decisions of the banks under their supervision except in the most extreme circumstances, especially in the context of debtors that do not pose a systemic threat to the national or international banking system" (IMF, 1999: 41–42). Again, this means that "non-systemic

countries" would have no option but to impose unilateral standstills.

Thus it appears that, for international bank loans, too, there are serious difficulties in reaching orderly and timely workouts on a voluntary and concerted basis in order to stem self-fulfilling debt runs and ensure that the creditors bear the consequences of the risks they take. As in the case of bonds, certain *ex ante* contractual arrangements can help facilitate orderly workouts. One possibility would be to introduce call options in interbank credits lines that would provide an automatic rollover under certain conditions, such as a request for IMF assistance by the debtor country. However, unless all debt contracts incorporate such automatic standstill clauses, including them in interbank lines alone can be counterproductive as it can trigger capital flight as soon as a debtor country runs into financial difficulties and enters into negotiations with the IMF. But such clauses are unlikely to be introduced voluntarily.

F. Conclusions

It thus appears that an effective and viable strategy for private sector involvement in financial crises in emerging markets would be to combine voluntary mechanisms designed to facilitate debt restructuring with internationally sanctioned temporary standstills to be used when needed. These arrangements need to be accompanied by the provision of international liquidity aimed primarily at helping debtor countries to maintain imports and economic activity, rather than to maintain open capital accounts and allow private creditors and investors to escape the crisis without losses. In general, normal access to IMF facilities, appropriately adjusted to allow for the expansion of world output and trade, should meet such needs. While in some cases additional financing may be required, it should also be recognized that, once exceptions are allowed on grounds of preventing global spillovers and systemic instability, they could easily become the rule, thereby aggravating the moral hazard problem. In this respect, the minimum strategy should be to require private participation, once official financing is raised above the normal lending limits – or a threshold level – as suggested by some of the Directors at the IMF Board.

Much has been written on the pros and cons of officially sanctioned payment standstills in the resolution of financial crises in emerging markets. There is strong resistance by some major creditor countries as well as private investors to a mandatory temporary stay on creditor litigation on the grounds that it would give rise to debtor moral hazard and weaken market discipline. That this need not be the case has been argued forcefully by the Deputy Governor of the Bank of England:

> Some have argued that articulating a clearer role for standstill may perversely alter debtor incentives, by weakening the presumption that debtors should pay their debts in full and on time. But an orderly standstill process should support, not supplant, market forces and market disciplines. Corporate bankruptcy law grew up as it became clear that market forces delivered losers as well as winners and that some orderly means was needed of dealing with the losers. In this way, bankruptcy law supports the market mechanism.
>
> The situation is no different in a sovereign context. A well-articulated framework for dealing with sovereign liquidity problems

> should reduce the inefficiencies and inequities of the current unstructured approach to standstills. It would support the international capital market mechanism. It would be no more likely to induce debtors to default than bankruptcy law is to induce corporate debtors to default. (Clementi, 2000)

Another concern is that the threat of a standstill could accelerate capital outflows, thereby aggravating the crisis. Indeed, that is why standstills and exchange controls need to be imposed rapidly, and why the decision to do so should rest with the country concerned. Furthermore, as noted above, the threat of suspension of payments could provide an incentive for creditors to engage in voluntary solutions, particularly for sovereign debt, thereby avoiding the need to impose standstills.

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It is also argued that standstills could make it difficult for the debtor country to regain rapid access to international financial markets, forcing it to make painful trade adjustments or to continue to rely on official financing. But that is precisely why such decisions can be expected to be taken with prudence. After all, countries that may need to impose temporary standstills are likely to be those that are closely integrated with international financial markets and would stand to lose if the decision was not exercised with care and prudence. In this respect, the recent Malaysian experience holds some useful lessons. The measures adopted by Malaysia included temporary and selective payments standstills, which sought to prevent the deepening of the currency crisis and widespread insolvencies. There was no significant outflow of capital when the controls were lifted in September 1999, and the country enjoyed an upgrading of its foreign currency credit in December of the same year as well as the normalization of relations with international capital markets.[23]

There is concern among policy makers in some emerging-market countries that the inclusion of internationally sanctioned standstills among the arsenal of measures for managing and resolving financial crises and the tying of the provision of large-scale emergency financing to greater involvement of the private sector would limit their access to international capital markets and would also reduce private capital flows to their economies. Such concerns are particularly widespread in middle-income countries with low saving and investment rates and uneven growth performance, and with only limited success in attracting greenfield FDI in tradeable sectors and achieving a stronger export base. Such countries are heavily dependent on financial inflows to meet current-account deficits that tend to increase rapidly as soon as domestic demand picks up.

The measures advocated here will almost certainly somewhat reduce aggregate financial flows to emerging markets by deterring short-term, speculative capital. However, this outcome would have a beneficial side, since such capital flows add little to the financing of development, while provoking significant instability and leading to a stop-go pattern of growth (see *TDR 1999*, chap. V, and *TDR 2000*, chap. IV). In this sense, arguments in favour of such measures have a rationale similar to those in favour of regulation and control of short-term, speculative capital inflows. There is often a temptation for countries to rely on surges in financial inflows, while paying insufficient attention to their longer-term consequences. However, it is difficult to attain rapid and sustained growth without undertaking the reforms needed to address

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structural and institutional impediments to capital accumulation and productivity growth – reforms which will reduce dependence on financial inflows.

As noted above, the risk of spillovers and contagion to other emerging markets seems to be the main reason for the reluctance of international financial institutions to encourage standstills in countries that are considered important for the stability of the system as a whole. Various channels of contagion have been mentioned in this context, including cutting exposure to other countries, liquidating assets held in other markets in order to meet margin payments, or a general withdrawal of funds from emerging markets (IMF, 2000f: 22). However, the introduction and use of standstills as part of standard tools in crisis intervention would influence investor and creditor behaviour and portfolio decisions, which could result in reducing such potentially destabilizing interdependences. More importantly, as noted above, such orderly debt workout mechanisms are quite different from messy unilateral defaults in their impact on the functioning of international financial markets.

Perhaps one of the most important potential benefits of binding in and bailing in the private sector is the possible impact on policy-making in the major creditor countries. Interest rate and exchange rate policies in these countries exert a significant influence on the competitiveness, balance of payments and capital flows of debtor developing countries, which cannot always be countered with domestic policy adjustment. Indeed, most major financial crises in emerging markets have been associated with sharp swings in exchange rates, interest rates and market liquidity in the major industrial countries. The latter have not always paid attention to the global repercussions of their policies, mainly because adverse spillovers to their financial markets from emerging-market crises have been contained, thanks largely to bailout operations. Nor has the IMF been able to deal with unidirectional impulses resulting from changes in the monetary and exchange rate policies of the United States and other major OECD countries, in large part because of shortcomings in the existing modalities of multilateral surveillance (Akyüz and Cornford, 1999: 31–33). Burden sharing by creditors in emerging-market crises can thus be expected to compel policy makers in the major industrial countries to pay greater attention to the possible impact of their policies on emerging markets. Indeed, it appears that the potential for adverse spillovers from the crisis in the Russian Federation played a crucial role in the decision of the United States Federal Reserve to lower interest rates in late 1998, even though, on the eve of the Russian default, the Fed was widely expected to move in the opposite direction. As is well known, the default caused considerable losses to Western investors and creditors, and threatened to set a precedent regarding compliance of emerging markets with their external obligations. Thus, it can be expected that effective mechanisms designed to involve the private sector in the resolution of emerging-market crises could bring a greater global discipline to policy-making in the major industrial countries – something that multilateral surveillance has so far failed to achieve. ■

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Notes

1 For an analysis of the policy response to the Asian crisis, see *TDR 1998* (chap. III), and *TDR 2000* (chap. IV).

2 A wider use of the concept includes greater transparency in standards of policy-making and improved data dissemination, as these measures are seen to be essential for markets to appropriately assess and price risks (IMF, 2000g, chap. V).

3 According to the Institute of International Finance, losses incurred by private investors since 1997 in emerging- market crises have amounted to $240 billion for equity investors, $60 billion for international banks and $50 billion for other private creditors on a mark-to-market basis (Haldane, 1999: 190). Losses incurred by foreign banks in the Asian crisis are estimated at some $20 billion (Zonis and Wilkin, 2000: 96).

4 Losses resulting from daily adjustments to reflect current market value, as opposed to historic accounting (or book) value.

5 On the private sector position, see IIF (1999), and IMF (2000g).

6 Unless stated otherwise, all quotations that follow in this section are from the same source (i.e. IMF, 2000h). For a more detailed discussion, see IMF (2000f). Temporary suspension was proposed in an earlier Working Party report to the Group of Ten: "… in certain exceptional cases, the suspension of debt payments may be a necessary part of the crisis resolution process" (Group of Ten, 1996: 3). Subsequently, it was supported by the Council on Foreign Relations Task Force (CFRTF); see CFRTF (1999).

7 This was also first proposed by the G-10 Working Party: "Such lending can both signal confidence in the debtor country's policies and longer-term prospects and indicate to unpaid creditors that their interest would best be served by quickly reaching an agreement with the debtor" (Group of Ten, 1996: 3).

8 On the "comparability of treatment" principle and its recent application, see Buchheit (1999); De la Cruz (2000); and IMF (2000g).

9 For this so-called problem of "the inconsistency of optimal plans", see Kydland and Prescott (1977).

10 See Miller and Zhang (1998). The same arguments about the ineffectiveness of official assistance policy in securing private sector involvement in crisis resolution were used in favour of the introduction of collective action clauses in bond contracts in order to facilitate restructuring (see Eichengreen and Ruhl, 2000).

11 A notable exception to calls for smaller IMF packages is the so-called "*Meltzer Report*" (see International Financial Institutions Advisory Commission, 2000). For a discussion of the debate on IMF crisis-lending, see Goldstein (2000).

12 In creating this facility all Fund members would agree to donate their share of the allocation to the facility and there would also be agreement that only developing countries would be entitled to draw on the facility. This clearly differs from another proposal, which is to allow the Fund to issue reversible SDRs to itself for use in lender-of-last-resort operations - that is to say, the allocated SDRs would be repurchased when the crisis was over. See Ezekiel (1998); United Nations (1999); and Ahluwalia (1999).

13 *Acceleration clauses* allow creditors to demand immediate repayment of unpaid principal following a default. Under *cross-default (or cross-acceleration) clauses*, creditors are entitled to bring forward their claims if the debtor has defaulted on other debts. *Put options* allow creditors to demand repayment ahead of the scheduled contract date, under certain conditions.

14 See, for example, Group of Ten (1996). This recommendation has been reiterated following the Asian crisis (see Group of Twenty-Two, 1998). For a discussion of problems in bond restructuring and CACs, see Eichengreen and Portes (1995); Dixon and Wall (2000); and Buchheit (1999).

15 In the case of English-law bonds issued under a trust deed, the trustee represents the interest of all bondholders and shares any proceeds recovered on a pro

rata basis. However, trustees rarely exist for sovereign issues (Yianni, 1999: 79–81; Dixon and Wall, 2000, box 1).

16 For some recent experiences of bond restructuring by emerging markets, see box 6.2.

17 This is also recognized by the IMF (2000f: 16).

18 The Bulgarian case of 1996–1997 is cited as an example of such market breaks leading to litigations (Miller and Zhang, 1998: 16).

19 See, for example, IMF (1999: 41–42; and 2000b, chap. V); and Eichengreen and Ruhl (2000: 5, footnote 7).

20 For support of this position based on a study of the Malaysian capital controls, see Kaplan and Rodrik (2000, particularly pp. 27–28).

21 For a description of the East Asian restructuring see Radelet (1999: 66–67).

22 The deal included a total debt of $21,740 million owed to 13 banks, and the maturities were extended from one to three years, involving spreads between 225 and 275 basis points. The spread on SRF was 300 basis points – lower than the maximum spread on maturity extension mentioned in the previous note (Ministry of Finance and Economy, Republic of Korea, 1999: 14).

23 See *TDR 2000*, box 4.1. This situation was also recognized by the IMF: “They [Malaysia’s controls] do not appear to have had any significant long-term effect on investor behavior” (IMF, 2000f, footnote 28). While it is suggested that “capital controls may have contributed to a decline in FDI” compared to the Republic of Korea and Thailand (ibid.: 24), it is quite likely that an important aspect of the stronger recovery of FDI in those two countries in 1999 was the spate of fire-sale investments and takeovers associated with the collapse of asset prices and exchange rates.

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