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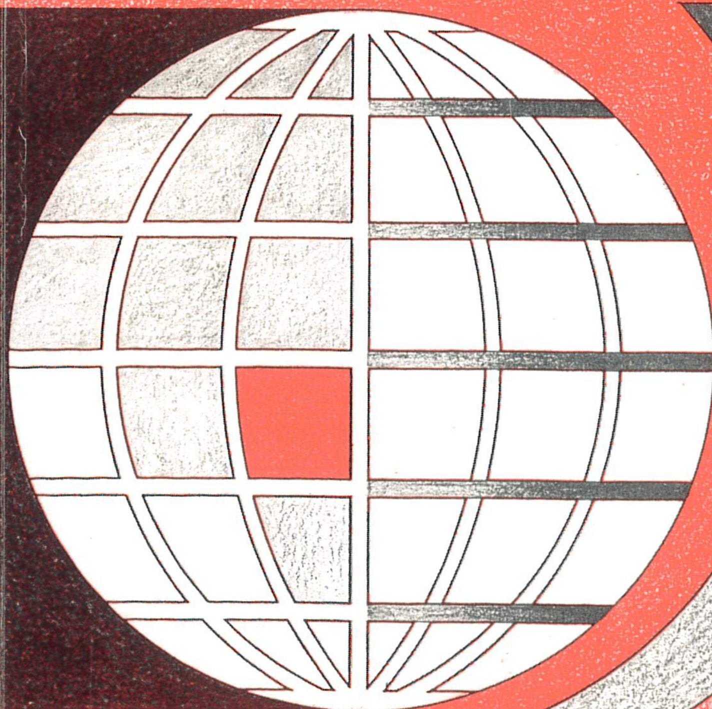

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
Geneva

THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM: DEVELOPING COUNTRY PERSPECTIVES

Proceedings of a Conference sponsored by the Group of Twenty-Four on the Occasion of the Fiftieth Anniversary of the Bretton Woods Conference

Cartagena, Colombia, 18-20 April 1994

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Abbreviations

AfDB	African Development Bank
AfDF	African Development Fund
AsDB	Asian Development Bank
ACMS	African Centre for Monetary Studies
AERC	African Economic Research Consortium
ASEAN	Association of South-East Asian Nations
BWI	Bretton Woods institution
CARICOM	Carribean Community
CFA	Communauté Financière Africaine
CFF	Compensatory Financing Facility (IMF)
CMEA	Council for Mutual Economic Assistance
EC	European Community
ECE	United Nations Economic Commission for Europe
ECLAC	United Nations Economic Commission for Latin America and the Caribbean
EFF	Extended Fund Facility (IMF)
EMS	European Monetary System
ERM	Exchange Rate Mechanism
ERP	Economic Recovery Programme
ESAF	Enhanced Structural Adjustment Facility (IMF)
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
Fed	Federal Reserve System (United States)
FSO	Fund for Special Operations (IDB)
G-3	Group of Three
G-5	Group of Five
G-7	Group of Seven
G-10	Group of Ten
G-24	Group of Twenty-Four
GAB	General Arrangements to Borrow
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GEF	Global Environment Facility
GNP	gross national product
HIC	highly indebted country
IBRD	International Bank for Reconstruction and Development
ICMB	International Centre for Monetary and Banking Studies
IDA	International Development Association
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFI	international financial institution
IMF	International Monetary Fund
ITO	International Trade Organization

LDC	least developed country
LIBOR	London Inter-Bank Offered Rate
LYC	low income country
MDB	multilateral development bank
MIGA	Multilateral Investment Guarantee Agency
NAFTA	North-American Free Trade Area
NCA	net cumulative allocation
NGO	non-governmental organization
NIC	newly industrialized country
NIE	newly industrialized economy
OAU	Organization of African Unity
ODA	official development assistance
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
PAR	post-allocation redistribution
PFP	policy framework paper
PPP	purchasing power parity
RDP	regional development bank
SAF	Structural Adjustment Facility (World Bank)
SAL	structural adjustment loan
SAP	Structural Adjustment Programme
SDR	Special Drawing Right
SELA	Sistema Económica Latino-Americana
SSA	sub-Saharan Africa
STF	Systemic Transformation Facility (IMF)
TNC	transnational corporation
UNCTAD	United Nations Conference on Trade and Development
UNCED	United Nations Conference on Environment and Development
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNFPA	United Nations Fund for Population Activities
UNICEF	United Nations Children's Fund
UNIDO	United Nations Industrial Development Organization
UNU	United Nations University
WBG	World Bank Group
WEO	World Economic Outlook (IMF)
WIDER	World Institute for Development Economics Research of the United Nations University
WTO	World Trade Organization

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Preface

This volume contains the main contributions to a conference, sponsored by the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24) on 18-20 April 1994, in Cartagena de Indias, Colombia. The conference was organized to provide an opportunity for developing country perspectives on international monetary and financial issues to be advanced on the occasion of the fiftieth anniversary of the Bretton Woods conference that led to the formation of the International Monetary Fund and the International Bank for Reconstruction and Development. It was originally authorized by the G-24 Ministers at their meeting in April 1993. An advisory committee of Philip Ndegwa, I.G. Patel and Richard Webb provided useful advice in the early stages of its planning.

At the autumn 1993 meetings, in the words of the G-24 Ministers' Communiqué, "they considered that these landmark meetings should provide an opportunity to take a long-term view of the working of the international monetary and financial system, experience with the development process, and the role of the developing countries in the international decision-making process. They expressed the hope that deliberations on these issues will contribute to a much needed strengthening of international economic cooperation and its institutions. In this context, they underscored the importance of examining ways to enhance the role and effectiveness of the Interim Committee and Development Committee, and to ensure that the views and interests of developing countries are presented effectively at the policy coordination fora of the industrial countries". At these same autumn meetings, the Government of the Republic of Colombia offered to host the conference in Cartagena, and urged that the meeting be held early in 1994. The offer was gratefully accepted.

In further consultations, the developing country Executive Directors in the IMF and World Bank and the G-24 Chairman agreed that the conference should take the form of a *technical* meeting, in which the issues could be discussed in an *open and independent* forum. The views expressed in this conference are therefore to be understood as the personal views of the contributors and do not necessarily reflect the views of the institutions or governments with which they may be associated.

The G-24 and the conference participants are deeply grateful to the Banco de la República and the Government of the Republic of Colombia for their warm hospitality and efficient conference support. They are also most grateful to the five external sources of financial support for the conference, without which it could not have taken place: the Ministry of Foreign Affairs, Government of Denmark; the International Development Research Centre (Canada); the Government of the Netherlands; the Norwegian Agency for Development Cooperation; and the Swedish International Development Authority. Lastly, they express their thanks to the United Nations Conference on Trade and Development which provided excellent technical support both for the conference itself and for this publication of its proceedings.

1

INTRODUCTION

Gerald K. Helleiner

When close to a hundred scholars and policymakers from nearly as many developing countries, all chosen on the basis of their experience and expertise, assemble to discuss controversial international monetary and financial issues in a free and *open* forum, one can be sure of vigorous exchanges. The G-24 Cartagena conference on the occasion of the fiftieth anniversary of the Bretton Woods conference was an extremely lively and productive one. It would be foolhardy for anyone to try to summarize so rich a set of proceedings. The papers and the written comments upon them, published here, will have to speak for themselves. But some introductory comments may nevertheless be helpful. This introduction contains: (1) some background on the fiftieth anniversary of Bretton Woods; (2) some comment on the overall structure of the discussions, and the organization of this volume; and (3) a catalogue of the major suggestions made by conference participants (which was prepared at the request of the Chair of the G-24 Deputies and circulated at the G-24 Deputies' and Ministers' meetings in Washington in late April 1994).

A. Bretton Woods, fifty years on

It is important, at the outset, to recognize that the Bretton Woods institutions have continued to function over fifty years of fairly turbulent global history. There can be little doubt that the developing countries still need the IMF and the World Bank; if they did not already exist, institutions performing essentially similar functions would have to be created. Conference participants agreed that congratulations were in order on the occasion of their fiftieth birthday.

To offer congratulations is not, however, to suggest that all is well. The conference heard a wide variety of suggestions for change and reform, some more significant than others. There was certainly no sense of complacency about the current state of international monetary and financial affairs. On the contrary, virtually all participants saw changes as desirable, and even necessary, if there is to be hope that the original objectives of the Bretton Woods conference and the institutions that sprang from it can be realized over the next decades. Considerable doubt was expressed about the *possibility* of change, and some uncertainty as to the possible sources of leadership for it. As always, there were both optimists and pessimists about the prospects.

What are the objectives in international monetary and financial reform-mongering? The original basic goals of the Bretton Woods institutions were to provide certain important public goods, in the form of stability, rules, a degree of equity, etc., to meet some of the most evident deficiencies of markets and national governmental functioning in the 1920s and 1930s. The signatories sought to support the maintenance of full employment and development, at national levels, through the provision of international arrangements that would reduce the need or temptation for autarkic economic measures that would be harmful both to other nations and ultimately to themselves; overcome some of the failures in international capital markets via governmental guarantees and contributions; and encourage financial and exchange rate stability at both national and international levels. The broad objectives of international (or global) economic governance have not significantly altered.

Whereas the broad objectives have changed very little, there have been *major* changes in the global environment within which the Bretton Woods institutions function, over

the fifty years of their life. They include the following:

(1) massive growth in membership, particularly membership on the part of newly-independent developing countries;

(2) vastly increased globalization of markets, particularly world financial markets, and the increased role of markets vis-à-vis governments in the international economy, via transnational corporations as well as capital markets;

(3) the end of United States hegemony in the Western world and the need for more complex plurilateral arrangements, followed by the thaw in the Cold War;

(4) the rise of new international economic institutions, both within the Bretton Woods system (IDA, IFC, MIGA, etc.) and outside it (including the regional development banks, and now the World Trade Organization);

(5) the rise in the relative importance of the Bretton Woods institutions vis-à-vis the United Nations in international economic affairs;

(6) significantly increased turbulence and instability in the international economy from the early 1970s onward.

There is widespread agreement that the world now needs better mechanisms for global economic governance, and mechanisms that also provide for greater global participation and/or representation. The problem is that these need to be created in a world that has become far more complex than that of 1944. They cannot be cobbled together by a small group of intellectuals and diplomats in a resort hotel, as at Bretton Woods.

There has really only been one major effort at international monetary and financial reform since Bretton Woods, that of the 1970s, which was, to a considerable extent, aborted, but which nonetheless led, among other things, to the creation of the Interim and Development Committees and eventually amendments to the IMF Articles of Agreement. The G-24 played a prominent role in these reform efforts. The fiftieth anniversary of the Bretton Woods institutions, which is prompting a rethink of many of the issues considered at that time, provides an opportunity for the G-24 to exercise influence in these spheres once again. The conference provided a useful, and potentially important, start-up for such a process of change.

B. Structure and organization of the conference and this volume

The conference discussions were organized around the presentation of 16 papers, each published in this volume; comments from predesignated discussants, most of which are also published here, sometimes in edited form; and active discussion from the floor, the contents of which could not be recorded for this volume. Some of the discussion from the floor is reflected in the next section of this introduction, which attempts an overall catalogue of the major policy suggestions made during the conference; but much of it unfortunately is not.

The conference papers (and comments upon them) are presented, for the purposes of this volume, in eight groups of two each. Inevitably, there is some overlap in the material presented under different subject headings; the authors frequently try to cover a wide range of material, and "everything is related to everything else".

The first group's papers, by Azizali Mohammed, and Yung Chul Park and Sangmoon Hahm, assess the implications for developing countries of the macroeconomic policies of the major industrialized countries, and, conversely, particularly in the paper by Mohammed, the implications for industrialized countries of developing country performance. From them (and in them) there emerged important discussions of the means through which more effective global macroeconomic management could be achieved, particularly through a more activist and empowered IMF.

The papers in the second group pursue some of these issues in greater detail. The need for more effective global management of international liquidity is persuasively argued in the paper by Ariel Buira. Guillermo Calvo addresses the problems of managing volatile international private capital flows, both through national policies and through international cooperation; these issues are also addressed in Mohammed's paper in the previous group. The latter problems elicited some of the liveliest exchanges of the conference, over the desirability and nature of appropriate policy responses. Should financial markets "run free", with additional governmental instruments provided to deal with potential crises? Or should efforts be increased to "control" or, at least, "throw some sand in the wheels" of global finance?

The papers in the third group address the longer-term issues of development finance for very low-income countries, particularly those in sub-Saharan Africa. Both Benno Ndulu's paper and that of Joseph Abbey call attention to the need for more reliable and greater amounts of official development finance, and improvements in the modalities and conditions through which it is provided. The importance of increased debt relief is also featured in these papers, particularly in that of Ndulu. A further paper on the debt question had been commissioned for the conference but, regrettably, it could not, in the end, be delivered. There was nonetheless vigorous floor discussion of the remaining unresolved debt problems of a large number of small and low- to middle-income countries; and, in particular, the problem of arrears and "overhangs" in respect of debt to international financial institutions. The importance of commodity market problems for the prospects of the low-income countries also featured prominently in these discussions.

In the fourth group of papers, the main issues in "structural adjustment" and in "systemic transition" are reviewed critically by authors who are deeply engaged in such efforts. Montek Ahluwalia seeks to identify the emerging consensus and areas of continuing dispute in structural adjustment programmes. He calls particular attention to the need for more diversity and de-concentration in research on the issues that remain unresolved. Parts of the paper by Patricio Meller in the next (fifth) group of papers move along a parallel track. Dragoslav Avramovic's paper surveys the difficult experience of the economies "in transition" and argues that the international financial institutions have inappropriately extended their influence and advice beyond their mandates in these countries.

The fifth group of papers extends the discussion of the previous group's papers into a consideration of the instruments for the exercise of policy leverage by the IMF and World Bank, and the question of conditionality. Patricio Meller surveys the recent Latin American experience of relationships with the international financial institutions, calling particular attention to the apparent convergence of policy opinion in many, though not all, areas of previous dispute. Roberto Junguito addresses the evolution of IMF-Bank relationships in the provision of policy advice, the continuing issues in the coordination of advice and cross-conditionality, and the possibility of a better institutional division of labour.

The sixth group of papers concerns the internal governance of the IMF and the World Bank, and the functioning of their principal committees. Basing their analyses on their considerable experience as Executive Directors, Alexandre Kafka and Moisés Naim offer valuable insights and practical suggestions both for improving the governance of these institutions and for increasing the influence of developing countries in their activities.

The papers in the seventh group, by Devesh Kapur and Richard Webb, and Delphin Rwegasira and Henock Kifle, consider the role of the regional development banks and, in particular, their relationships with the World Bank, in the emerging system of development institutions. They agree that the regional banks have certain advantages - in terms of a greater sense of developing country "ownership" and closer familiarity with region-specific problems - that are likely to continue to give them increasing relative influence. An appropriate division of labour among the multilateral development banks has still to emerge.

The final group of papers addresses the prospects for increasing developing country influence in the international monetary and financial system. Terrence Farrell sees fairly limited prospects, and points to the particular difficulties faced by the large number of small countries in terms of exerting influence, as well as in other respects. Lal Jayawardena, on the other hand, emphasizes the possibility of forming new coalitions - with small industrialized countries and/or with Japan, among others - in pursuit of common objectives and common approaches. An important suggestion in this regard, made in the final discussion of the conference, was to create a new, representative, intergovernmental committee, similar to the Committee of Twenty that operated in the early 1970s, to review the current state of the international monetary and financial system and its premier institutions, and make recommendations for improvements.

An important address made to the conference by the President of the Republic of Colombia, Dr. César Gaviria Trujillo, is also reproduced here in an appendix.

C. Major suggestions

The summary that follows is a personal one. It attempts to catalogue what I believe to have been the major suggestions made by conference participants, both in papers and in comments and floor discussion, without commenting on the degree to which there may have been agreement on them. It cannot pretend to include every single suggestion that was made. This catalogue was presented orally at the conclusion of the meetings, but there was no effort

to seek consensus on it. It therefore has no "collective" status whatsoever (although it was circulated at the G-24 meeting in late April, 1994, in Washington, for information) and should certainly not be taken as a set of agreed conclusions. The material is categorized into (1) issues of economic policy substance, and (2) issues of process and governance.

1. Issues of economic policy substance

(a) Liquidity

- The IMF should estimate the global need for liquidity on a regular basis, e.g. annually, assessing such need in terms of its distribution, no less than its aggregate. It should "manage" global liquidity by distributing SDRs in accordance with its estimates of this global need.
- There should be a new allocation of SDRs, with arrangements for those who do not need them to transfer them, at concessional rates where appropriate, to those who do, particularly the low-income countries who would otherwise have to compress their imports further in order to build reserves, or directly to IDA.
- There should be a low conditionality IMF facility, and/or contingency clauses in all IMF/Bank funding to provide "first line liquidity" for low-income countries.
- In the light of the new role of global private financial markets, the IMF should augment its role by exercising surveillance over them and interacting more with their participants rather than just, in its traditional manner, with governments.
- A new IMF facility may be appropriate to allow countries to ride through short-run and temporary capital flows created by crises in financial markets; but the resources necessary to be effective in this regard could be large, raising the question of their opportunity costs, for example, in terms of improved liquidity for low-income primary producers. This deserves more study.

(b) Volatile private capital flows

- There is new concern over the role of volatile private flows of capital and their implications. It is necessary to work toward an agreed new global regime for private capital movements. If there are to be orderly foreign exchange markets, and thus sustainable trade policy regimes, rules in this sphere are important, no less important than in trade.
- The IMF and World Bank should devote research attention to market imperfections and failures, and the prospects of "bubbles" and "runs" in financial markets, and alternative means of reducing their possible negative effects. This research should include consideration of the circumstances in which capital controls may be appropriate, the prospects of new swap arrangements among central banks (including those not previously benefiting from them), and the possibility of increasing the IMF's capacity to serve as a "lender of last resort". There should be preparation, in advance, for possible "runs" and crises.

(c) Debt

- The remaining debt overhang problems of some sixty developing countries, whose prospects without debt writedowns are bleak, should at last be settled. Case-by-case approaches to such settlements are appropriate, and some such basis as secondary market prices would provide appropriate relief.
- The arrears to the international financial institutions should finally be cleared out, and the growing problem of IMF/Bank debt overhang in many low-income countries should be directly addressed. The possibilities and modalities for writing-down some IMF/Bank debt need to be discussed directly and openly rather than remaining unacceptable topics for discussion.

(d) Development finance

- The poor prospects for both public and private flows of longer-term finance to a large number of developing countries, particularly low-income ones, are worrisome. Ways must be found to increase IDA flows, and new ways (sometimes old ideas) for levering the limited official flows into larger total flows should be considered, e.g. interest subsidies and guarantees for commercial flows.
- The low-income countries, especially those in sub-Saharan Africa, need more external flows than they now appear likely to receive, if they are to achieve minimally-acceptable rates of development.

(e) Global macroeconomic management

- The global economy requires coordinated macroeconomic management in the interests of all, rather than just a few, countries. More stable economic growth, orderly foreign exchange and financial markets, liberal trade policies, full utilization of capital and labour, symmetry in adjustment processes, and the selection of an appropriate monetary-fiscal policy mix, are all matters of general interest.
- The IMF must play a greater role in this global management. How this is to be achieved requires more urgent and more serious study.

(f) Appropriate adjustment/ development policy

- There has been significant convergence in views on appropriate policies, with both orthodox and non-orthodox analysts and practitioners giving some ground; but there is still not total consensus. In the spheres of financial reform, trade policy and the efficacy of "big bang" approaches, for instance, disagreements remain.
- Country-specific circumstances, economic and socio-political, vary greatly. Local "ownership" is critically important.
- IMF/Bank conditionality should be longer-term in its orientation, less rigid and more geared to results than to policy compliance.
- Conditions on politically-sensitive issues like human rights and income distribution are inappropriate.
- Since trade matters will be handled in the World Trade Organization (WTO), and trade policy instruments are typically "swamped" by exchange rate movements anyway, trade policies may also be inappropriate for Fund/Bank conditionality; thought needs, in any case, to be devoted to the prospect of emerging overlap in this sphere of international economic governance.

(g) Commodity markets

- There has been improper neglect of international commodity market problems, and international policies for addressing them, in the Fund and Bank. In light of their particular importance to low-income countries, and fifty further years of experience since the important discussion of these issues in the run-ups to Bretton Woods (and Havana), there needs to be a reconsideration of Fund/Bank approaches in this sector.

2. Issues of process and governance

(a) Increasing role for developing countries in global economic governance and IMF governance

- Apart from their large and growing share of global population, the developing countries are now perceived as playing a major role in the world economy (through the use of PPP exchange rates for measuring GNP). New environmental concerns and heightened financial market links between North and South also argue for their increased participation (corresponding with a process of enhanced democratization) in the Fund and the Bank, and global economic governance more generally.
- The efforts at such participation and cooperation among the developing countries, perhaps together with small industrialized countries (and others), in the pursuit of joint interests in the international financial institutions (IFIs) and in global macroeconomic management should be intensified. The developing countries can perform more satisfactorily in the IFIs if they participate in them more as shareholders and less as supplicants.
- The developing countries should consider alternative means of building effective coalitions of the "non-five" that are general and ongoing, as well as issue-specific and temporary: either via an added economic role for the United Nations Security Council or via a new constituency-based "non-five" group to interact directly with the G-7. The initiative for changes in governance arrangements can only come from outside the "five". Such efforts would probably be initially more successful if they focused on a narrow agenda, e.g. international macroeconomic and monetary management or, possibly, the development of "sustainable development compacts".

(b) Suggestions for improved IFI governance

- Reconsider the roles of the Executive Boards with a view to making them function more effectively, perhaps by reducing their size or via an Advisory Committee (which could be formed without altering the articles); perhaps by extending the terms of Executive Directors.
- Reconsider the role, functioning, and even the existence of the Development Committee, which has been ineffective, and the Interim Committee, which has become a "rubber stamp" for G-7 decisions.
- Change staff recruitment practices in favour of a broader orientation and greater policy experience.
- Establish an Evaluation Office for the IMF.
- Change the constituency system so as better to consolidate countries with common interests within single constituencies.
- Greatly decentralize World Bank supported research and advisory activities so as to reduce the overconcentration, unnecessary expense and inefficiency in Washington, and to raise their credibility and quality.
- Address many "nitty-gritty" issues on the basis of independent (non-management, non-G-7) study, e.g. appropriate levels of reserves, appropriate accounting for building expenses, burden sharing, etc.

(c) IMF/Bank relations

Consider such options as the following:

- merge the IMF and the Bank;
- upgrade the role of the IMF in global macroeconomic management and the attainment of symmetric adjustment, and have it concentrate on that global monetary role, en route to a global central banking function;
- upgrade the role of the World Bank in all financial issues, short-term and long-term, relating to developing countries that are primarily dependent upon official sources of external finance, particularly low-income and small countries; and/or authorize a new role for it in world capital markets;
- in any case, work to achieve consistency between Fund and Bank activities.

(d) Some first steps towards change

- Establish an intergovernmental committee with broad representation, along the lines of the Committee of Twenty of the 1970s, mandated to reconsider the functioning of the international financial institutions after fifty years and their future role in a changing world economy, with a view to achieving improvements in their overall efficiency and democratic governance. This would open up the discussion of all of these suggestions for change, together with others that will undoubtedly emanate from other conferences, studies and commissions in this fiftieth anniversary year.

(e) Regional development banks and the IFIs

- The regional development banks have grown in importance and are likely to continue to expand their relative importance. The appropriate modes for interaction and division of labour between regional development banks and IFIs will have to evolve. The committee proposed above might also consider these issues.

(f) The WTO and IFIs

- The relative responsibilities of the WTO and the IFIs will have to be clarified, as well as their modes of interaction. Again, this issue might also be addressed by the committee proposed above.

(g) The role of the G-24

- The developing countries often have widely divergent interests. They cannot expect to be united on all, or some would even say most, issues. They need to pursue common interests where they exist and form coalitions where appropriate.
- Technical exchanges, unmediated by the IFIs, such as the Cartagena conference, are extremely useful and important.

- Research papers that are prepared from outside the IFI system are also extremely important to counter its near "monopoly" of research on the economic problems of developing countries.
- If the committee proposed above is created, some kind of caucus in support of the developing country representatives will have to be devised. That might create an opportunity for reconsidering the role and *modus operandi* of the G-24 itself.

I. GLOBAL MACROECONOMIC MANAGEMENT AND THE INTERESTS OF DEVELOPING COUNTRIES

2

IMPLICATIONS FOR IMF POLICIES ARISING FROM EFFECTS ON DEVELOPING COUNTRIES OF INDUSTRIAL COUNTRY MACROECONOMIC POLICIES

Azizali F. Mohammed

A. *Introduction*

A study on the effects on developing countries of the macroeconomic policies of industrial countries was commissioned by the Intergovernmental Group of Twenty Four (G-24) on International Monetary Affairs; it was submitted to the Ministers at their meeting in Washington on 25 September 1993. In welcoming the study, the Ministers "drew attention to the study's principal conclusion that performance of the developing countries is not only affected by industrial country policies, but also directly affects the prospects for growth in the industrial world". Ministers called on the Fund "to continue work on the interdependencies between industrial and developing country policies as an integral part of its surveillance responsibilities" (IMF, 1993c, p. 334). Other conclusions of the study (referred to hereafter as the G-24 study) are summarized in the annex to this paper.

The Ministers had in mind the higher growth rates being currently registered by developing countries, despite the prevalence of recessionist conditions in most of the industrial world, and the manner in which developing countries had shored up the demand for industrial country exports in recent years. This experience suggested that a switch in the leader-follower relationship of industrial and developing countries might be occurring, with the latter beginning to "acquire certain locomotive properties" (Mohammed, 1993, p. 39).

B. *Recognizing developing country growth momentum*

This development is evidently of significance and may not be easily dismissed as a temporary phenomenon that would abort once lags in response to changes in industrial country activity are overcome. There is at least a presumption that higher growth rates could well be maintainable by a number of developing countries under their own momentum, especially where both trade and investment flows are growing faster through a process of mutual liberalization of trade and investment regimes among countries of a region, such as is already happening in East and South-East Asia.[1] The growth of the "Chinese Economic Area" (CEA) comprising China, Hong Kong and Taiwan Province of China, has been characterized as a fourth "growth pole" of the global economy, with its imports projected to rise by $100 billion over the next three-year period, and to increase from about two thirds of Japanese imports currently to a level exceeding that of Japan by the end of the decade (*International Economic Insights*, May/June 1993). Developing countries in the Latin American region might carry a similar momentum, with three of them being included in the list of 10 countries identified as

1 Nomura Research Institute (Tokyo) notes that Asia's elasticity coefficient measuring reponse to growth elsewhere has fallen from around 1.5 per cent in the early 1970s to just under 0.3 per cent in 1990-1993; it estimates 6 per cent average real growth across the six ASEAN and the three NIEs in North-East Asia (Hong Kong, Republic of Korea and Taiwan Province of China) in 1993 and 6.5 per cent in 1994.

likely to account for 75 per cent of the world's total trade growth in the period ending 2010 (Garten, 1994).[2]

Given this perspective, it would appear appropriate to expect the IMF, as part of its global surveillance responsibilities, to refine its models of the world economy so as to pay greater attention to these linkages. It has already introduced a major shift of emphasis by revising the weights used in its *World Economic Outlook* exercise for aggregating output growth and other economic indicators.[3] Moving from market exchange rates to purchasing power parity based weights has resulted in a more accurate measure of the relative size of developing country economies, primarily through incorporating a more realistic valuation of nontraded output. Because market exchange rates have deviated significantly from their purchasing power equivalents over extended periods, the shift in weights produces a contrast in trend of GDP shares that is rather startling. Thus, exchange rate based weights indicate the share of industrial countries rising from about 68 per cent in 1983 to slightly under 74 per cent in 1992, with a corresponding decline for developing countries; in contrast, purchasing power parity based weights indicate the share of developing countries increasing from a little over 32 per cent in 1983 to just under 37 per cent in 1992, while that of industrial countries declines slightly from 55.45 per cent to 54.63 per cent of world GDP (IMF, 1993b, chapter VI). (The larger loss is registered by the transition countries of the former Soviet Union and Central and Eastern Europe.)

The present models tend systematically to underestimate the influence of demand by developing countries for industrial world exports, because they incorporate *average* magnitudes rather than *incremental* ones. Thus, United States exports contribute no more than 9 per cent to its GDP; exports to developing countries account for only a fraction of that number, and their influence on aggregate developments in the United States economy would therefore be treated as minimal. Yet the G-24 study demonstrated that the 1989-1990 United States recession would have persisted into 1991 and the recovery in 1991-1992 would have been weaker but for the strength provided by the increase in exports to the developing world.[4] The growing importance of developing country markets might well provide the critical margin of demand that could, depending on cyclical phasing, spell the difference between growth and recession for individual industrial countries. A closer consideration of such demand impulses that affect "turning points" in industrial country cycles might bring greater clarity to the Fund's assessment of the growing interdependencies in the global economy. And this, together with a greater appreciation of important feedback processes between industrial country policies and the performance of developing countries, might perhaps persuade the G-7 that better coordination and consultation with developing country policy-makers, through the Fund, is not a matter of altruism on their part, but a recognition of the growing dependence of their own prospects for a durable recovery and sustainable growth on the expansion of their trade with the developing world.

C. *Enlarging IMF contacts with private markets*

Another major development of recent years has been the restoration of creditworthiness of a number of middle-income and a few low-income developing countries and the resumption of capital flows to them, predominantly from private market sources, at fairly moderate spreads over those available to prime borrowers. Indeed, the share of flows from official sources, whether bilateral or multilateral, begins to pale in significance relative to private flows, as indicated by data for recent years. While direct investment flows have maintained a fairly steady upward trend, it is other private flows that have shown the most buoyant growth. International bond issues of developing countries have risen from $6.2 billion in 1990 to $23.6 billion in 1992 and were in excess of $21 billion in the first half of 1993. Equally striking has been the rise in

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2 The 10 countries identified are Argentina, Brazil, India, Indonesia, Mexico, Poland, Republic of Korea, South Africa and Turkey, plus the economic zone of China, Hong Kong and Taiwan Province of China. Their merchandise imports are forecast to be $1 trillion higher by the year 2010 than in 1990, or triple the combined increase expected for the rest of the world.

3 The revised weights were introduced in IMF (1993d), annex IV, pp. 116-119.

4 The global dimension of this insight is found in IMF (1993e), p. 7, which, after noting that aggregate developing country output is expected to increase by 6 per cent in 1993 and by 5.5 per cent in 1994, proceeds to state that "the resulting buoyancy of developing country imports - which are projected to rise by 9 per cent in both 1993 and 1994 after 10 per cent growth in 1991 and 1992 - highlights the crucial contribution of these countries to global economic prosperity, especially in view of the recessionary conditions persisting in many industrial countries".

international equity issues, where the corresponding numbers are $1.2 billion and $9.4 billion, with the first half of 1993, showing an inflow of $4.1 billion. In both categories, market re-entrants, i.e. countries that had lost access in the 1980s because of their debt problems, have been substantial recipients, with roughly one half of the bond and equity issues (by dollar amount) raised by them in 1992 (IMF, 1993a, table 2, p. 4). It is interesting to note that commercial bank lending commitments have stayed rather stable (at annual rates around $17 billion) during the same period and with little more than $1 billion directed annually towards market re-entrants, indicating continuing caution on their part in dealings with countries where bank debt has been restructured in the recent past.

While a part of the private inflows represents return of flight capital, especially following phases of structural reform and financial sector liberalization, particularly in Latin American countries, a good part of the rest may incorporate a *push* element, i.e. policies and circumstances in major industrial country markets rather than *pull* factors, i.e. better policies and improving conditions in recipient countries. There is clearly a question as to the durability of such flows, as and when the global environment of low international interest rates and weak activity in the industrial countries begins to change, as indeed may already be happening with the recent rise in United States long-term interest rates.[5] Given the rise in current account deficits in recipient countries - an ineluctable concomitant of the process of absorbing foreign capital into the domestic economy - a sudden falling off in such inflows could precipitate a balance-of-payments problem, since current account outcomes take far longer to adjust than capital account ones, especially those resulting from rapid change of investor sentiment in asset markets.

Two questions arise in this context: can the Fund be doing something directly with market participants to dampen the potential volatility of market flows? Could the Fund be exploring a new type of credit facility that could be quickly activated to help recipients handle temporary interruptions in capital flows? As to the first question, a certain precedent could be found in the Fund's action during the debt crisis years, when it was prepared to brief "steering" or "advisory" committees of the international banks on the balance-of-payments prospects of individual debtor countries, albeit only when so requested by these countries to do so. It has also participated at meetings of the Berne Union which represent export credit and credit guarantee agencies where individual country situations are discussed; here again, staff presence can be explained by the fact that these agencies are official entities, or work under the direction of their official "guardian" authorities. Similarly, its presence at "Paris Club" meetings is justified by their official auspices.

The Fund has hitherto been constrained about stepping out of the official circuit on the basis that it is an inter-governmental organization and that it is for its government shareholders to pass on any of its individual country judgements, arrived at in the course of its bilateral surveillance function, to their own private market participants through whatever regulatory, supervisory or other mechanisms they chose to employ. There is also the delicate issue that while a recipient country might not object to any positive judgements that the Fund may proffer publicly, they would not welcome any negative ones; even if it chose to remain silent when unable to render a favourable judgement, that silence itself could easily be construed as a negative signal. Yet the unprecedented growth in size and scope of private capital markets, the patent inability of even the most powerful governments to quell massive private flows of funds across their foreign exchanges, and the fact that the investor base in private equity and bond markets is much too diverse and spread out to be reached by official agencies, raise the issue whether the Fund's surveillance function can ever be effectively exercised if it remains confined within the official domain.[6] This tends to be a particularly restricted domain since the Fund deals traditionally with the monetary authorities (i.e. central banks and finance ministries) whereas security markets are more often than not regulated by independent agencies of the State or are self-policing. In preparing its periodic reports on international capital markets, the Fund staff presumably maintain extensive contacts with market practitioners and their various associations. The question is whether there is something more than only the publication of its general findings that the Fund should be undertaking, especially in influencing market judgements (e.g. the credit ratings of developing country borrowers produced by rating agencies like Moody's Investor Service and Standard

5 An example is the sharp decline in prices for dollar-denominated "Brady Bonds" (*The Economist*, 1994), p. 92.

6 This is of course part of a larger question, i.e. whether the Fund's role in the international monetary system can be effective as long as it remains so restricted; the issue has been raised recently in Polak (1993). He questions the "widespread proprietory bias about the 'system' as belonging to governments" and suggests "that this bias may account for much of the disappointment in the actual working of the system".

and Poor's) to assist member countries that have come to depend increasingly on private market flows to manage their balances of payments.[7]

D. A new IMF facility?

Another question raised by the growth of private market flows is whether the Fund could be devising quick-activating credit mechanisms to help countries deal with sudden changes in capital flows, especially when these result substantially from circumstances beyond the recipient country's own control. In recent days, the idea for a new facility has been floated by an eminent international economist, Peter Kenen, in the following terms:

> The Fund should encourage its members, especially those that experience large capital inflows, to build up their reserves, by earmarking extra credit facilities for those countries' use ... The target (for reserve buildup) could be formulated in flow or stock terms, as an annual rate of increase in reserves or a level to be reached by a specified date. Once such targets were agreed, the Fund could recommend to the Executive Board that the countries meeting them be promised supplementary access to Fund credit, above and beyond their ordinary drawing rights. The amount of supplementary credit would be geared to each country's reserve target ... up to an agreed ceiling. The supplementary credit would be made available under the conditions normally applied to drawings in the first credit tranche, without imposing onerous policy conditions; it would be available *pari passu* with the use of the country's own reserves (Kenen, 1993).

The merit of such a facility would lie in countries not having to build up their reserves by as much as would be prudent if they could not count on using extra reserve credit. Thus the basic concept of the Fund as a "second line of reserves" would be strengthened by replacing the need for higher owned reserves through access to reserve credit.

Ideas for new short-term facilities have a long and generally checkered career in the Fund. The basic issue is whether a particular balance-of-payments problem can be identified *ex-ante* as strictly temporary and reversible and therefore justifying low policy conditionality. If the problem turns out not to be so, there can be a genuine concern that access to a large supplement to normal drawing rights would result in difficulties of repayment within the Fund's normal three-to-five-year reimbursement period. However, given the potential for volatility of private capital flows, there would appear to be merit in exploring the creation of such a facility, provided that a fairly tight policy-conditioned programme of adjustment were simultaneously negotiated, to come into effect once it became evident that the exogenous conditions that disrupted capital flows were not quickly reversible. The Fund would simply declare its willingness to consider granting a line of credit, leaving it entirely to the initiative of members whether they wanted to partake of it. Similarly, the fact that access to such a facility had been negotiated would again be entirely up to the member to publicize (or not), so that any signalling advantage to be gained out of the existence of supplementary access would be a matter for the member country authorities to decide. Given the ample liquidity currently available to the Fund, there would not appear to be any supply constraint on grafting a *rallonge* onto existing drawing rights to deal specifically with capital flow volatility; however, if the role of the Fund in influencing capital flows and helping to reduce their risks were to grow, it would be necessary to reconsider the size of the Fund.

E. Fund jurisdiction over capital movements

National monetary and fiscal policies have substantive consequences for private capital movements, and these policies would appear to be covered under the Fund's macroeconomic analytic mandate. However, there are too many microeconomic elements underlying the macroeconomic level in the case of capital account transactions to be confident that the Fund could monitor the distribution and efficiency of use of capital flows through its macroeconomic mandate alone.

While Article VI authorizing the Fund to request member countries to impose capital

[7] The issue clearly goes beyond that of the Fund's postures vis-à-vis capital markets. Fund staff reports based on periodic (usually annual) Article IV Consultation discussions are available only to governments and are often held to restricted circulation within the agencies that traditionally deal with the Fund, i.e. central banks and treasuries. Yet in the democratic societies of today, it can plausibly be argued that the Fund's surveillance function can prove effective only if its judgements enter the public domain and can be debated in public fora. For a contrary view, see Finch (1993).

controls can be safely dismissed (on a par with the "scarce currency" clause) as obsolete under today's conditions, it should still be interpreted as expressing a certain caution, if only because many capital flows go through asset markets and therefore would involve faster adjustments than current account transactions. Hence the analogy with the Fund's current insistence that developing member countries achieve current account convertibility with all possible speed should not be pushed too far; what the Fund needs to implement is a transitional legal regime for capital account transactions affecting developing countries that would permit them to reap the advantages of capital account liberalization while minimizing some of its more awkward consequences.[8]

Finally, there is an emerging issue of jurisdiction vis-à-vis the World Trade Organization (WTO). While the primacy of the Fund's jurisdiction has been explicitly safeguarded under GATT 1994 and the General Agreement on Trade in Services (GATS) in respect of current transactions, the possibility that measures to restrict capital flows can be undertaken outside the balance-of-payments safeguard provisions will require the Fund to clarify its own areas of responsibility in capital account transactions in order to avoid conflicts of jurisdiction.[9]

F. *Interface with trade issues*

The issue of coordination is, of course, much broader than any conflict of jurisdiction. There has been a plenitude of problems in ensuring consistency of policy advice to the common membership of the two Bretton Woods institutions and adding a third agency will not make coordination any easier, especially if the trade policy surveillance function takes on a broader policy scope. At its core is the concern that any trade liberalization process remains hostage to unpredictable exchange rate fluctuations brought about, in recent years, by massive movements of speculative capital, as in September 1992 in Europe and again in August 1993. Here the contrast between the rules and disciplines being accepted under GATT 1994 and the virtual abandonment of a code of conduct in the exchange rate area is stark. There is little that the Fund can do to improve the working of the international monetary system in the face of an unwillingness on the part of its principal shareholders to modify the present "non-system" of floating exchange rates among the major currencies. As the G-24 study pointed out, large changes in cross-rates, often the consequence of divergent macroeconomic policies in industrial countries, expose developing countries to risks that they do not generate and imposes costs by forcing them either to pay to hedge against them or to carry the risks where the hedging options are too expensive or simply unavailable. It would perhaps be in the interest of the majority of Fund member countries to move the international monetary system in a more orderly direction, such as through evolution towards some type of "target zone" arrangement. This, however, might have to await the day that industrial governments are able to regain some greater flexibility in their fiscal policies, though not in any fine-tuning sense, but rather as a means of relieving monetary policy in the medium-term from having to carry the responsibility for contra-cyclical adjustment, along with that of inflation control, as well as the promotion of exchange rate stability.

In the meantime, the Fund must continue to speak out against forms of "aggressive bilateralism" that focus incorrectly on bilateral trade or current imbalances; its full analytical capacities must be brought to bear on the issue of overall payments imbalances, which are determined over the long-run by the saving/investment nexus and by the behaviour of the real exchange rate and which are durably addressed by macroeconomic and structural policy changes rather than through trade practices. The Fund also needs to step up its regional surveillance activity, especially in the case of regional trading arrangements encompassing industrial and developing countries, to seek to assure that their evolution does not damage the multilateral trading and payments system or adversely affect developing countries, including those in South Asia and in sub-Saharan Africa, that might remain outside such regional groupings.

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8 These problems are described in the G-24 study and summarized in paras. 4 and 5 in the annex; see also Schadler *et al.* (1993).

9 The WTO is explicitly instructed to cooperate with the Fund and the World Bank with a view to achieving greater coherence in global economic policy making and its Director-General is required to review with the heads of the Bretton Woods institutions the implications of the WTO's responsibilities for joint cooperation.

ANNEX

Major conclusions of the G-24 Study

The level of world saving has declined between 1971-1980 and 1981-1990 and a larger proportion of it was absorbed by industrial countries, especially the United States. The industrial countries, as a group, registered a negative figure for *net* lending i.e. an excess of investment over saving, averaging 0.3 per cent of aggregate GDP in the 1976-1980 period, of 0.4 per cent in the 1981-1985 period and of 0.7 per cent in the 1986-1992 period, a rate that is projected to 1993-1994 in the *World Economic Outlook* estimates. While this is not reflected in equivalent external current account deficits, due to the existence of a statistical discrepancy, the persistence of a dissaving element, even after adjusting for unrequited transfers and net factor incomes, suggests an absence of any significant overall *real* transfer of resources from the industrial countries to the rest of the world over an extended period of time.

Over the same period, an excess of (gross) *private* saving over private investment indicated that it was public sector dissaving that produced the aggregate *net* lending statistic for the industrial countries as a group. The resulting accumulation of public sector debt - the ratio of gross public debt to nominal GDP in the OECD countries rose from about 40 per cent for the G-7 countries in 1970 to a little over 63 per cent in 1992 - would have a significant impact on the level of interest rates, especially when combined with a monetary policy stance designed to restrain inflation. Even after monetary policy moved to a more accommodative stance at the turn of the 1980s, the resultant decline in *nominal* interest rates did not produce an equivalent decline in *real* interest rates because of the inflationary risks seen by bondholders in the persistence of high public sector deficits. With public indebtedness continuing to rise relative to GDP, long-term *real* interest rates are likely to remain higher in the 1990s relative to levels prevailing in the 1960s and the first half of the 1970s. Model simulations at the World Bank indicate that, everything considered, developing countries stand to lose between one half to one per cent a year of income growth in the medium-term as a consequence of continued higher real interest rates.

A sharp rise in dollar interest rates at the beginning of the 1980s triggered the debt crises; a swing in the cost of borrowing of more than 18 per cent led to an abrupt increase in debt-servicing burdens for countries that had borrowed at adjustable short-term rates for dollar-denominated credits and were facing a simultaneous slowdown in export earnings due to the 1980-1982 recession in the United States and some other industrial countries.

The gradual restoration of credit-worthiness of a number of middle and low-middle income indebted countries that implemented major programmes of stabilization and structural reform, including financial liberalization, coincided with a period of declining returns to financial investments in major industrial countries experiencing recessionary conditions towards the end of the 1980s. The combined result was a surge in private capital market flows to developing countries - rising from under $22 billion in 1989 to over $47 billion in 1992 - the main growth being in portfolio flows drawn by high total returns on bonds and equities available in emerging markets. While easing the financial constraint and enlarging the availability of capital, and thus the potential for higher investment and growth, the inflows have created a number of concerns in recipient countries. These include the risks of an overheating of the economy, an unsustainable growth of private consumption, pressures on prices and speculative excesses in asset markets. To the extent that large capital inflows are channeled through the domestic banking system, systemic risks have intensified where the banks are unable to find appropriate credit outlets for the incoming funds. Most worrisome is the sense of vulnerability to a sudden reversal of the inflows, or their abrupt cessation, if the external factors were to turn around, such as a change in the monetary-fiscal policy mix in a major industrial country like the United States, resulting in a rise in international interest rates.

In order to reduce such uncertainty, one solution has been to build up foreign exchange reserves. Many developing countries find it difficult, however, to sterilize the monetary expansion associated with an accumulation of reserves and are left with two undesirable

options: either refrain from reserve accumulation, beyond a point, and allow the nominal exchange rate to appreciate or engage in non-sterilized intervention and allow the price-level to rise: in both cases, the currency appreciates in *real* terms and can create a competitiveness problem. If fiscal policy actions are also constrained in practice, and if the re-imposition of direct restrictions is ruled out, the remaining alternative is to accelerate structural reforms; enhancements in productivity emerging from advancing the reform process can over time improve the competitiveness of the economy.

About one third of the developing countries (out of a total of 130) peg to a single major industrial country currency; another four, all Middle East oil producers, also peg, but within slightly broader margins (than 2.25 per cent), to the United States dollar; with the exception of 23 developing countries that are characterized as "independently floating" all the rest are pegged within narrow or somewhat broader margins to a composite "basket" of the major currencies. Large fluctuations in cross-rates among the major currencies occasioned by disparate macroeconomic conditions and policies, create exchange rate disturbances for a large number of developing countries, especially single-currency peggers, e.g. the CFA countries.

Another set of effects arise from the currency composition of outstanding debt relative to the currency composition of net export receipts. With most primary products, including oil, invoiced and paid for in United States dollars, countries like Indonesia and Algeria, that have a substantial component of their debt denominated in non-United States dollars, incur severe liability management problems whenever there are abrupt changes of large magnitude in cross-rates between the dollar and non-dollar currencies over short periods of time.

Since real resource transfers involve current account changes, the correction of industrial country saving/investment balances links directly to levels of trade; thus the desired correction needs to be achieved at higher, and not lower levels of exports to, and imports from, the developing world. This emphasizes the imperative of resolving trade issues in a constructive way, especially in the area of agricultural export subsidization, the use of "contingency" protection devices and the exercise of implicit coercion on developing country trading partners in the context of bilateral and sectoral trade negotiations. It is also important to ensure that standards relating to environmental protection and labour welfare standards that are affordable in high-income countries do not undermine the basis for comparative advantage if poorer countries are required to meet them on pain of losing access. Also essential is the need to ensure that the spread of regional trading arrangements encompassing industrial and developing countries, of which NAFTA is a precursor, does not end up by discouraging open multilateral trade or having profoundly negative effects on countries excluded from regional groupings.

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3

GLOBAL MACROECONOMIC MANAGEMENT AND THE DEVELOPING COUNTRIES

*Yung Chul Park and Sangmoon Hahm**

A. Introduction

As markets are increasingly integrated globally, industrialized countries' firms, banks and households have become increasingly dependent on a healthy and growing developing world. Expanding and more open developing countries' markets would serve developed countries' exporters and investors, while households would enjoy relatively cheap imports from developing countries. Thus, if developing economies encounter an economic crisis, it will retard the economic growth of the developed countries. Even though such a crisis could result from the industrialized countries' monetary, fiscal, and exchange rate policies, there seems to be an almost total lack of consideration of the effects on the developing economies when the industrialized countries formulate their economic policies.

In this paper, we show how the economic policies of the industrialized countries affect the developing economies, and indicate what the governments of the developing countries should do about this. We first review how the G-5 and G-7 countries coordinate monetary, fiscal and exchange rate policies; then in section B we discuss the effectiveness of such coordination in terms of announced goals. We find that after a promising start in 1985-1987 (from the Plaza Agreement to the December 1987 telephone communiqué), the economic policy coordination deteriorated. The deterioration resulted from the fact that the G-7 members found it difficult to fulfil their fiscal policy agreement and to agree on foreign exchange market intervention tactics.

In section C, we show that the developed countries' economic policies affect the developing economy in many ways. First, developed countries' macroeconomic policies may affect the price of agricultural products or raw materials on which many developing countries exports depend. Second, developed countries' tight monetary policies contributed to the debt crisis in the early 1980s. Third, developed countries' policies, together with the state of their economies, resulted in huge foreign capital inflows to Asian and Latin American countries in the early 1990s.

In section D, we briefly indicate the need for establishing channels for conveying information between developed and developing countries. One such channel may be the Article IV consultations within the IMF. We then discuss what would be the appropriate exchange rate and fiscal policies for the developing economies. We also discuss ways to reduce volatile short-term capital inflows. Finally, we indicate the need for bank regulatory structure reforms to avoid a banking crisis that could result from huge capital inflows.

B. Policy coordination among industrialized countries[1]

1. Recent history

In the Bretton Woods system, which lasted until 1973, countries agreed to fixed, but adjustable, exchange rates. Exchange rates

* We are grateful to Shahen Abrahamian, Antonieta de Bonilla and participants of the G-24 Conference for helpful comments.

1 This section relies heavily on the works by Funabashi (1989) and Dobson (1991).

could be changed only with IMF approval. Governments were expected to adjust their monetary and fiscal policies to maintain the exchange rate objective, and were allowed to establish controls to restrict capital flows.

During the 1960s many Europeans accused the United States of flooding the world with inflationary dollars; the United States in turn charged Europeans with their failure to develop capital markets. Throughout the period many unilaterally revalued or devalued their currencies in violation of IMF disciplines and at times even without consulting the IMF. Increased capital mobility, decreased trade barriers and advances in information technology contributed to increase the spillovers of domestic policies. For example, a relatively expansionary United States monetary policy resulted in a rise in international inflation. These factors played a role in the demise of the Bretton Woods system in 1973.

The Bretton Woods system did not survive, but interest in reviving a fixed exchange rate system persisted, especially in Europe. In the early 1970s this resulted in the currency intervention arrangements known as the "snake", in which the EC central banks agreed to confine fluctuations among their currencies within a common margin of 2.5 per cent. These arrangements were superseded in 1979 by the launching of the EMS. Meanwhile, other governments expected that with a flexible exchange rate system they could pursue independent domestic policies without regard for spillovers and international consequences. Yet interdependence still remained. One reason was that countries were not indifferent to the value of their currencies. Another was that the rapid structural changes that had undermined the Bretton Woods system continued to increase the incidence and impact of spillovers. The oil price shocks, for example, created sizeable external imbalances, which governments could only deal with effectively in a cooperative fashion.

Several attempts to coordinate policy were made in and around the annual economic summits that were initiated in 1975. Economic performance in the 1970s was not satisfactory. Rising inflation, recession, and unemployment plagued the industrial economies. After the 1973 oil shock, policy priorities shifted to coping with the impacts of the oil price shock and the need to avoid beggar-thy-neighbour policies.

Current account and inflation constraints made it obvious that countries acting on their own could not solve the problem. The United States had been able to restore growth after the 1974-1975 oil shock and recession with a tax cut, but its current account and exchange rate came first under upward and then downward pressure. Part of the reason for the downward pressure lay with the United States policy of maintaining the domestic oil price below world prices. Meanwhile both Germany and Japan were running current account surpluses; the United States felt that more expansionary domestic policies were needed in those countries.

The leaders of the major industrial countries considered a policy bargain to address unemployment and oil import dependence at successive summits in London in 1977 and Bonn in 1978. In London, they were able to agree on growth objectives, but subsequently these objectives could not be attained. In Bonn, Germany committed itself to increase its fiscal deficit by 1 per cent of GNP, Japan to increase public spending if it failed to meet its growth target, and the United States to raise domestic oil prices to world levels.

The Bonn summit was criticized in the light of subsequent macroeconomic performance: inflation soared and was followed by the severe 1980-1981 recession. However, it was not a failure of coordination. The problem was the totally unexpected oil shock in 1979. The expansionary fiscal policy affected the inflation only marginally. However, monetary policies were too expansionary.

In October 1979 the Federal Reserve changed the conduct of United States monetary policy and adopted an anti-inflationary stance. Other central banks followed. The synchronization of monetary policy produced an aggregate restrictive effect that deepened the ensuing recession more than any single institution intended. Following the election of President Reagan in 1980, the new United States administration seemed to consider cooperative arrangements dispensable. After the United States reduced taxes, the structural deficit increased, creating a saving-investment imbalance and thus a deterioration in the United States external balance.

The G-5 Plaza Agreement in September 1985 introduced a change in the United States administration's exchange rate stance from one favouring freely floating exchange rates to one favouring exchange rate management. At the Plaza Hotel meeting, G-5 treasuries and central bankers agreed to coordinate their foreign exchange market interventions in order to accelerate the decline of the dollar.

The United States Treasury was aiming for a regular surveillance process that could lead to commitments to policy change. A surveillance procedure was adopted at the Tokyo

summit in 1986 and finance ministers were requested to make an annual report to the leaders at the summit. At the Venice summit in 1987 leaders broadly delegated economic matters to their ministers. In the absence of an economic crisis the summit agenda turned to other global issues, such as international drug trafficking and the environment in 1989, the reintegration of Eastern Europe in the world order in 1990, and the Uruguay Round of GATT negotiations.

In 1987 the major policy focus was (as it had been since the 1985 Plaza agreement) on foreign exchange market developments, the implementation of Louvre Accord policy commitments, and setting up a surveillance process. By 1988, the discussion centered on accounting for the unexpectedly strong growth after the 1987 stock market collapse, and addressing associated inflationary concerns. Tight monetary policies were favoured by the central banks, although the degree of concern about inflation varied from country to country.

Differing views had a profound impact on how coordination was developed after the Tokyo summit in 1986. An example is the February 1987 Louvre Accord. At that time, United States employment levels were high and domestic demand was robust, but its fiscal deficit was approximately 5 per cent of GNP, and its current account deficit was close to $140 billion, despite the substantial depreciation of the dollar. Japan and Germany, by contrast, were running large current account surpluses with growth remaining sluggish. Unemployment in Europe was high mainly due to restrictive regulations and other distortions. The interest rate differential between the United States, on the one hand, and Germany and Japan, on the other, narrowed throughout this period, thereby reducing the relative attractiveness of dollar-denominated assets, despite the coordinated round of discount rate cuts in the spring of 1986 and market perceptions that United States monetary policy would have to be tightened that year. By December 1986 the nominal value of the Deutsche mark climbed to 2.02 from 3.31 to the dollar in March 1985, a 64 per cent appreciation; the yen climbed to Y162.29 from Y260.24 at the dollar's peak in February 1985, a 60 per cent appreciation.

Policies to deal with these problems were to include a reduction of the United States fiscal deficit in order to restrain growth in domestic demand. To maintain world demand while United States demand was restrained, demand in countries with excess capacity was to be stimulated. Countries with structural rigidities, those in Europe, were to undertake microeconomic reforms in order to remove obstacles to growth and adjustment. Finally, some further depreciation of the United States dollar was considered to be helpful. This was essentially the policy package adopted at the Louvre meeting.

Yet the main focus of the Louvre meeting was on the mechanics of exchange market intervention. By mid-1986 Japan and Germany worried that further appreciation of their currencies would put an excessive burden on their exporters and lead to a recession and rising unemployment. The United States was interested in sharing the burden of adjustment: in exchange for United States cooperation to stabilize exchange rates, Japan and Germany were to stimulate domestic demand. Due to rising inflation and dependence on continued capital inflows to finance fiscal and current account deficits, the United States wanted to stabilize the dollar. These factors compelled the United States to enter into the currency stabilization arrangements at the Louvre.

The difference between the substance of the Louvre Accord (i.e. policy changes) and the focus at the ministerial meeting that produced the accord (i.e. exchange market intervention) was also a symptom of differing views of the surveillance process. One view, held by France and Italy, and from time to time by the United States, was an approach to coordination based on exchange rate intervention: if there were pressure on key exchange rates, coordinated intervention should be used and/or macroeconomic policies should be changed to keep the exchange rates unchanged.

The other view, held by Japan, Germany, the United Kingdom and Canada, and sometimes by the United States, was that the central objective was to reduce external imbalances. According to this view, if there is a pressure on the exchange rate, it reflects a change in the "fundamentals". Adjusting fiscal policies would remove the underlying shock that gave rise to the misalignment of exchange rates and the current account imbalances, but the response to that adjustment would necessarily include a realignment of real exchange rates. Monetary policy could act to hold nominal exchange rates fixed during this transition, but this would put the entire burden of adjustment on the domestic price level. These two approaches, however, should result in the same conclusion: agreement on intervention or changes in monetary and/or fiscal policies. In practice, however, disagreements arose about what was "fundamental", that is, requiring changes in exchange rates, and about whether intervention would also require changes in short-term interest rate policy (especially if such changes would conflict with the domestic objectives of monetary policy).

These differences of view continue to have an important effect on the evolution of the coordination process.

2. *The impact of policy coordination*

(a) Fiscal policy

Fiscal policy is the main tool for reducing external imbalances, because of its influence both on patterns of growth in domestic demand and output and on saving and investment activity. Fiscal restraint was sought in the United States from the mid-1980s, and in other deficit countries such as Canada and Italy. Fiscal consolidation in the United States, it was hoped, would slow domestic demand growth, reduce pressures on interest rates, reduce the attractiveness of the United States dollar vis-à-vis the other major currencies, and thereby reduce the external deficit. Japan and Germany also pursued medium-term fiscal consolidation in the first half of the 1980s, but tackling their large current account surpluses required faster growth of domestic demand than of output, and therefore fiscal stimulus in these countries became an issue in the coordination process later in the decade. More specifically, from 1982 through 1985 the United States and Canada were injecting fiscal stimulus (that is, increasing their deficits), while Italy, Japan, Germany and the United Kingdom were withdrawing stimulus. These stances were the opposite of what was needed to reduce the current account imbalances; thus they indicate the lack of international cooperation in those years.

However, by the time of the Louvre meeting in February 1987, governments were willing to coordinate fiscal policies. The United States planned to reduce the fiscal deficit to 2.3 per cent of GNP by 1988 and to hold the growth of public spending to less than 1 per cent of GNP in fiscal year 1988. Germany stated its willingness to increase the tax cuts planned for the fiscal year 1988; and Japan committed itself to consider a comprehensive plan to stimulate domestic demand, which was announced later in the spring and revised at the Venice summit. In the end, the United States withdrew stimulus marginally; Germany's stance became less restrictive. There was little change in Japan's stance. However, in respect of current account imbalances, measured as a share of GNP, the trends showed progress. The United States current account deficit dropped to 2.1 per cent of GNP in 1989 from its peak of 3.6 per cent in 1987. The Japanese surplus dropped to 2.0 per cent in 1989 from its peak of 4.4 per cent in 1986. The German surplus, however, after falling in 1987 from its peak of 4.4 per cent, climbed to 4.6 per cent in 1989.

(b) Monetary policy

Monetary policy, the chief instrument for achieving price stability, is not very useful in reducing current account imbalances. For example, tight United States monetary policy could reduce domestic absorption and thus help to reduce the trade deficit, but to the extent interest rates rise and the dollar appreciates as a result, the effect is to hinder the reduction of the trade deficit. The monetary policy commitments made public in the G-7 process have been relatively few, but those that were made have been carried out. In the Plaza Agreement, such commitments related in all cases to the attainment of price stability, with the exception of Japan's commitment to pursue a more flexible policy "with due attention to the yen rate". In the Louvre Accord, commitments departed somewhat from domestic preoccupations with price stability: Germany was willing to use monetary policy to improve growth conditions; Japan announced a discount rate reduction. The 1985-1989 period was one of fairly stable inflation in the G-7 countries. The few monetary policy commitments that had been made in the policy coordination process were carried out. Japan, however, pursued too much monetary ease after tightening in 1985: its GNP deflator rose gradually after 1987.

(c) Foreign exchange market intervention

Intervention by national authorities in the foreign-exchange markets affects exchange rates in two ways: through a portfolio balance effect and through a signalling effect. In the latter, intervention affects exchange rate expectations by signalling to the markets the authorities' future policy intentions. The portfolio balance effect, on the other hand, works by affecting the relative supply of bonds denominated in different currencies.

Most of the available evidence supports the conclusion that sterilized intervention may have a temporary signalling effect, but by itself has no lasting effect on exchange rates. Two official reports in the early 1980s came to the same conclusion. In 1983, the Working Group on Exchange Market Intervention concluded (in its Jurgensen Report) that sterilized intervention can have some short-run impact, but that it does not appear to have any long-run

impact on exchange rates. In 1985, deputies of the Group of Ten endorsed the 1983 conclusions in their final report, and observed that official intervention can play a role in reducing exchange rate volatility.

The effects of foreign exchange market intervention can be summarized as follows. First, the goal of the Plaza Agreement to accelerate the decline of the dollar was met; intervention had an immediate impact on the dollar, which fell 4 per cent in the days immediately after the meeting. This intervention resulted in the substantial decline in the dollar through early 1987.

Second, one goal of the Louvre Accord was to stabilize the dollar. Intervention was directed to this goal, as to some extent were changes in monetary policy, although inflation concerns in the United States were also very real. Some degree of stability was achieved, but the authorities set the reference range for the dollar at a higher level than would be consistent with slower growth in United States fiscal and trade deficits.

Third, following the collapse of world stock prices in October 1987, the goal was to stabilize the dollar after the publication of macroeconomic and structural policy commitments in the December G-7 communiqué. This goal was achieved: concerted intervention was successful in restoring the authorities' credibility. This may in turn have been a factor influencing stability in markets in subsequent months. The lowering of German interest rates late in 1987 also contributed to a change in interest differentials that began to favour the dollar.

Fourth, in the summer of 1988, the authorities wanted to stabilize the rising dollar. Intervention was undertaken by the United States and German authorities, and German interest rates rose. The interest differential moved against the dollar, and the dollar began to stabilize in August.

Finally, the record points to success in realigning and stabilizing the dollar within a range since late 1987. In nominal terms, the dollar hit a low of DM1.59 in the first week of 1988, and then varied between its December 1987 level and a peak of nearly DM2.00 in mid-1989. Against the yen, the dollar has followed a different pattern, reaching a low of Y123 in the first week of 1988, and moving into the range of Y144 to Y157 in the first half of 1990. In the second half of 1990, the dollar depreciated against both currencies: in real effective terms the United States currency fell to its lowest level in at least 30 years. The decline in the dollar has reflected a significant narrowing in interest rate differentials and strong cyclical growth in Japan and Germany at a time when United States growth slowed significantly.

So far, we have reviewed how the industrialized countries formulate monetary, fiscal and exchange rate policies in the context of G-7 meetings. As we have seen, after a promising start in 1985-1987, the coordination process among the G-5 and G-7 deteriorated. One of the main reasons for the deterioration was that the G-7 members found it difficult to fulfil their fiscal policy commitments and to agree on their foreign exchange market intervention tactics. In the future, coordination among industrialized countries might improve. With an integrated Europe, the G-7 could become a G-3 with representatives from the European Union, Japan and the United States (or the NAFTA). Such a reduction in the number of participants could increase the degree of cooperation. However, when the G-7 countries discuss policy coordination, they rarely consider the consequences for the developing economies. In the following section, we discuss how the policies of industrialized countries affect the developing countries.

C. *Economic structure of the developing economies*

To understand macroeconomic relationships between the developed and developing parts of the world economy, we need to know the typical characteristics of a developing economy's structure. First, financial markets in developing countries are heavily controlled. Governments keep interest rates below the equilibrium level, so that loans tend to be rationed. However, financial markets in many developing economies are currently going through internal and external liberalization. Second, direct government involvement in the economy extends beyond the financial markets. Governments own a significant portion of the economy's firms, and government spending is very high as a proportion of GNP. Furthermore, the government finances a large part of its outlays by printing money, which results in high inflation. Third, exchange rates are set by the government rather than determined in the market. In some countries different exchange rates apply to different categories of transaction. Private international borrowing and lending are heavily restricted. Finally, natural resources or agricultural commodities make up an important share of exports in many developing countries.

When a developing country has a current account deficit, it is selling assets to foreigners to finance the difference between its spending and its income. The capital inflows that finance developing countries' deficits typically take several forms. In the 1970s and the 1980s, developing countries borrowed directly from commercial banks in the developed countries. In 1970, roughly a quarter of the developing countries' external finance was provided by banks; in 1981 banks provided $98.3 billion in loans, an amount roughly equal to the non-oil developing countries' current account deficit for that year. Some Latin American countries became much more dependent on bank finance in the 1980s than average figures indicate. These countries' sharp shift toward bank finance was an important element in the post-1982 debt crisis. While direct foreign investment had been an important source of developing countries' external finance during the 1970s, it fell in the 1980s from over $20 billion in 1982 to just under $13 billion in 1987. In the late 1980s and the early 1990s, foreign capital flows to developing countries have increased sharply. During 1989-1992, capital flows to Asian developing countries amounted to $129 billion, and those to Latin America to $144 billion. In this period, commercial bank loans have been replaced by bond and equity portfolio flows and by foreign direct investment.

More specifically, the oil shock of 1973-1974 resulted in huge current account surpluses among OPEC countries. The surplus funds were lent to developed countries, and banks in those countries found it profitable to lend the funds to developing country borrowers. OPEC countries did not want to assume the risks of direct lending to developing countries and preferred to acquire safer assets located in industrial economies. At that time, banks in developed countries faced negative real interest rates at home; they were eager to lend to developing country borrowers. Even with a borrowing premium, developing countries faced historically low real interest charges for foreign loans, which encouraged them to borrow abroad.

The second oil shock brought a renewed surge in the current account surpluses of the main oil exporters in 1979. Oil producers' earnings were once again recycled to developing country borrowers. The developing countries borrowed close to $100 billion in that year to finance their overall current account deficits. From a year-end level of $336 billion in 1978, the indebtedness of these countries rose to over $600 billion by the end of 1982. In 1982, however, the oil exporters were themselves running a deficit, and therefore did not provide the funds to finance the still large deficit of the other developing countries. As a result, developing countries encountered difficulty in borrowing from developed country banks, even before the debt crisis erupted in the second half of 1982.

The severity of the debt crisis was tied to the developed country banks' practice of variable-interest-rate loan contracts. By the late 1970s, a large portion of developing country debt (particularly that of Latin American countries) carried variable interest rates. Heavy borrowing on a floating rate basis left developing countries exposed to the danger that a sharp rise in interest rates would increase their interest burden dramatically. Such an increase occurred in the late 1970s, and it set the stage for a widespread debt crisis comparable only with that of the 1930s.

Adverse effects came through two principal channels: United States interest rates and the dollar's exchange rates. As indicated in section B, the United States (and other countries' central banks) conducted tight monetary policies in 1979. Consequently, there were sharp rises in dollar interest rates and in the dollar's exchange market value. Thus, LIBOR, to which interest rates on many developing country loans are tied, rose sharply in 1979. This rise in LIBOR made new borrowing more expensive and increased the interest payments due on previous loans. The interest rate effect was reinforced by the behaviour of the dollar. Since much developing country debt is denominated in dollars, the dollar's appreciation increased the real value of the external debt service. As the world economy slid into recession in 1981, developing countries were carrying an unprecedented external debt burden. United States interest rates were at a peak, and these rates were reflected in payments on both new borrowing and older floating rate debt. Much of the short-term borrowing was coming due, and developing countries faced the choice of repaying these loans or refinancing them at historically high interest rates. Furthermore, as indicated, the overall current account surplus of the oil exporters turned to a deficit between 1981 and 1982; and with inflation falling throughout the industrialized world, commercial banks in the developed countries found they could now earn high real returns by lending at home. As a result, developing country debtors were finding it increasingly hard to borrow from the banks that had eagerly financed their earlier current account deficits.

The 1981-1983 growth slowdown in industrial countries had two immediate effects on the developing countries. First, as growth slowed in the industrialized world, they began to face diminished demand for their exports.

This fall in exports reduced the growth rate of output in developing countries. Second, the reduction in demand for developing countries' exports tended to lower their prices. Dependence on exports of agricultural products and raw materials poses a macroeconomic problem, because commodity prices are highly variable relative to those of manufactured goods. In turn, drastic shifts in the prices of a country's most important export goods cause corresponding shifts in real income and the current account. The fall in export prices caused a slump in the economy and a current account deficit. Thus, developing countries' export prices are particularly sensitive to macroeconomic policies adopted in industrialized economies.

A reduction in aggregate demand in the industrialized countries is quickly transmitted to the developing world through falling export volumes and commodity prices. Developing countries' real income declined, not only because output growth slowed, but also because the prices of the primary commodities they exported fell relative to the price of their imports. A further negative factor was increased protectionist pressure in a number of industrialized countries, which made it harder to sell in industrial country markets. After rising steadily from the mid-1960s to the 1980s, commodity prices plunged dramatically in 1981 and 1982. The fall in prices was not entirely due to the fall in worldwide aggregate demand. The dollar's appreciation also put downward pressure on dollar commodity prices. Latin American developing countries were especially hard hit: output growth was only 0.3 per cent in 1981 and -0.8 per cent in 1982. The staggering -2.7 per cent growth rate these countries suffered in 1983 was a direct result of the debt crisis, which started in August 1982.

In the years since 1982, American banks had reduced the share of developing country loans in their portfolios and increased the ratio of bank capital to such loans. With their balance sheets now less vulnerable to default, the banks were signalling their intention to play a tougher game with indebted countries. The resource transfer to developing countries dropped sharply in 1987 and output growth slowed in the problem debt regions. By early 1989, secondary market prices for developing country loans had reached new lows. With debt servicing problems, average GNP growth per capita in the developing countries was -0.8 per cent during 1981-1989, whereas it had averaged 2.6 per cent per year during 1970-1980.

In the late 1980s and early 1990s, many developing countries encountered a phenomenon not entirely of their own making: a huge increase in foreign capital inflows. Theoretically, capital inflows may reduce interest rates and generate an increase in demand and higher output. However, massive capital inflows can destabilize the economy. Massive capital inflows into the stock market will raise stock prices. As perceived wealth increases, household consumption and speculative real estate investments may rise. Consequently, the real exchange rate appreciates and exports decrease. Furthermore, if households increase borrowing to finance higher consumption and speculative activities, a banking crisis may result. Capital inflows, especially the ones intermediated by the domestic banking system, will increase money supply and the price level, which in turn raise the nominal value of assets. If financial institutions allow households to borrow more as the nominal value of collateral increases, it can lead to a banking crisis in which asset prices decline, as in the case of Finland and many other countries.

In an empirical investigation of ten Latin American countries, Calvo, Leiderman and Reinhart (1993) indicate that about one half of the capital inflows in these countries during 1989-1992 was caused by external factors: low interest rates and a recession in the United States. Capital inflows to Latin America, which averaged about $8 billion a year in the second half of the 1980s, surged to $24 billion in 1990, $39 billion in 1991 and $54 billion in 1992. In countries like Chile and Mexico, an important part of the inflows has financed increases in private investment; yet, in countries like Argentina and Brazil, there has been an increase in private consumption. Most countries have been experiencing a real exchange rate appreciation since January 1991. There was a large increase in United States dollar stock prices in major Latin American markets in 1991. This increase has resulted in similar rises in prices and regional market funds traded in the United States and elsewhere. Although the high differential rate of return on Latin American assets has been associated with a rise in capital inflows, the inflows have not decreased the large differentials. In some countries, such as Argentina, the interest rate differential decreased sharply as capital poured in; in others, such as Chile, interest rate differentials did not greatly change. These different patterns may reflect cross-country differences in the use of sterilized versus non-sterilized intervention. The external factors that affected the capital inflows were the sharp decrease in United States interest rates and the continuing recession in the United States and other industrialized countries. Foreign capital also flowed to Thailand in 1988 and to other Asian coun-

tries during 1989-1992. These inflows resulted from declining profit margins in Japan and the United States, which induced Japanese and American firms to relocate production to areas where lower wages prevailed.

There are differences in the way capital inflows affect the economy in these regions. In Latin America, capital inflows have been accompanied by real exchange rate appreciation; in Asia such an appreciation is less common. The differences in the composition of aggregate demand are relevant in determining whether the real exchange rate appreciates or not. First, for the Asian countries investment as a share of GDP increased by about 3 percentage points during the capital inflows period. For the Latin American countries, on average, investment decreased; the inflows during the 1990-1992 period were primarily associated with an increase in consumption. Second, the behaviour of public consumption also influenced the real exchange rate by affecting both the level and composition of aggregate demand. In some of the Asian countries, most notably in Thailand, the capital inflows coincided with a contraction in fiscal expenditure. These expenditure cuts may reduce the real exchange rate pressure, since the fiscal contraction tends to reduce aggregate demand; and public consumption tends to be more biased than private sector consumption towards non-traded goods. As for the conduct of monetary policy, sterilization had limited success in reducing monetary growth in Latin American countries. For the Asian countries the experience with sterilization policies was mixed. In countries like Malaysia, sterilization increased short-term interest rates and greater short-term inflows resulted, as was the case of Colombia in 1991 (Bercuson and Koenig, 1993). In countries like Singapore, sterilization polices were more successful in limiting the expansion in the credit and monetary aggregates. If credit growth is successfully limited, aggregate demand is curtailed and the pressure on the prices of non-traded goods is dampened. As for the composition of capital inflows, while in the Asian countries 44 per cent of the increase in capital inflows took the form of foreign direct investment, for the Latin American countries it only accounted for 17 per cent. It is to be noted that, if the capital inflows take the form of foreign direct investment, not usually intermediated through the domestic banking system, there is no accompanying domestic credit expansion and sudden capital outflows are less likely.

D. Policy options of the developing countries

As indicated in section B, the record of the G-5 and G-7 in constructing a workable process of policy coordination is a mixed one; after a promising start in 1985-1987, the coordination process has deteriorated in more recent years. The surveillance process became systematized, but the G-7 members found it difficult to fulfil their fiscal policy commitments and to agree on intervention tactics. However, as already indicated, with an integrated Europe the G-7 could become a G-3 with representatives from the European Union, Japan and the United States (or the NAFTA). Such a reduction in the number of participants might increase the efficiency of the coordination process and reduce the transaction costs of bargaining in the future. If this were the case, the impact of developed countries' economic policies on developing country economies would greatly increase.

The debt crisis and recent capital inflows into developing countries were at least partly due to developed countries' interest rates, exchange rates and macroeconomic situation. However, when industrialized countries formulate their policies, they rarely consider the consequences for the developing economies. One way to remedy this is to establish channels for conveying information and differing views upward, as well as for reporting discussions and decisions back downward. Information could be supplied from well-established fora for surveillance and policy cooperation, particularly Article IV consultations within the IMF. (Article IV of the IMF Articles of Agreement requires the IMF to maintain surveillance of members' exchange rates and economic policies and performance.) If such consultations take place on a bilateral basis between IMF staff and individual member countries, officials of other countries participate in detailed Executive Board discussions. Developing countries could use Article IV consultations to prevent sharp changes in industrialized countries' monetary, fiscal, and exchange rate policies.

1. On the policy responses to capital inflows

When the differential between domestic and foreign interest rates is large and the exchange rate is not expected to depreciate, the differential is likely to induce a massive capital inflow, as was recently the case in Latin America and Asia. Such a massive flow can desta-

bilize the economy, as has been the case in Finland and other countries (Akerholm, 1994; Mathieson and Rojas-Suarez, 1993). In the following we consider several measures that may slow down the inflow in such cases and discuss the issue of reforms in banking regulation.

(a) Monetary and exchange rate policies to reduce capital inflows

Sudden capital inflows tend to increase the money supply and cause exchange rate appreciation, which, in turn, will result in higher inflation and higher balance-of-trade deficits. Typically, sterilization, the exchange of bonds rather than money for foreign exchange, is the first line of defence against surges in capital inflow. Higher reserve requirements on bank deposits also discourage inflows to the banking system. Other policies that discourage foreign capital inflows include: various forms of central bank borrowing from commercial banks, the shifting of government deposits from commercial banks to the central bank, raising interest rates on central bank assets and liabilities, and curtailing access to rediscount facilities.

However, such policies could also discourage inflows of long-term capital, such as foreign direct investment. Furthermore, aggressive sterilization through open market operations risks intensifying the conditions that attracted capital inflows: by augmenting the supply of bonds, it puts upward pressure on domestic interest rates, sustaining an important attraction for additional inflows. In the case of Colombia, a substantial reduction in sterilization in mid-1992 resulted in a large drop in short-term interest rates, a slackening of inflows, and a deceleration of monetary aggregates. Furthermore, according to the experiences of Chile and Spain, financial market actors quickly found ways to evade the impediments to capital inflows. Within a year of imposition, impediments needed to be broadened several times. In Chile, reserve requirements were initially extended over the course of one and a half years, first to all foreign deposits and then to inter-bank deposits. A similar pattern occurred in Spain. In Spain, evasion also occurred by channeling inflows through subsidiaries of foreign companies, making them direct investment rather than loans or deposits.

To encourage long-term foreign direct investment and discourage short-term capital inflows, the government may reduce (or even eliminate) reserve requirements for longer-term borrowing from abroad, that is, the government may adopt a variable deposit requirement system such as the one used in Australia. The government may also create a long-term (say, five years or longer) domestic currency denominated bond exclusively for foreigners, and use it when sterilizing foreign capital inflows. The coupon rate of the bond may be anywhere between a long-term international bond rate and the domestic government bond rate.

(b) Fiscal policies that reduce capital inflow

Another policy to dampen undesired effects of capital inflows is to decrease government spending and, thus, lower domestic interest rates and production. As the differential between domestic and foreign interest rates narrows, capital inflows will slow down. Furthermore, as incomes decrease, imports will fall and the balance of trade improve. Finally, since government spending is intensive in non-traded goods, the demand for non-traded goods will decrease more than the demand for traded goods, and prices of non-traded goods will fall relative to those of traded goods. This results in a depreciation of the real exchange rate and an improvement in the trade balance. Even if the government cannot reduce the level of its spending, it can still lower the real exchange rate by shifting the composition of its spending in favour of traded goods.

The government may also impose (or raise) a consumption tax. Since consumption is also intensive in non-traded goods, a higher consumption tax tends to decrease the demand for non-traded goods. This, in turn, results in an increase in the relative price of traded goods and a depreciation of the real exchange rate. Similarly, any policy that promotes foreign direct investment may result in a depreciation of the real exchange rate, since investment is intensive in traded goods.

(c) Taxes on securities transactions and short-term borrowing

Taxes on short-term borrowing abroad have also been used in some countries to reduce capital inflows: for example Israel in 1978 and Chile in 1991. Imposition of a securities transactions tax may reduce the volatility caused by positive feedback traders who tend to trade frequently. (Positive feedback traders purchase securities when prices rise and sell securities when prices decrease.) The transactions tax

primarily affects short-term speculators, those who buy and sell within the trading day, or within days or weeks. The transactions tax has the property (on average) of automatically phasing itself out in long-term trading since, as a proportion of returns, it becomes negligible as the holding period increases. For short-term speculators such a tax may represent a significant proportion of the returns they hope to achieve on each transaction. These short-term traders believe that they can do better than the market, and that the extra return more than compensates them for the extra risk and extra costs (for instance, in information gathering) that such a strategy entails. Since short-term speculative activities will bear the brunt of the transactions tax, the tax will reduce the volatility caused by short-term speculators.

2. *Reform in banking regulation*

During the period of large capital inflows, credit growth may exceed deposit growth; rapid credit growth tends to strain credit approval and result in an increase in lending to more risky projects. Suppose that the system of prudential regulation is weak and that the levels of bank capital (in relation to risky assets) and provisions for loan losses are inadequate. If the government provides free deposit insurance (implicit in the Republic of Korea), an unstable macroeconomic environment would intensify the problem of moral hazard in the banking system. This appears to be what happened in the Southern Cone countries of Latin America in the late 1970s, and in the Philippines, Indonesia and Turkey. It was observed that in good times the banks kept all their profits and in bad times walked away from large losses, the bulk of which was covered by the government. Furthermore, penalties for such unsound banking practices were rarely enforced. Thus, banks had an incentive to provide risky loans at high interest rates. Even in a stable macroeconomic environment, such as the United States in the mid-1980s, a relaxation of prudential regulation led to financial breakdown. In an unstable macroeconomic environment, it may lead to an increased probability of default and an accelerated financial collapse.

When moral hazard is present, macroeconomic instability increases distress borrowing at higher interest rates by firms needing to roll over maturing debt, as well as by those near bankruptcy. Deposit insurance creates an expectation among banks and their borrowers that the government will rescue everyone. The result may be a perverse situation in which an increase in interest rates results in an increasing number of firms that are unable to service debt obligations and therefore are forced to borrow at higher interest rates. As this process continues, many firms exhaust their capacity to borrow, and non-performing loans carried by banks begin to grow rapidly. Due to poor government supervision, excessive risk taking is undertaken by banks in expectation that failure will pose no problem, because the government will bail them out, while success will mean substantial profits for their shareholders.

Thus, strong regulatory and supervisory policies are important to minimize moral hazards in the banking system, ensure the viability of the banking industry and make interest rate liberalization more effective. The regulatory authorities must strengthen prudential regulation with respect to capital requirements and the range of banking supervision. Prudential regulations should embrace the whole spectrum of risks in the banking industry: credit risk, as well as default, liquidity, interest and foreign exchange risks.

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Antonieta Del Cid de Bonilla

I would like to start my comments by sharing the points of view expressed by Azizali Mohammed in his comprehensive study prepared on the occasion of the interministerial meeting of the G-24 in September 1993, related to the increasing need to differentiate among developing countries. In fact, as he asserts, the dynamism in economic growth recently experienced by a number of countries in East and South-East Asia, the progress already achieved in the economic reform process of some Latin American countries, the transition process of the formerly centrally-planned economies of the East and the strong structural adjustment efforts under way in the 16 countries of sub-Saharan Africa, are clear evidence that currently it is no longer possible to talk about developing countries as a homogeneous group. This acknowledgement suggests that the effects on developing countries of industrial countries' economic policies will contain considerable differences.

Mohammed highlights in his paper the need to recognize the developing countries' growth momentum, mentioning that there is at least a presumption that higher growth rates could well be sustainable by a number of developing countries under their own momentum, especially where both trade and investment flows are growing faster through a process of mutual liberalization of trade and investment regimes among countries of a region. For that reason, he adds, better coordination and consultation with developing country policy-makers, through the Fund, should follow a recognition by industrial countries that their own prospects for a durable recovery and sustainable growth depend on the expansion of their trade with the developing world.

There seems to be some degree of contradiction between the above affirmations and the author's concern about the negative effects on developing countries of a sudden reversal of capital inflows, stemming mainly from the expected changes in United States economic policy that could be reflected in higher interest rates. Let me underscore some important remarks on capital movements. Capital flight experienced by several developing countries at the end of the 1970s and early 1980s was characterized mainly by the following three factors:

(1) external conditions, particularly the increase in the United States interest rates;

(2) domestic macroeconomic mismanagement in a context of interest and exchange rate rigidities (the monetary authorities used to settle limits on interest rates and exchange rate systems were administered or fixed); and

(3) domestic political instability.

With only a few exceptions, the above conditions have dramatically changed in recent years in developing countries that are recipients of strong capital inflows. There are external and internal factors involved. On the external side, the decline since 1991 of the United States interest rates has played an important role; on the internal side, the implementation of macroeconomic programmes towards economic stabilization and outward oriented growth and the consolidation of democratic processes, both factors diminishing the risk of investing either short- or long-term capital in these developing countries, are worth mentioning.

Taking this into consideration, and the fact that the difference between the earnings of domestic and external financial assets remains high in most cases, it is hard to imagine that a sudden change in the industrialized countries' economic policies, leading to higher yields for their financial assets, could result in a severe decline of capital inflows or, even more, in capital flight. Moreover, according to data presented by Mohammed in his G-24 study, the share of portfolio equity and bonds relative to overall capital inflows amounts to 9 per cent, while foreign direct investment accounts for 17.7 per cent. It is likely that the latter level will remain in developing countries as long as favourable macroeconomic and political conditions are sustained.

From this point of view, and taking into account that large capital inflows have posed a

number of problems in macroeconomic management for recipient countries, a slowing down of these inflows could result in relief for domestic macroeconomic policies. In fact, both speakers stated that large capital inflows could result in a reduction of external competitiveness, inflation or increased quasi-fiscal deficits, to the extent that central banks intervene through sterilization. Other possible effects they mentioned were the risks that could arise in the financing system.

In addition, if we consider that the decline in capital inflows is a temporary matter and a result of exogenous factors, it would be extremely reasonable to compensate a shortage of these inflows by using part of the accumulated international reserves, bearing in mind that most of the countries that have successfully accomplished economic reforms and stabilization programmes have also made significant progress in the implementation of more flexible exchange rate regimes.

In this context, I consider it very necesary to urge multilateral institutions to concede additional credit facilities, not for the purpose of compensating for temporary reductions in capital inflows, but in order to support a faster economic and productive transformation of developing countries that will ensure them long-term capital flows.

Regarding the paper prepared by Yung Chul Park and Sangmoon Hahm, I find it descriptive rather than analytic, suggesting general recommendations without being conclusive. I consider the authors give little importance to recent macroeconomic developments in developing countries. In a further effort, it would be important to reinforce this study by analysing the significant economic reforms implemented in many developing countries in recent years and the relevance of such reforms in differentiating the impact on these countries of the macroeconomic policies of industrial countries.

Shahen Abrahamian

Azizali Mohammed addresses a critically important issue, namely the implications for IMF policies arising from the effects on developing countries of the policies of developed countries. He begins by noting, quite rightly, that the pace of economic activity in the developing countries has a significant influence on the pace of activity in industrialized countries; that the weight of the developing countries in the world economy has been increasing (largely due to the phenomenal expansion in East and South-East Asia); and that the linkages need closer scrutiny and attention; and that East and South-East Asia may now be able to sustain its own growth momentum, independently of the course of industrialized countries.

There is one point in his argument, however, that gives me trouble. It is changes in the level of *net* exports (not gross exports) to developing countries that shore up economic activity in industrialized countries at times of recession. A balanced growth of exports and imports between developing and developed countries has a neutral impact on aggregate demand; the same is true of a growth of trade among developing countries.

It unfortunately still remains roughly true that developed countries "earn what they spend" (i.e. they create their own export markets in the South by purchasing imports from the South) whereas developing countries "spend what they earn" (i.e. their imports grow automatically with export growth). It would be preferable - for both developed and developing countries - if developing countries were always able to offset export shortfalls caused by recession in industrialized countries by borrowing and/or drawing on reserves rather than have to deflate. This point has, of course, been argued and discussed in the Fund, the Bank, UNCTAD and elsewhere for many decades. All the more pity, then, that the thrust of IMF conditionality in recent years has pushed in the opposite direction, even to the point of turning the Compensatory Financing Facility into what Sidney Dell aptly called a "fifth credit tranche". Would a "grandmotherly" Fund, whose main concern is to ensure that countries live within their means, look kindly on new ideas on how to introduce an "automatic stabilizer" into the world economy by making it easier for small commodity-dependent economies to ride out balance of payments shocks?

Besides, although the development argument in favour of stabilizing developing countries' foreign exchange receipts is as strong as ever, the idea is now much less appealing to the industrialized countries than it used to be. The fact is that the share of their exports going to primary producing countries is now much lower.

On the other hand, if commodity price volatility has lessened as a source of disturbance to the world economy, fluctuations in private capital flows have surely increased. Mohammed's paper is right to focus on this issue. He takes the view that the recent growth of private financial flows are the result of a *pull* (from better policies and improving conditions in recipient countries), and a *push* (from "policies and circumstances in major industrial country markets"). But there is also another factor at work in asset markets. History is replete with experiences of manias, crazes, bandwagons, bubbles, panics, and so on. Would one try to explain the Tulip Mania or the South Sea Bubble in terms of push or pull? These stemmed from the very nature of financial markets. (It is, I know, very hard for many people to accept the suggestion that "market forces" are not everywhere a solution, and can be the problem. But facts are even more stubborn than economists!)

I therefore find much merit in Mohammed's call for steps to be taken to minimize what he calls "the more awkward consequences of capital account openness". Personally, I would press this point harder: why should we take it for granted that capital account convertibility is the right goal? While I do see advantages in Peter Kenen's proposal for a facility to offset capital outflows, I worry that this would encourage countries to open up too much, instead of taking steps to keep out undesirable types of flows, steps that could include not only the traditional controls but also "market-based" measures.

This brings me to the paper by Yung Chul Park and Sangmoon Hahm, which provides a wideranging and informative discussion of the interdependence issue, including a very useful discussion of "Policies that reduce Capital Flows". Much more could, of course, be said on techniques to affect capital movements. We in UNCTAD shall be doing so in the *Trade and Development Report, 1994*, so I shall not take up your time now.

The thing that bothers me most in all discussions of policy coordination is the prevalence of pre-Keynesian thinking. We have a curiously bifurcated - or schizophrenic - approach. The Japanese economy is typically viewed from a Keynesian perspective, and even those who would look at horror at any suggestion for pump-priming elsewhere routinely call for fiscal deficits in Japan (this is put in terms of stimulating "domestic growth", the word "demand" not being inserted in between, as it should be to make sense, presumably because 'demand' is not a polite word to use, except when advocating its reduction!). Moreover, the fact that Japan is incurring big deficits by anyone else's standards is usually ignored, as is the fact that the Japanese Government very sensibly separates the current from the capital budget, and regards borrowing to finance the latter as entirely legitimate, not a symptom of fiscal laxity. Nor is anything said about the lack of flexibility in Japanese labour markets. (Until recently, anyway, there was no unemployment to speak of; does that not mean that Japanese labour markets must have been "flexible"?) But when one comes to Europe, an unadulterated pre-Keynesian approach is used, balancing the government accounts is regarded as an ultimate objective of policy, no amount of fiscal retrenchment is considered too much, and the unemployment is blamed almost entirely on "structural factors".

If we are to succeed in getting coherent macroeconomic policy coordination, we must, I think, unify our thinking and our analytic approach. We cannot pick and choose theory in accordance with political expediency, depending on whether a demand gap manifests itself as an external trade surplus or a domestic surplus of labour. Nor can we afford to wage a crusade against budget deficits as if they were the only thing that mattered. To succeed in coordination, much more weight must be given to the need for high and stable levels of activity in industrialized countries. There is too much focus on imbalances among countries, and too little on the aggregate gap between output and capacity output. Unless policy coordination is firmly anchored to some kind of high-employment target, the issue can easily be hijacked and turned into a question of country-by-country *surveillance* designed to ensure that countries put their own house in order, rather than being about how countries can adjust their policies to put the global economy in order. The surveillance approach will push in the direction of *convergence*, something which may well be the antithesis of coordination. And in view of the credence given to monetarist thinking, the stress on convergence will give a strong deflationary bias to policy and policy cooperation.

That is precisely what is happening in Europe. One would have thought that, given the high rates of unemployment and low rates of capacity utilization, the name of the game would be coordinated expansion. But not at all. The name of the game is convergence, in particular the Maastricht debt and deficit targets. These imply, for some countries, an absolutely massive fiscal retrenchment, comparable to Mexico's (even bigger in fact, since Europe unlike Mexico cannot lower its fiscal imbalances much by lowering inflation and thus bringing down the nominal interest rate).

Coordination for global balance would require attention to be given to indicators of global rather than purely national performance. The Baker proposal for the use of a commodity price index could have provided a way forward, but it has apparently led nowhere.

An aggregate current account target for the industrialized countries vis-à-vis the rest of the world would also be necessary, otherwise the objectives of individual countries may be impossible to reconcile.

This would, in turn, lead us naturally to consider the adequacy and predictability of long-term capital flows to developing countries, and thus to the question of official flows.

However, that subject has been banished from the international monetary agenda and relegated to a separate slot in international discussions. In this respect, we are back to where we were 50 years ago.

If international monetary cooperation continues to be a game of snakes and ladders, we can only hope that in the future the developing countries will have the good fortune to land on a ladder.

II. INTERNATIONAL LIQUIDITY, CAPITAL MOBILITY AND THE DEVELOPING COUNTRIES

4

INTERNATIONAL LIQUIDITY AND THE NEEDS OF THE WORLD ECONOMY

Ariel Buira

ABSTRACT

The efforts made 50 years ago to establish monetary cooperation on a world-wide basis resulted in the formation of the Bretton Woods institutions. The Second Amendment of the Fund's Articles of Agreement 25 years later, which broadened its responsibilities in the sphere of international liquidity by creating the SDR, expressed the international community's dissatisfaction with a monetary system in which the main source of liquidity expansion was the balance-of-payments deficits of the United States. It sought to find a more rational mechanism for adjusting the world's supply of international reserves to the needs of the world economy.

The paper describes the determinants of demand for international liquidity and, through regression analysis, confirms the existence of a stable relationship between demand for international reserves and the level of production, imports, and the variability of international transactions.

The sources of international liquidity are reviewed. While industrial countries and a small number of developing countries have ample access to international capital markets, most developing countries and economies in transition are limited to credits from governments and international financial institutions. The limitations of these credits and of the role of the Fund in the adjustment process are discussed.

The distribution of international reserves is analysed since 1960. Today, 22 industrialized countries and 18 developing countries hold 90 per cent of international liquidity, while some 138 countries with little access to international financial markets hold only 10 per cent of international reserves. Faced with a reserve scarcity, many low income countries are forced to reduce imports, with a consequent adverse impact on their economic growth and the expansion of world trade.

Taking a global view, the current mechanisms for the creation and distribution of international liquidity are found to be inefficient and inequitable. Moreover, there is no reason to expect that the growing demand for international liquidity will be matched by an appropriate expansion of supply.

Based on the existence of a stable demand function for international reserves, the liquidity needs of the world economy and of different groups of countries can be estimated. In this light, a proposal is presented to make the management of world liquidity consistent with the objectives of the IMF as established in article 1 of its Articles of Agreement (AMF, 1993a).

A. Introduction

Fifty years ago, the efforts made to establish monetary cooperation on a world-wide basis resulted in the formation of the Bretton Woods institutions: the International Monetary Fund and the International Bank for Reconstruction and Development. The Articles of Agreement of the International Monetary Fund (IMF) stated that the purposes of this institution, among others, were "to promote monetary cooperation, to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income of all member countries".[1] Twenty-five years later, in 1969, the Second Amendment of the Articles of Agreement broadened the Fund's responsibilities in the sphere of international liquidity by creating the Special Drawing Rights. The purpose was to enable the Fund to meet the need, as and when it arose, to supplement existing reserve assets. The objectives pursued by the creation of the SDR were summarized by the Managing Director of the Fund (IMF, 1969) as follows:

- the expansion of international trade, economic activity and development;
- the promotion of multilateral payments and elimination of restrictions;
- the promotion of exchange stability and orderly exchange rate adjustments;
- the correction of payments maladjustments and reduction in payments disequilibria without resort to measures destructive of national or international prosperity; and
- the avoidance of economic stagnation and deflation as well as excess demand and inflation in the world.

The Second Amendment of the Articles of Agreement of the IMF expressed the international community's dissatisfaction with a monetary system in which the main source of liquidity expansion was the balance-of-payments deficits of the United States, as well as the wish to find a more rational and effective mechanism for adjusting the world supply of international reserves to the global long-term needs of the world economy (IMF, 1972). In other words, the Second Amendment sought to satisfy international liquidity requirements without having to rely on the deficits of some countries becoming the source of reserves for others.[2]

For developing countries, the Second Amendment was especially important, in view of its stated purposes of "developing the productive resources of all member countries" and of "promoting the expansion and balanced growth of international trade". While many of the imbalances of developing countries resulted from domestic factors, these were magnified by the difficulties these countries faced in gaining access to commercial and financial markets.

This paper describes the determinants of the demand and supply of international liquidity, and assesses the functioning of the existing mechanisms for its creation and distribution. Section B will deal with the demand for international reserves, while section C will analyse the sources of international liquidity, and the role played by the IMF in the adjustment programmes in view of the purposes set forth in article I of the Articles of Agreement and in the Second Amendment. Section D will consider the main aspects of the distribution of international liquidity, attempting to answer the question of whether or not the current scheme is efficient and equitable. Finally, section E sets forth the paper's conclusions.

B. The demand for international liquidity

International liquidity is generally defined as the total internationally acceptable means of payment immediately available to the authorities of any individual country, either for financing the country's balance-of-payments deficit or for intervening in exchange markets to stabilize the value of the country's currency (Fleming, 1961). The traditional definition, by referring only to resources actually held by the country's monetary authorities, excludes resources that may be accessed by using assets held by residents of that country in widely accepted currencies. Furthermore, the traditional definition does not consider resources to which a country may have potential access, such as credits from international agencies, monetary authorities of other countries, banks and other private sources.

1 Article 1 of the Articles of Agreement of the International Monetary Fund.

2 Ever since the Second Amendment, it was clear that if an "asset settlement" facility was established for all member countries, the SDR would become the main source of reserve creation.

Although the concept of international liquidity is broader than that of international reserves, it is at the same time not only vaguer, but also virtually impossible to measure. For this reason, for purposes of quantitative analysis, the concept of international reserves is normally used as an approximation to international liquidity.

The different factors affecting the demand for international reserves have been widely discussed in the economic literature (for example, Cooper, 1970; Landell-Mills, 1988). Among those more frequently recognized are:

- The balance of the requirements of government and private entities and individuals for carrying out international transactions. As is evident, there is a direct relationship between, on the one hand, the demand for reserves, and, on the other, the volume of international trade, the variability and seasonality of foreign exchange revenues and expenditures, and the magnitude of the balance-of-payments deficit.

- The need for intervention in the exchange markets. Under fixed exchange rate systems, the monetary authorities require liquidity to cover the differences between the supply of and demand for foreign exchange. Even in countries with a flexible exchange rate, central banks intervene in currency markets to reduce the volatility of the exchange rate arising from short-term capital movements and other factors.

- The need to show a strong financial position. Broadly speaking, a high level of international reserves fosters confidence in the stability of the country's economic policy and in the value of its currency; it also facilitates borrowing abroad.

- Attention to future contingencies. This is a precautionary reason. Faced with the risk that external credit may not be available when required in future, the authorities hold a higher stock of reserves than would be desired in a situation of easy access to it. The greater the difficulty in obtaining external financing, the greater the demand for reserves. For this reason, industrialized countries and some others with ample access to external credit, maintain relatively low levels of reserves as a proportion of the value of their imports.

- As with any other type of assets, holding international reserves has costs. In practice, the financial cost tends to be measured as the difference between the interest rate on the country's international liabilities and the rate of return on reserves. At low levels, the opportunity cost of holding reserves includes the negative effects on production and employment of reducing imports in order to protect the level of reserves.[3]

There is a considerable number of empirical studies on the demand for international reserves.[4] These include both "equilibrium" and "disequilibrium" econometric models. The first assume that the adjustment between supply and demand for reserves is instantaneous. The second approach allows for a lag between supply and demand, i.e. it assumes an adjustment process in which changes in the actual level of reserves in a given period are determined by the difference between desired and actual levels observed in the previous period. It should be noted that, despite this conceptual difference in the approaches, the independent variables used as determinants of the demand for reserves are very similar. Clearly, several of the abovementioned determinants of the demand for international reserves do not allow an easy quantification. Consequently, only some are considered in the various econometric estimates of this variable.

To represent a country's international transactions, analysts have used either the value of national production or that of imports. The coefficient in both cases is expected to show a positive sign. The average propensity to import has been used as an approximation to the marginal propensity to import or to the degree of openness of an economy. Generally, the import propensities have a positive sign. As an indicator of the financial cost of holding reserves (r), the difference between the interest rate on the country's external debt and the returns on investing international reserves, has been used. However, estimates using this variable have generally not yielded significant results.

Finally, an indicator of the variability of international transactions seeks to measure the effects of factors such as variations in harvests or terms of trade, and lags between foreign exchange receipts and outlays. Although the econometric approaches used to estimate demand for reserves consider different measures

3 In other words, the opportunity cost can be expressed as the difference between the return that could be obtained if the funds were employed at home (via imports) and the rate of return on reserves.

4 Possibly the most representative are the studies by Heller and Khan (1978), Bilson and Frenkel (1979), Lizondo and Mathieson (1987), and Landell-Mills (1988).

of variability, their coefficients are found to be significant and positive.

The estimates in this study were made with the equations used by Bilson and Frenkel (1979) for the case of the "disequilibrium" approach, and by Frenkel (1983) for the "equilibrium" approach. The estimates cover a longer period than their original estimates and include recent years.

1. *Equilibrium approach*

The equation of the equilibrium approach is:

$$\ln Rt = \beta 0 + \beta 1 \ln Zt + \beta 2 \ln Yt + \beta 3 \ln mt + ut,$$

where: R = real international reserves; Y = real product; m = the average propensity to import; Z = a measure of the variability of international transactions,[5] and t = an index of time.

An 18-year period was considered (1975-1992)[6] for 20 developed countries and 29 developing countries.[7] Regressions were estimated separately through cross-section and time-series analysis. The objective was to analyse the implications for reserve demand of country groups having unequal access to external financing and of some countries being issuers if reserve currencies.

In addition, two sub-periods were considered: 1975-1981 and 1982-1992. This division sought to measure the impact of the external debt crisis on the determinants of the demand for international reserves for each group of countries.[8]

Table 1 displays the coefficients of the estimates obtained for each period, as well as the corresponding values of the "t" statistics.

From the results obtained from the regressions, the following conclusions may be drawn:[9]

(a) The elasticities of demand for international reserves in relation to income and the average propensity to import are higher for developing countries than for industrialized countries. This may be explained by the fact that developing countries have limited access to secondary sources of international liquidity. In contrast, developed countries have a lower accumulation of reserves owing to their easy access to capital markets. Additionally, account

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5 To calculate the variability indicator 18 regressions were run for each country derived as: $RNT = \beta 0 + \beta t-1\ T + u$; where $T = t-15,...,t-1$. RNT = nominal international reserves in the year T. Subsequently, the value of the coefficient $\beta t-1$ is used to calculate:

$$Z^*t = \sum_{T=t-14}^{t-1} (R_T - R_{T-1} \quad \beta_{t-1})2 / 14$$

which is defined as the variance of changes in the levels of nominal international reserves (RN), adjusted by trend. To this measure of variability the square root was applied and it was divided by nominal imports of the corresponding year (IMt). $Zt = Z^*t / IMt$, thus deriving the measure of variability of international transactions.

6 This period was considered because it complements Frenkel's and Lizondo's estimates, whose analyses cover the period from 1963 to 1984. This is why in other parts of the document a longer period is covered: 1960 to 1992, and for some information through September 1993.

7 Except for two developed and three developing countries (omitted due to statistical problems), the countries selected for this analysis are those included in the papers by Frenkel (1983) and Lizondo and Mathieson (1987). This was done with the objective of comparing the results and pondering the stability of the demand for international reserves over different time periods. In the case of the developed countries they include: the United States, Canada, Australia, Japan, Austria, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom. The developing countries are: Argentina, Brazil, Chile, Colombia, Egypt, the Republic of Korea, Costa Rica, the Dominican Republic, Ecuador, El Salvador, the Philippines, Ghana, Guatemala, Honduras, India, Israel, Jamaica, Jordan, Malaysia, Mexico, Panama, Pakistan, Paraguay, Peru, Sri Lanka, Sudan, Thailand, Tunisia and Venezuela.

8 The data used were taken from IMF, *International Financial Statistics*, November 1993. The national currency values of the gross national product were converted into dollars using the average exchange rate for the same year. All series used in the regression were deflated by the GDP deflator for the United States with the base as 1985. The figures used were in billions of dollars.

9 The above coefficients were obtained with generalized least squares, since with the method of ordinary least squares the value of Durbin-Watson reports a first-order auto-correlation. Table 2 shows the differences in the estimations obtained with each of the two methods. In general, the coefficients obtained from the regressions are very similar, both to those of Frenkel (1983) and Lizondo and Mathieson (1987). It should be noted that if one wishes to make comparisons with the estimations reported by Lizondo and Mathieson (1987) then one must consider estimations of ordinary least squares, which was the method used in this article. This author did not report the Durbin-Watson values in his regressions.

Table 1

ESTIMATES OF DEMAND FOR INTERNATIONAL RESERVES BASED ON THE EQUILIBRIUM MODEL

$$\text{Ln } R_{n,t} = \beta 0 + \beta 1 \text{ Ln } Z_{n,t} + \beta 2 \text{ Ln } Y_{n,t} + \beta 3 \text{ Ln } m_{n,t}$$

(Generalized least squares)

	Industrial countries						*Developing countries*					
Period	$\beta 0$	$\beta 1$	$\beta 2$	$\beta 3$	*R2*	*Standard error*	$\beta 0$	$\beta 1$	$\beta 2$	$\beta 3$	*R2*	*Standard error*
1975-1992	-0.541	0.2417	0.8842	0.6424	0.96	0.282	-0.344	0.491	1.171	1.082	0.9	0.5
	(-1.98)	(4.13)	(25.15)	(5.34)	D.W.	1.9	(-1.42)	(1031)	(23.07)	(11.71)	D.W.	2.0
1975-1981	-0.469	0.276	0.953	0.897	0.93	0.349	-0.369	0.438	1.142	0.996	0.86	0.565
	(-1.07)	(2.88)	(19.89)	(5.32)	D.W.	2.0	(-1.08)	(6.39)	(15.78)	(6.93)	D.W.	1.9
1982-1992	0.323	0.447	0.954	0.957	0.96	0.279	0.31	0.631	1.181	1.347	0.89	0.526
	(1.13)	(6.46)	(26.40)	(7.36)	D.W.	1.9	(1.03)	(9.25)	(21.06)	(13.22)	D.W.	2.0

Table 2

ESTIMATES OF DEMAND FOR INTERNATIONAL RESERVES BASED ON THE EQUILIBRIUM MODEL

$$\text{Ln } Rn,t = \beta 0 + \beta 1 \text{ Ln } Zn,t + \beta 2 \text{ Ln } Yn,t + \beta 3 \text{ Ln } mn,t$$

		Industrial countries						*Developing countries*					
Period		*β0*	*β1*	*β2*	*β3*	*R2*	*Standard error*	*β0*	*β1*	*β2*	*β3*	*R2*	*Standard error*
Estimates by J. Frenkel													
1963-1972	O.L.S.	4.108	0.594	1.059	1.353	0.85	0.504	4.848	0.0317	1.191	1.428	0.76	0.623
		(16.5)	(8.03)	(27.15)	(13.53)			(21.55)	(5.11)	(29.78)	(14.42)		
1963-1972	G.L.S.	4.196	0.315	0.953	0.582								
		(10.18)	(3.79)	(12.22)	(3.11)								
1973-1977	O.L.S.	3.381	0.75	1.106	1.619	0.85	0.543	3.346	0.575	1.114	1.02	0.77	0.694
		(8.81)	(5.47)	(22.57)	(7.39)			(10.79)	(5.99)	(2.15)	(8.72)		
1973-1979	O.L.S.	3.615	0.636	1.105	1.52	0.86	0.532						
		(12.47)	(6.06)	(29.08)	(9.5)								
1973-1984	O.L.S.	3.748	0.432	1.031	0.925								
		(8.13)	(3.63)	(13.22)	(4.24)								
Estimates by S. Lizondo													
1963-1972	O.L.S.	4.028	0.612	1.061	1.361	0.85	0.503	4.172	0.511	1.212	1.545	0.78	0.616
		(16.00)	(8.24)	(34.71)	(13.72)			(20.77)	(9.17)	(30.67)	(16.02)		
1973-1977	O.L.S.	3.418	0.721	1.107	1.598	0.84	0.547	3.111	0.662	1.065	1.023	0.77	0.682
		(9.17)	(5.27)	(22.53)	(7.11)			(10.83)	(7.28)	(21.06)	(8.99)		
1973-1979	O.L.S.	3.647	0.62	1.108	1.533	0.85	0.535	2.834	0.746	1.086	1.067	0.79	0.659
		(12.18)	(5.87)	(28.26)	(9.23)			(11.88)	(9.96)	(26.74)	(11.50)		
1980-1984	O.L.S.	2.771	0.788	1.085	1.473	0.89	0.475	2.407	0.787	1.192	1.346	0.81	0.68
		(7.79)	(7.12)	(28.34)	(10.38			(8.54)	(9.41)	(25.80)	(12.62)		
1973-1984	O.L.S.	3.505	0.59	1.083	1.376	0.86	0.532	2.947	0.674	1.116	1.131	0.78	0.702
		(15.13)	(7.81)	(38.40)	(12.55)			(15.96)	(11.90)	(35.31)	(15.65)		
Our estimates													
1975-1992	O.L.S.	0.838	0.612	1.037	1.221	0.89	0.444	-1.71	0.482	1.207	1.281	0.76	0.769
		(5.13)	(15.28)	(47.72)	(16.22)			(-0.97)	(12.69)	(38.32)	(17.91)		
	G.L.S.	-0.541	0.2417	0.8842	0.6424	0.96	0.282	-0.344	0.491	1.171	1.082	0.9	0.5
		(-1.98)	(4.13)	(25.15)	(5.34)			(-1.42)	(1031)	(23.07)	(11.71)		
1975-1981	O.L.S.	0.625	0.541	1.077	1.403	0.87	0.492	-0.289	0.448	1.161	1.081	0.74	0.758
		(2.04)	(7.54)	(27.77)	(10.44)			(-1.04)	(7.58)	(21.76)	(9.23)		
	G.L.S.	-0.469	0.276	0.953	0.897	0.93	0.349	-0.369	0.438	1.142	0.996	0.86	0.565
		(-1.07)	(2.88)	(19.89)	(5.32)			(-1.08)	(6.39)	(15.78)	(6.93)		
1982-1992	O.L.S.	0.972	0.662	1.009	1.092	0.91	0.406	0.178	0.586	1.229	1.432	0.78	0.753
		(5.14)	(13.58)	(39.43)	(12.37)			(.79)	(11.49)	(32.21)	(16.05)		
	G.L.S.	0.323	0.447	0.954	0.957	0.96	0.279	0.31	0.631	1.181	1.347	0.89	0.526
		(1.13)	(6.46)	(26.40)	(7.36)			(1.03)	(9.25)	(21.06)	(13.22)		

should be taken of the fact that a few developed countries are issuers of reserve currencies; therefore, their demand for reserves tends to be less sensitive to the variables here considered.

(b) In general, for both groups of countries the variable with the greatest relative importance is the national product (GNP or GDP), whereas the least significant one turns out to be the variability of international transactions.

(c) The estimated elasticities of demand for international reserves of developing countries are higher in 1982-1992 than in the period 1975-1981. This may be interpreted as an increased use of international reserves as a source of liquidity, given that this group of countries had very restricted access to international credits, particularly from 1982 to 1987.

(d) The estimated elasticities of demand for reserves in relation to income and to the average propensity to import change less in industrialized countries than in developing countries between the two periods considered. This is consistent with points (a) and (c) above.

After obtaining estimates of demand for international reserves for developed and developing countries, an estimate was made of how the elasticities of demand for reserves of reserve-currency countries differ from those of the rest of the industrialized world. As expected, the results show that reserve-currency countries present substantially lower elasticities of demand for international reserves in relation to the average propensity to import (m) and the variability of international transactions (Z) than those of all other developed countries (see table 3).

2. *Disequilibrium approach*

The disequilibrium model requires the use of two equations:

$$\ln RDn = \beta 0 + \beta 1 \ln Zn + \beta 2 \ln Yn + \beta 3 \ln mn + un \quad (1)$$

$$\ln Rn,t - \ln Rn,t{-}1 = \alpha + \beta (\ln RDn,t - \ln Rn,t{-}1) + en,t \quad (2)$$

Equation (1) defines long-term demand for international reserves (RDn) of country "n". These values are obtained from the averages of the dependent and independent variables for the period in each country. The regression of this equation with the averages provides estimates of the coefficients and residuals for each observation, which represent the "specific factor" (un) of the corresponding country. By applying the coefficients and adding the residuals to the independent variables in each annual observation, the value of the desired reserves in a particular year and for a specific country can be obtained, i.e.:

$$\ln RDn,t = \beta 0 + \beta 1 \ln Zn,t + \beta 2 \ln Yn,t \; \beta 3 \ln mn,t + un$$

Equation (2) defines the adjustment process of the stock of international reserves. The independent variable is derived from the difference between the desired reserves at the start of the period t and the observed reserves at the end of the period t-1. The coefficient defines the speed of adjustment of the observed reserves to the desired reserves.[10]

In contrast with the high R^2 obtained by the equilibrium approach, the R^2 of the disequilibrium approach are very low;[11] however, the levels of significance are good (see table 4). Comparing the results of the two periods (1975-1981 and 1982-1992), the speed of adjustment can be seen to decrease in both groups of countries (to approximately 0.4 from 1982 on, compared to the 0.5 figure in the 1975-1981 period). These results are consistent with the fact that one of the sources of reserves, foreign borrowing, was restricted for developing countries, so that reserves could only be accumulated through surpluses in the current account.

In sum, the estimates confirm that a stable relationship exists between the demand for international reserves and the level of production, the average propensity to import, and the variability of international transactions. The results show that the demand for international reserves of developing countries tends to be more sensitive to variations in income and international trade than that of developed countries. In addition, the variable that tends to have the higher elasticity in reserve demand is the value of a country's national product. This, coupled with the difficulties of access to secondary sources of liquidity, means that in periods of low reserves developing countries have little room for manoeuvre. In other

[10] The data used for this approach, as well as the periods and countries considered, are exactly the same as those used in the case of the equilibrium approach described above.

[11] These results coincide with those of other authors (Bilson and Frenkel, 1979).

Table 3

ELASTICITIES OF DEMAND FOR RESERVES OF RESERVE CURRENCY AND NON-RESERVE CURRENCY COUNTRIES

(Generalized least squares)

	Industrial countries					
	$\beta 0$	$\beta 1$	$\beta 2$	$\beta 3$	*R2*	*D.W.*
Reserve currency countries [a]	-1.10 (-1.41)	0.48 (3.79)	1.08 (5.90)	0.69 (2.73)	0.80	1.80
Non-reserve currency countries	1.00 (2.54)	0.64 (8.01)	1.01 (23.35)	1.14 (6.57)	0.94	2.00

a France, Germany, Japan, the United Kingdom and the United States.

words, the accumulation of reserves usually has a higher cost for developing countries - in terms of lower imports and production and employment - than for industrialized countries.

Finally, it is important to highlight that the existence of a stable relationship between, on the one hand, the demand for international reserves, and, on the other, production and international trade, makes it possible to estimate the liquidity requirements of the world economy.

C. *Sources of international liquidity*

The primary sources of international liquidity are gold, foreign exchange (reserve currencies and government securities) and allocations of Special Drawing Rights (SDRs). These primary sources constitute the "international monetary base" for financial intermediation between governments, central banks, official financial institutions and private international banks. The secondary sources of international liquidity, for their part, comprise the trading and issuance of international assets that distribute and multiply the initial supply of the means of payment.[12]

The termination of the convertibility of the United States dollar into gold, the breakdown of the system of fixed exchange rates and the adoption of a regime of floating exchange rates initiated in 1971, led to a diminished importance of gold in the total "international monetary base". From 40 per cent of the international reserves of IMF member countries in 1970, gold holdings dropped steeply in the years that followed to 9 per cent of the total in 1980 and fell thereafter to the current 4 per cent (see table 5). Conversely, the proportion of foreign exchange in total international reserves rose from 57 per cent in 1970 to 94 per cent in 1992.

In reviewing the currency composition of the reserves, the dominant role of the United States dollar is clearly evident. Although the relative importance of that currency has been decreasing in recent years (table 6), to date more than half of total international reserves are still denominated in United States dollars.[13] Throughout the period covered by this study United States payments imbalances have been the main supplier of liquidity to the world economy.

When reserve-currency countries record payments deficits, they have the freedom, at times considerable, to settle them without undertaking adjustment policies. The rest of the world's acceptance of their currency as a

12 The possibility of multiplying the international means of payment created by primary sources occurs basically in the Eurocurrency markets. Friedman (1971) notes that "The existence of the Eurodollar market increases the total amount of dollar balances available to be held by nonbanks throughout the world for any given amount of money (currency plus deposits at Federal Reserve Banks) created by the Federal Reserve System. It does so by permitting a greater pyramiding on this base by the use of deposits at United States banks as prudential reserves for Eurodollar deposits."

13 The loss of relative importance of the dollar is explained basically because government securities denominated in other reserve currencies are more attractive, since they offer higher yields.

Table 4

ESTIMATES OF DEMAND FOR INTERNATIONAL RESERVES BASED ON THE DISEQUILIBRIUM MODEL

$$\text{Ln Rn,t} - \text{Ln Rn,t}-1 = \beta 0 + \beta 1 (\text{Ln RDn,t} - \text{Ln Rn,t}-1)$$

(Ordinary least squares)

	Industrial countries				Developing countries			
Period	β0	β1	R2	Standard error	β0	β1	R2	Standard error
Estimates by J. Frenkel								
1964-1972	0.053 (3.31)	0.54 (9.82)	0.32	0.208	0.049 (2.72)	0.415 (8.83)	0.21	0.295
Estimates by S. Lizondo								
1964-1972	0.053 (3.25)	0.545 (9.79)	0.32	0.208	0.053 (3.26)	0.384 (8.19)	0.19	0.267
1973-1977	0.025 (1.03)	0.412 (5.31)	0.2	0.257	0.046 (1.59)	0.751 (10.29)	0.4	0.33
1973-1979	0.044 (2.13)	0.401 (6.45)	0.21	0.249	0.056 (2.61)	0.653 (10.86)	0.34	0.333
1980-1984	0.009 (0.44)	0.552 (6.98)	0.3	0.221	-0.005 (0.17)	0.496 (7.43)	0.25	0.347
1973-1984	0.037 (2.34)	0.268 (5.83)	0.12	0.258	0.072 (3.52)	0.315 (7.31)	0.12	0.393
Our estimates								
1975-1992	0.006 (0.39)	0.295 (6.04)	0.1	0.263	0.046 (2.42)	0.202 (6.18)	0.07	0.418
1975-1981	0.001 (0.062)	0.487 (5.16)	0.18	0.243	0.037 (1.33)	0.52 (6.66)	0.21	0.365
1982-1992	0.041 (2.25)	0.38 (0.38)	0.15	0.25	0.048 (2.00)	0.418 (7.88)	0.18	0.402

reserve asset enables these countries to finance their payments deficits simply through the issuance of currency. In other words, these countries are not obliged to pay for their imports by running down reserves or through the sale abroad of goods and services. They enjoy the considerable benefit of international "seigniorage".[14]

The United States has been the country that has made the greatest use of this recourse. The United States balance-of-payments outcome depends on its levels of savings and investment. These in turn, are affected by economic policy measures often aimed at correcting internal imbalances. It follows that changes in the United States balance-of-payments account and, consequently, in its contribution to the international monetary base, need not coincide with the world economy's needs for liquidity.

Although primary liquidity creation is a reserve-currency country's prerogative, other developed countries encounter few difficulties in satisfying their demand for international means of payment. First, because they have wide access to secondary sources of liquidity, and second, because of the existence of lines of credit among their central banks ("swaps") that assure them rapid access to sizeable amounts of resources in case of any contingency, allow-

[14] By "seigniorage" is understood the current value of income from investments made thanks to the placement of the issued monetary liabilities, less the current value of interest payments to their holders and the expenses of the issue.

Table 5

TOTAL RESERVES AND THEIR COMPOSITION

(Per cent of total)

	Total reserves	*Gold*	*SDR*	*Foreign currency*
1970	100.00	39.78	3.35	56.87
1975	100.00	18.37	4.51	77.12
1980	100.00	9.43	3.33	87.24
1985	100.00	7.61	4.15	88.24
1990	100.00	4.80	3.03	92.17
1991	100.00	4.53	2.92	92.55
1992	100.00	4.04	1.77	94.19
1993-III	100.00	4.24	1.90	93.86

Source: IMF, *International Financial Statistics.*

ing the adjustment process to be carried out smoothly and, consequently, in a less costly manner.

For developing countries as a whole, access to international financing reached important amounts in recent years. In 1992, the net flow of resources[15] channelled to these countries grew 27 per cent in real terms. Direct foreign investment flows grew at an annual rate of 34 per cent during the period 1990-1992. Furthermore, there is clear evidence that the demand for securities issued by developing countries has increased substantially: the share of developing countries in new bond issues rose from 2.1 per cent in 1989 to 8.7 per cent in the first half of 1993; at the same time, their share of total stocks sold abroad reached 40.9 per cent during 1992 and 32.5 per cent in the first half of 1993.

However, the number of countries that have benefited from this important flow of resources is very small. One cannot pass over the fact that, in 1992, 59 per cent of total direct foreign investment flows channeled to developing countries were concentrated in only five of them. On the other hand, of the more than 150 countries that the IMF considers to be developing, only 27 currently place securities on international markets, and only seven of these accounted for 85 per cent of bond issues and over 50 per cent of stock offerings during 1992.[16]

The situation of low-income developing countries and of the so-called "economies in transition" is particularly difficult. The main sources of external financing for these countries are international financial institutions and credits from governments.

However, access to official credit is subject to certain difficulties. First, the process for obtaining these resources is usually slow. For instance, the disbursement of credits earmarked for infrastructure projects from international development banks[17] may take several years. Secondly, the preparation of projects may become a real problem in some countries owing to the shortage of qualified professionals. In other cases, countries are not able to provide the counterpart funds required by some credits. On the other hand, credits that allow for a rapid disbursement are often conditioned to the

[15] That is, the sum of net flows of long-term official and private debt, plus donations, excluding technical assistance, plus the net flow of direct and portfolio investment.

[16] The five countries that received the bulk of direct foreign investment were: Argentina, China, Malaysia, Mexico and Thailand. The seven that account for the placement of securities were: Argentina, Brazil, China, Hungary, Mexico, the Republic of Korea and Turkey. More dramatic is the fact that Argentina and Mexico accounted for 66 per cent of the flow of direct foreign investment to Latin America in 1992, and that Mexico accounted for 33 per cent of bonds and 25 per cent of stock issues sold abroad for all developing countries in that same year.

[17] The World Bank, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank and others.

Table 6

CURRENCY COMPOSITION OF RESERVES [a]

(End of period)

	1975	*1980*	*1985*	*1990*	*1991*	*1992*	*1992* [b]
All countries							
United States dollar	79.4	68.7	64.8	57.5	58.4	64.4	55.3
German mark	6.3	13.8	15.1	18.6	16.5	13.0	12.5
Japanese yen	0.5	3.5	8.0	8.8	9.4	8.1	7.8
Pound sterling	3.9	2.9	3.0	3.4	3.6	3.2	3.1
French franc	1.2	1.2	0.9	2.3	2.8	2.5	2.4
Swiss franc	1.6	3.1	2.3	1.4	1.4	1.3	1.3
Netherlands guilder	0.6	0.9	1.0	1.1	1.1	0.7	0.7
Not specified	6.5	5.9	4.9	6.9	6.8	6.8	16.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: IMF, *Annual Report* (various issues).

a The SDR value of ECUs issued against United States dollars is added to the SDR value of dollars, but the SDR value of ECUs issued against gold is excluded.

b Monetary composition of reserves when holdings of ECUs are considered as a separate reserve asset. The share of ECUs in total holdings of currencies was 17 per cent for industrial countries and 9.4 per cent for all countries.

adoption of certain economic measures that may face strong political resistance.

Second, official agencies have increasingly limited resources. The net transfer of resources[18] from official financial institutions (bilateral and multilateral) to low-income countries decreased from an average figure of $10.6 billion during the period 1987-1989, to $8 billion in 1992. Furthermore, the net use of IMF credits by these countries (purchases less repurchases less interest payments) has been negative in the last seven years,[19] except in 1992, in spite of the great balance-of-payments needs of these countries.

A third difficulty comes from the increase in the number of countries that compete for this type of financing, particularly as the formerly socialist economies have become members of the Fund. It is to be noted in this respect that the number of IMF member countries increased from 155 to 178 between 1991 and 1993. Given the enormous financial needs of these countries, and the important political considerations involved, international financial institutions have channelled substantial amounts of resources to them.[20]

In addition, development banks at times tend to concentrate their resources in the larger developing countries or in those with a higher level of development, because they present a greater number of well prepared projects and offer greater creditworthiness.

Under these circumstances, the group of low-income developing countries, which encompasses 60 per cent of the world's population, and includes those countries with the most urgent needs for financing, has accounted for only about 30 per cent of the total flow of borrowing resources channelled to all developing countries in the last three years.

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18 Disbursements less amortizations less interest payments (World Bank, 1993).

19 IMF, *Annual Report*, several years.

20 The share of the so-called "economies in transition" in total financing granted by the IMF increased from 8.7 per cent in 1990 to some 15.7 per cent in 1993. In the case of stand-by arrangements, over 60 per cent of the resources were channelled to these countries in 1993 (35.9 per cent in 1990). The participation of the formerly socialist economies in the flow of Official Development Assistance increased from 1.4 per cent in 1990 to 7.1 per cent in 1992. This reallocation of resources limits the amounts available for the developing countries.

The limited resources of these countries makes them very vulnerable to external payments problems. Thus, with restricted external financing, meeting their international obligations often forces them to contract their domestic demand significantly. The outcome of this situation is lower levels of investment and economic growth, with the ensuing social cost and the perpetuation of high levels of poverty and unemployment.

Forcing low-income developing countries to rebuild their international reserves by reducing their imports and obtaining lower growth rates contradicts any strategy for their development and for the expansion of world trade.

The role of the IMF merits consideration given its influence on the availability of international liquidity. From the purposes set forth in the Articles of Agreement of the IMF, it is easy to conclude that this institution should play a central role in the process of creation and distribution of international liquidity. The Fund is a primary source of liquidity because it has the power to make unconditional allocations of SDRs to member countries in proportion to their quotas in the institution.

Although SDRs are the first reserve asset to be created by an international decision with the purpose of becoming the main reserve asset on a world scale, their share in the total international reserves of IMF member countries fell from 9 per cent in 1971 to 2.1 per cent in 1993. The marked decline of the SDR share in international liquidity is related to the infrequency with which the Fund has allocated this international asset and the small amounts allocated.[21] SDRs were created in 1969, and were last allocated in 1981.[22]

In addition to allocating SDRs, the IMF participates in the distribution of international liquidity through two channels: (a) granting credit directly to its member countries, and (b) serving as a catalyst so that countries can obtain resources from other official and private sources.

However, the IMF is facing difficulties in carrying out these tasks effectively. The first problem is due to the size of the Fund itself. The sum of member countries' quotas as a proportion of world trade (exports plus imports) reached its historical maximum of 7 per cent in the late 1950s, and has fallen to the 2.7 per cent it now represents (see table 7).

Further to the Ninth General Review of Quotas, the IMF terminated its policy of enlarged access. This had permitted it to borrow and place these funds at the disposal of those member countries whose financial needs exceeded the amount they could draw from IMF resources, albeit at higher interest and with shorter amortization periods.

Moreover, the access limits to IMF credit as a percentage of quotas, were reduced from 110 to 65 per cent in one year, and from 440 to 300 per cent over three years as of November 1992. Within the Fund (IMF, 1992) little importance is given to this, with the argument that in this way the institution maintains its liquidity position for the coming years, and that member countries' potential access to financing is not impaired in absolute terms. No consideration is given to the fact that available resources, in themselves limited, have suffered a sharp relative decrease as a result of the reduction in the size of the Fund.[23]

It is also important to note that since the debt crisis, the mix of adjustment and financing in IMF programmes has displayed a marked shift toward adjustment, despite the burden that debt service imposed for highly indebted countries. Thus, these countries have had to implement adjustment programmes while making substantial net transfers of resources to creditors. It is not surprising therefore that the adjustment programmes of these countries met with numerous failures.

Partly as a result of constraints on financing, the implementation of an economic programme negotiated with the IMF does not guarantee a successful adjustment. In an analysis of 266 programmes backed by the IMF over the period 1979-1989, Killick and Malik (1992) and Killick, Malik and Manuel (1992) show that a little over half of these programmes (52 per cent) failed, in the sense that they did not attain their targets and the countries were not able to disburse all the resources they had

21 In addition, the characteristics that have been imposed on the SDR limit its attractiveness. Unlike other international reserve assets, these can be maintained only by the monetary authorities of member countries and 15 other official holders. Since no market exists where SDRs can be exchanged directly for other reserve currencies or negotiable instruments expressed in these, outside the Fund they cannot be used to intervene in foreign exchange markets and their usefulness as a reserve asset is severely limited.

22 There are in fact 34 member countries that have not participated in SDR allocations simply because they joined the IMF after 1981.

23 At the same time, the cost of IMF resources is high. Over the period 1989 to early 1994, the IMF charges, adjusted for "burden sharing", remained above the United States Government's cost of funds. This result reflects the policy of reducing the non-remunerated part of the reserve tranche of member countries.

Table 7

RATIO OF IMF QUOTAS TO MERCHANDISE TRADE

(Billions of dollars)

	(A) *Total IMF quotas*	*(B)* *Total trade*	*(A) / (B)* *(Per cent)*
1950	8.037	116.100	6.922
1955	8.751	174.100	5.026
1959	14.640	209.900	6.975
1965	20.932	355.800	5.883
1970	28.776	596.500	4.824
1976	44.997	1899.900	2.368
1978	74.628	2508.900	2.975
1983	95.389	3475.200	2.745
1990	122.280	6755.600	1.810
1992	199.161	7409.200	2.688

Source: IMF, *International Financial Statistics*; "Financial Organization and Operations of the IMF", Treasurer's Department, *Pamphlet Series No. 45*, Third Edition.

available.[24] Although IMF programmes on average financed 9.9 per cent of countries' imports, successful programmes on average financed 16.9 per cent, while in failed programmes the IMF financed only 6 per cent. This suggests that many of the failures were due to insufficient funding.

There was also a marked tendency to reduce imports during the period when the programmes were in operation. At the same time, investment rates fell substantially, not only during the programme years, but also in the years immediately following. This association of programmes with lower investment rates would seem to be inconsistent with the objectives stated in article 1 of the Fund's Articles of Agreement of facilitating the expansion of trade, economic activity and development, and of supporting adjustment without resorting to measures destructive of national and international prosperity.

It has been argued that, more than providing funds, the IMF's approval of a programme plays an important "catalytic role" on inflows of external credit and investment. However, experience shows that this effect is generally weak. Consequently, insufficient funding on the part of the IMF is not offset by inflows of private capital. Therefore, it is not surprising that many programmes fail due to underfinancing.[25]

Another case worth mentioning is that of programmes affected by temporary exogenous factors, such as a drop in the terms of trade, floods, droughts and other natural disasters. The Fund does not provide countries with adequate financing to face these temporary situations; on the contrary, it usually demands further adjustment measures from them.

It should be recalled that one of the basic ideas of the Bretton Woods agreement was a distinction between temporary external payments problems and those brought about by structural factors. In the first case, it was not considered advisable to implement measures aimed at restraining domestic demand because of the deflationary effects that this would entail for the country and for the world economy as a whole. This philosophy has changed radically since the early 1980s. Today, a typical IMF programme prescribes measures that require a compression of domestic demand, i.e. con-

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24 Edwards finds that most countries which have followed IMF programmes show a certain improvement in their external accounts and in their inflation levels, but that in meeting growth targets, these programmes have been successful much less often. Khan reaches similar results via a review of IMF programmes implemented in developing countries between 1973 and 1988 (Edwards, 1990; Khan 1990; Buira, 1983 and 1988).

25 It has been suggested that the catalytic role of the Fund is currently fulfilled through additional official rather than private capital flows. Nevertheless, this is a weak argument since, as explained above, net transfers of resources from official creditors to low income countries have diminished significantly over the last years.

traction of salaries in real terms and reductions in government spending, regardless of the problem's origin (Killick, 1992). This clearly shows that there is reduced willingness to co-operate in the solution of problems that affect numerous developing countries.

D. *Distribution and adequacy of international reserves*

An analysis of the distribution of international reserves from 1960 to September 1993, shows important changes in the relative participation of industrial economies and developing economies (see table 8). From 1960 until the early 1970s, industrialized countries maintained approximately 80 per cent of international reserves, while developing countries held the remaining 20 per cent.

With the 1973-1974 increase in international oil prices there was a large transfer of resources from developed country net importers of crude petroleum, to certain developing countries. Consequently, a considerable change came about in the distribution of international reserves on a world scale. The share of industrialized countries fell to around 60 per cent of the total by 1975, and remained at this level, with a few fluctuations, until 1993.

The marked downward trend of the participation of industrialized countries in total reserves is explained mainly by developments in reserve currency countries, particularly in the United States (see table 8). Expressed as a percentage of the world total, United States international reserves fell by 25 percentage points between 1960 and September 1993, i.e. from 32.3 per cent to merely 7.3 per cent.

Developments in the distribution of reserves within the developing countries as a group are of even more interest. For analytical purposes these were divided into three groups. The first includes 18 countries that currently have access to international financial markets on a voluntary basis.[26] The second group contains those petroleum producing countries not included in the first group,[27] while the third group comprises all the remaining developing countries. The results are shown in table 8.

As can be seen, the increased participation of developing countries in total world reserves from 1960 to 1993 is accounted for by those countries with access to international financial markets. The proportion of international reserves held by these countries shows a continued upward trend in the period examined. In fact, it grew from 7.5 per cent in 1960 to 31 per cent in September 1993.[28]

The situation in the rest of the developing world is totally different. The first "oil shock" meant that producer countries were able to increase their participation in total world reserves substantially in the early 1970s. However, figures show a continued drop in later years to levels lower than those observed in 1960. In the case of the other 94 countries there were no major changes throughout the period examined; in September 1993 they held barely 8 per cent of world reserves.

The above clearly shows that world distribution of international reserves is extremely uneven. Today, 22 industrialized countries and 18 developing countries control 90 per cent of international liquidity. In these circumstances, some 138 developing countries have no voluntary access to international financial markets. Furthermore, 110 of them hold only 10 per cent of total international reserves.[29] These are inadequate to allow these countries to utilize their economic potential. Low income countries face the most pressing needs for international reserves and have the greatest difficulty in gaining access to them. Faced with a reserve scarcity, these countries are forced to reduce imports below the levels they could otherwise have attained; this in turn affects the sales of their trading partners.

Table 9 shows the months of imports covered by reserves in the various country

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26 The following countries were considered: Argentina, Brazil, Chile, China, Colombia, Hungary, Indonesia, Israel, Malaysia, Mexico, the Philippines, the Republic of Korea, Singapore, South Africa, Taiwan Province of China, Thailand, Turkey and Venezuela. Other developing countries with access to international financial markets were excluded, either because of lack of information, or because they have not resorted to markets in the past two years, or because they have a less than 0.5 per cent share in total securities and/or stock issues in foreign markets. It should also be noted that although it is true that these 18 countries have had access to voluntary international financial markets, this has been insufficient in many cases.

27 Although some oil countries have voluntary access to international financial markets, their participation is very modest.

28 In several countries the increase in international liquidity is accompanied by a rise in the ratio of external debt to reserves.

29 The IMF *International Financial Statistics* does not publish information on international reserves for the rest of developing countries, but it is known that they are low, and that in some countries the situation is precarious.

Table 8

DISTRIBUTION OF INTERNATIONAL RESERVES BY GROUPS OF COUNTRIES

(Per cent)

	1960	*1970*	*1980*	*1990*	*1993* [a]
All countries	100.00	100.00	100.00	100.00	100.00
Industrialized countries	83.89	77.86	60.47	65.90	58.59
Reserve currency countries [b]	57.24	43.67	35.02	33.04	31.99
United States	32.28	15.54	6.06	8.94	7.26
Non-reserve currency countries	26.65	34.18	25.45	32.85	26.61
Developing countries	16.11	22.14	39.53	34.10	41.41
With access to international capital markets [c]	7.47	11.08	14.71	24.57	31.33
Oil producers	2.31	4.01	16.09	3.77	1.89
Others	6.33	7.05	8.73	5.76	8.18

Source: IMF, *International Financial Statistics.*

a As of September.

b France, Germany, Japan, the United Kingdom and the United States.

c The following countries are included: Argentina, Brazil, Chile, China, Colombia, Hungary, Indonesia, Israel, Malaysia, Mexico, the Philippines, the Republic of Korea, Singapore, South Africa, Taiwan Province of China, Thailand, Turkey and Venezuela. Other developing countries with access to international capital markets were excluded because of lack of information, because they have not resorted to markets in the past two years or because they account for less than 0.5 per cent of total securities and/or stock issues in foreign markets.

groups considered.[30] The conclusions that can be drawn from these figures are consistent with those from the analysis of the distribution of total reserves. However, a remark should be made about the evolution of this indicator for developing countries. The import coverage of reserves for this group as a whole rises over the period studied. This indicator falls (with some fluctuations) in the case of oil producing countries; it increases substantially for countries with access to international financial markets, and to a lesser extent for the remaining countries.

The latter, i.e. those which do not have access to international financial markets on a voluntary basis and which are not important oil producers, present the most interesting case. The import coverage of reserves in these countries rose from 2.1 months in 1960 to 2.2 in 1980 and 2.8 in 1990. During 1991 and 1992 the reserves to imports ratio rose considerably for this group of countries, reaching 3.7 in the latter year. At first sight, this coverage of foreign purchases would seem satisfactory. However, it is explained by the evolution of this ratio in a group of 21 countries whose aggregate imports stagnated over the period 1990-1992.[31] In other words, for most countries in this group the increased coverage of imports by reserves observed in recent years was due to policies of import contraction that limited their rate of economic growth and the expansion of world trade.

Therefore, the concern of some industrialized countries about the possible inflationary repercussions of a moderate injection of liquidity into the world economy is surprising, particularly at a moment when the rate of inflation in many of them is the lowest of the last 20 years.

Can we assume that the growth of international reserves over the coming years will be consistent with a satisfactory expansion in

30 In the case of certain countries the figures do not include those years when the IMF did not publish information on international reserves and/or imports.

31 IMF, *International Financial Statistics*, several issues. The countries are Afghanistan, Bahrain, Bangladesh, Bhutan, Botswana, Burundi, Costa Rica, Egypt, Fiji, Guatemala, Guyana, India, Morocco, Mauritius, Nepal, Paraguay, Peru, Tonga, Togo, Vanuatu and Zaire.

Table 9

IMPORT COVERAGE OF INTERNATIONAL RESERVES

(Months)

	1960	*1970*	*1980*	*1990*	*1992*
All countries	5.75	3.69	2.79	3.42	3.28
Industrialized countries	6.97	3.75	2.34	2.93	2.59
Reserve currency countries [a]	8.18	3.70	2.27	2.43	2.24
United States	14.18	4.10	1.28	1.98	1.58
Non-reserve currency countries	5.29	3.82	2.45	3.70	3.13
Developing countries	3.01	3.51	3.93	5.02	5.24
With access to international capital markets [b]	4.01	4.34	3.35	5.85	6.00
Oil producers	4.74	6.68	9.78	7.17	4.33
Others	2.11	2.23	2.17	2.79	3.68

Source: IMF, *International Financial Statistics.*

a France, Germany, Japan, the United Kingdom and the United States.

b The following countries are included: Argentina, Brazil, Chile, China, Colombia, Hungary, Indonesia, Israel, Malaysia, Mexico, the Philippines, the Republic of Korea, Singapore, South Africa, Taiwan Province of China, Thailand, Turkey and Venezuela. Other developing countries with access to international capital markets were excluded because of lack of information, because they have not resorted to markets in the past two years or because they account for less than 0.5 per cent of total securities and/or stock issues in foreign markets.

world trade and production? The examination of the sources of international reserves made in section C suggests that it is highly unlikely that this will be the case. Furthermore, on past experience the pattern of distribution of reserves among countries can be expected to continue to be inefficient and inequitable.

The above problems, which reflect a gap in international cooperation, stem from the absence of an international institution that effectively weighs and provides for the liquidity needs of the world economy as a whole and of the different groups of countries. In compliance with its Articles of Agreement, the International Monetary Fund should be called upon to perform this task. As the econometric estimates presented in section B show, there is a stable relation between the demand for international reserves and world production and trade. Thus, it is possible to estimate the liquidity needs of the world economy as a whole and that of different groups of countries.[32]

Under current rules, an increase in international reserves of the order of magnitude required over the next few years would be the result of chance. There is no reason to expect that the growing demand for reserves will be satisfied by an equivalent expansion in supply. Therefore, it is necessary to develop mechanisms that will provide certainty that the future evolution of world reserves will be consistent with a healthy growth of GDP and international trade. This matter, which is of crucial importance to the international community, should be managed in a rational and responsible manner.

E. Conclusions

Our study of the evolution of international liquidity over the last 30 years has shown the following:

[32] Based on these econometric relations the demand for international reserves of the world economy over the next few years was estimated. The purpose of this exercise was simply to illustrate the increase in reserves consistent with a satisfactory evolution of world production and trade. The results of the estimates made are shown in table 10. Details of these projections are given in the annex.

(1) Despite the objectives that the international community has set itself since the creation of the Bretton Woods institutions, and especially since the Second Amendment, the growth of international liquidity depends on the external imbalances of the world's major economies, which continue to be the main source of international liquidity. In addition, access to secondary sources of liquidity, i.e. the international capital markets, is largely limited to industrialized, and a few developing countries.

(2) The present distribution of international liquidity is inefficient and inequitable. Most countries in the world are forced to limit their imports and level of activity to avoid payment crises. The situation of low income countries is particularly serious, as their need for international reserves is greater and their access to them more difficult.

(3) The IMF has not played the central role in the creation and distribution of international liquidity assigned to it. In addition, its resources have gradually decreased as a proportion of world trade and are insufficient to provide adequate support to adjustment programmes. As a result, these programmes often fail, and, even when successful, generally give rise to high costs in terms of unemployment and low economic growth.

(4) Although the international community adopted the objective of making SDRs the principal reserve asset, their share in international liquidity has decreased notably and today the SDRs are of little importance.

(5) The present problems related to the creation and distribution of international liquidity, are largely due to the fact that no institution effectively evaluates the needs of the world economy and how they can best be met. Therefore, it is unlikely that left to itself the supply of international liquidity will match the liquidity requirements of the global economy and of the different groups of countries, so as to "facilitate the expansion and balanced growth of international trade, and contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members".[33]

(6) Since the demand for international reserves is a stable function of the behaviour of production and world trade, it is possible to determine the liquidity needs of the global economy and of the different groups of countries.

(7) In the same manner that the central bank of each country estimates every year what the economy's liquidity needs will be under certain price and GDP growth assumptions, the International Monetary Fund could estimate the overall liquidity needs of the world economy, and of different groups of countries, considering their access to the various sources of international liquidity. Based on this analysis, the international community could, through the IMF, consider what measures would be appropriate to adjust the supply of international liquidity to levels consistent with growth with stability in the world economy.

(8) To this end, the IMF could allocate SDRs for the appropriate amount to be distributed among member countries according to their quotas. Industrial countries could donate their allocation to international institutions, such as the International Monetary Fund and the World Bank. These in turn would make them available to those developing countries facing difficulties of access to other sources of finance.[34] The benefits for the world economy of a better management of world liquidity seem evident.

33 See Article 1 (ii) of the Articles of Agreement of the IMF.

34 These international institutions might also consider the possibility of partly subsidizing the interest rate charged on the use of these resources in the case of low income developing countries.

ANNEX

Estimates of the demand for international reserves 1993-1998

Two scenarios were considered for the period 1993-1998 for both the industrial and developing countries. The first scenario takes the medium-term estimates given in IMF (1993b, October) as its starting point. These figures assume average real GNP growth of 3 per cent for industrialized countries and of 5.6 per cent for developing countries.[35]

Since the *World Economic Outlook* does not forecast import growth over the period, an income elasticity of 1.5 was used to project the imports of industrial countries. This elasticity is the average of the estimates made by various authors in recent years (Goldstein and Kahn, 1984). On that basis, an average annual growth rate for imports of 4.5 per cent in real terms was obtained. While it may be expected that the income elasticity of demand for imports of developing countries will be greater than that of industrial countries, the same assumption was used in both cases. Thus, the estimated annual increase in imports of developing countries averaged 7.2 per cent in real terms from 1993 to 1998.

The second scenario takes into account the effect of the successful conclusion of the Uruguay Round. On the basis of GATT estimates, which project that the level of world trade in the year 2005 will be 12.5 per cent higher than it would have been without the Round, the rate of growth of imports of industrial and developing countries was adjusted. Thus, under this assumption annual growth rates for imports of 5.3 per cent and 8.1 per cent in real terms are projected for 1993 to 1998. These coupled with the income elasticity assumed, result in real annual increases of GNP of 3.6 per cent for industrialized countries, and of 6.7 per cent for developing countries.

For the independent variable Z, which measures the variability of international transactions, a constant value was assumed for the forecasted years equal to the average for the five previous years. On the basis of these assumptions and the econometric estimates contained in section B, the demand for international reserves was estimated. The results are shown in table 10.

As can be seen, the estimated average annual growth of demand for international reserves of industrial countries consistent with the figures assumed for the evolution of their trade and production are 6.9 per cent (nominal) under scenario 1, and 7.6 per cent under scenario 2. The corresponding figures for developing countries are 8.5 and 9.4 per cent respectively.

Table 10

PROJECTIONS OF THE DEMAND FOR INTERNATIONAL RESERVES [a]

(Billions of dollars)

	20 industrial countries		*29 developing countries*	
	Scenario 1	*Scenario 2*	*Scenario 1*	*Scenario 2*
OBS 1992	565.6	565.7	173.4	173.4
1993	595.1	595.7	181.3	181.3
1994	636.1	640.9	193.5	195.4
1995	682.1	692.4	210.2	214.3
1996	732.3	748.9	230.7	237.5
1997	786.4	810.2	254.9	265.0
1998	844.3	876.4	282.8	296.8
Average annual growth 1992-1998 (percentage)	6.9	7.6	8.5	9.4

Source: IMF, *International Financial Statistics*, and *World Economic Outlook*, October 1993.
a Figures in nominal terms.

[35] It should be noted that the IMF projections cover the period 1995-1998. In the tests made, the medium-term economic growth rates are applied from 1993 onward since, as pointed out above, the object of the test is to analyse the growth of international reserves compatible with the sound expansion of the world economy.

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5

THE MANAGEMENT OF CAPITAL FLOWS: DOMESTIC POLICY AND INTERNATIONAL COOPERATION

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ABSTRACT

Capital flows into developing countries have exhibited a substantial increase since 1990. The change is especially dramatic in Latin America, where flows have more than doubled. However, capital flows have also been substantial in Asia where, as in Latin America, the change in those flows has represented about 3 per cent of GDP. This phenomenon has roots in both domestic and external factors. Statistical analysis for Latin America suggests that the weight of these factors is about the same. Therefore, in addition to good domestic policies, external factors are likely to play an important role in future developments. In this connection, the paper singles out two factors that may contribute to a gradual drying up of capital flows towards developing countries: (a) a worsening of the current account (of the balance of payments) in the industrialized countries (implying an improvement in the developing countries), and (b) a tendency on the part of developing countries to channel capital inflows more towards a current account deficit, and less towards the accumulation of international reserves. The combination of these two factors implies (recalling that, abstracting from errors and omissions, capital inflows = current account deficit + reserves accumulation) lower capital inflows into developing countries.

A discussion of the macroeconomics of capital inflows reveals the possibility that capital inflows may be driven by: (a) self-fulfilling prophecies, whereby capital inflows create favourable conditions for capital to continue flowing in, and, symmetrically, for capital to continue flowing out on the face of capital outflows, somewhat independently of a change in "fundamentals"; (b) stabilization programmes that cause greater efficiency in domestic credit markets, thus facilitating capital inflows, and, in stark contrast, (c) stabilization programmes that induce speculative capital inflows due to imperfect credibility of policy and/or policymakers. Conditions (a) and (c) justify government intervention, while (b) does not.

Government intervention to offset the effects of capital inflows may also be called for when these flows (a) bring about wide swings in relative prices (e.g. real exchange rates), or (b) interfere with other domestic policies, a prominent example being explicit or implicit insurance on bank deposits by the central bank. Consideration (a) may call for controls on capital mobility to prevent **temporary** *and* **unanticipated** *changes in relative prices, while consideration (b) may call for a permanent control on massive capital outflows.*

There is a wide menu of policies to deal with capital mobility. However, on the whole, few are effective and some may be counterproductive. For example, open-market sterilization of capital inflows may contribute to a larger fiscal deficit (due to the spread between domestic and international interest rates) and seriously interfere with price stabilization. Fiscal policy may be effective if based on cutting government expenditure, but may fail if exclusively based on raising income taxes. In contrast, a direct tax on capital flows may be highly effective, although its effect is likely to dwindle over time as individuals and firms find ways to bypass such a tax (through under- or over-invoicing imports

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and exports, for example). The monetary impact of capital flows could be attenuated by allowing the exchange rate to fluctuate (within certain bands). This policy, however, may not be effective if the economy is highly "dollarized".

This is an area where international cooperation could be highly effective, particularly to help in lowering the probability of currency runs and financial disruptions that accompany massive capital outflows. Unfortunately, however, the sums that would have to be involved are far larger than those committed to institutions like the IMF. An indirect way to obtain international support for the domestic financial system is to facilitate the entry of international banks.

A. Introduction

The Bretton Woods system was designed to provide an effective framework for free trade among sovereign nations and to accelerate the process of reconstruction. A major short-run concern of the system's architects was growing protectionism after World War II. In that respect, the IMF was created to cover short-term balance-of-payments imbalances that, otherwise, might have led countries to impose trade barriers. It is worth emphasizing, though, that balance-of-payments difficulties were expected to arise mostly from trade-balance deficits, and much less from deficits in the capital account.[1]

In contrast with the motivation behind the Bretton Woods system, the modern international economy is characterized by a high degree of capital mobility. Financial capital crosses national frontiers at the speed of light, and the sums involved are substantial.[2] Countries go through capital-inflows bonanzas in the midst of a collapse in their terms of trade, and fail to recover from balance-of-payments crises even though they are capable of mustering sizeable trade-balance surpluses (e.g. several highly-indebted countries in the 1980s). Therefore, the capital-flows issue has taken centre stage in the debate about the appropriate international financial system and the role of international financial institutions.

This paper is heavily coloured by recent events and, hence, it is biased toward short-run issues. However, the long run being a succession of short runs, the discussion will hopefully help in exhibiting the pros and cons of different longer-run operating procedures.

Section B presents a brief description of recent capital-inflows episodes in several developing countries. This helps to set the stage for the rest of the paper and to identify the key factors behind capital flows. Section C discusses the macroeconomics of capital mobility in greater detail and section D explores possible - and plausible - grounds for government intervention. Section E discusses several domestic policies to ameliorate the effect of capital inflows, while section F complements the discussion by bringing in the possibility of international cooperation. Section G closes the paper with some final remarks.

B. Recent developments

International capital flows started to change their course around 1990, away from industrialized countries that had been the beneficiaries of those flows during most of the 1980s - notably the United States - and into developing ones, some of which - notably highly-indebted countries - had endured almost a decade of virtual exclusion from the international capital market. Initially, the phenomenon was attributed to the good economic performance of a handful of countries. Eventually, however, it became apparent that the phenomenon was widespread, affecting both countries showing an exemplary policy record and countries still grappling with ineffective macroeconomic policy, showing that the phenomenon has a global nature. The flows are large - amounting to about 3 per cent of GDP for Latin America and Asia, and reaching 15 per cent of GDP for countries like Malaysia and Thailand (Calvo, Leiderman and Reinhart, 1993b) - and have kept their intensity until

1 The Articles of Agreement aim at eliminating trade and exchange restrictions, and at establishing currency convertibility. However, their emphasis is on *current account* convertibility, rather than on *capital account* convertibility (Green and Isard, 1991).

2 Feldstein and Horioka (1980) claim that net capital flows are small, given the high correlation between national saving and investment. Even granting the validity of the Feldstein-Horioka finding (for a criticism, see Obstfeld, 1986), spikes of capital flows have been at the heart of recent major financial disruptions, as witnessed by the recent currencies turmoil in Europe. The Feldstein-Horioka conjecture is especially debatable for developing countries where capital flows have been substantial.

Table 1

LATIN AMERICA: BALANCE OF PAYMENTS, 1985-1994 [a]

Year	Balance of goods, services and private transfers [b] ($ billion) (1)	Balance on capital account plus net errors and omissions [b] ($ billion) (2)	Change in reserves [c] ($ billion) (3)	-(3)/(2) x 100 (4)
1985	-5.5	6.5	-1.0	15
1986	-19.8	13.2	6.6	-50
1987	-11.8	15.0	-3.2	21
1988	-13.4	5.7	7.7	-135
1989	-10.1	12.7	-2.6	20
1990	-8.5	23.6	-15.1	64
1991	-20.5	38.9	-18.4	47
1992	-34.7	53.4	-18.7	35
1993	-35.1	39.1	-4.0	10
1994	-38.2	43.2	-5.0	11

a Data for Western hemisphere from IMF, *World Economic Outlook* (various issues).
b A minus sign indicates a deficit in the pertinent account. Balance on goods, services and private transfers is equal to the current account balance less official transfers. The latter are treated in this table as external financing and are included in the capital account.
c A minus sign indicates an increase.

now.[3] Furthermore, the phenomenon is currently spreading to countries that were excluded from the first wave of capital inflows; as in the case of Ecuador, and increasing its intensity in some "hot" spots, like Hong Kong and China.

Tables 1 and 2 present some key characteristics of the above phenomenon for Latin America and Asia. These areas provide a useful testing ground for the hypothesis that the recent flows reversal is a global phenomenon. The two areas have no close links with each other through trade or otherwise. However, starting in 1990 both areas experience a sizeable increase in capital inflows which, on an annual basis, more than double the flows in the period 1985-1989. Another interesting common characteristic is that, as shown in column (4) of tables 1 and 2, the initial surge (i.e. in 1990) was met with reserve accumulation of over 60 per cent of total capital inflows, while in 1993-1994 reserve accumulation has been below 40 per cent in Asia, and slightly over 10 per cent in Latin America. Hence, more and more, capital inflows take the form of larger current account deficits. Thus, reserve accumulation "fatigue" or "satiation" in Asia and Latin America appears to be setting in. Actually this kind of fatigue can be observed in the behaviour of the stock of international reserves in developing countries as a whole. According to the IMF, in the period 1990-1991, reserves in those countries grew at an average annual rate of more than 19 per cent, while in the period 1992-1993 they grew at 9 per cent, and the forecast for 1994 is 7 per cent.

Table 3 shows that despite strong similarities, the two regions exhibit some interesting contrasts. In the first place, while in the period 1990-1992 investment in Asia increased by three percentage points of GDP (in relation to 1984-1989), in Latin America it declined.[4] Furthermore, over the same periods the *increase* in foreign direct investment represents 44 per cent of the *increase* in capital inflows in Asia, while it is only 17 per cent in Latin America. Calvo, Leiderman and Reinhart (1993b) suggest that these differences may help to explain the fact that the real exchange rate (i.e. the relative price of tradeables with respect to non-tradeables) shows, on average, a less pronounced appreciation in Asia than in Latin America during the capital inflows episode (i.e. from 1990). This point will be further elaborated in what follows.

3 In this paper Asia and Latin America refer to the group of countries labelled Asia and Western hemisphere, respectively, in IMF (1993).

4 It is worth noting that intra-Latin America differences are also important. For example, while investment substantially increases in Bolivia and Chile, it declines in Argentina, Brazil and Peru.

Table 2

ASIA: BALANCE OF PAYMENTS, 1985-1994[a]

Year	*Balance of goods, services and private transfers*[b] *($ billion)* *(1)*	*Balance on capital account plus net errors and omissions*[b] *($ billion)* *(2)*	*Change in reserves*[c] *($ billion)* *(3)*	*-(3)/(2) x 100* *(4)*
1985	-18.7	22.7	-4.0	18
1986	-1.1	25.5	-24.4	96
1987	14.8	24.7	-39.5	160
1988	2.6	8.7	-11.3	130
1989	-8.1	17.1	-9.0	53
1990	-10.0	31.6	-21.6	68
1991	-10.2	49.5	-39.3	79
1992	-125.2	47.1	-21.9	46
1993	-31.2	41.7	-10.5	25
1994	-26.8	42.3	-15.5	37

a Data for Asia from IMF, *World Economic Outlook* (various issues).
b A minus sign indicates a deficit in the pertinent account. Balance on goods, services and private transfers is equal to the current account balance less official transfers. The latter are treated in this table as external financing and are included in the capital account.
c A minus sign indicates an increase.

The real exchange rate plays a key role in resource allocation and income distribution. As shown in Calvo, Leiderman and Reinhart (1993b) most countries experiencing capital inflows have exhibited a tendency towards appreciation of their real exchange rate. The rationale is simple. A surge of capital inflows takes the form of either reserve accumulation, or a deficit in the current account of the balance of payments. The first form has no obvious consequences on the real exchange rate. The second, however, reflects an increase in the excess demand for tradeable goods (abstracting from exogenous surges of transfers from abroad) which, in turn, is likely to reflect a surge in aggregate demand.

Given the initial relative price of tradeables with respect to non-tradeables, the increase in aggregate demand is likely to spill over to both tradeable and non-tradeable goods. Supply conditions of these two types of goods are, as a general rule, quite different. The supply of tradeable goods is more price-elastic than the supply of non-tradeable goods, particularly for countries which are small in international markets. Thus, the surge in aggregate demand is likely to increase the relative price of non-tradeable goods or, equivalently, to appreciate the real exchange rate.

Since, as noted above, Asia seems to devote relatively more of its capital inflows to investment - which for small developing countries is likely to contain a large tradeables component - the composition of aggregate demand in Asia is likely to be slanted towards tradeable goods. Thus, following the logic of the above paragraphs, one would expect a smaller appreciation of the real exchange rate in Asia than in Latin America.

Direct foreign investment may also ameliorate the effect of capital inflows on the real exchange rate. The reason for this is slightly more subtle than in the previous case. Direct foreign investment is financed from abroad and, in principle, does not require the services of the domestic financial system (specifically, domestic banks). In contrast, investment financed by the domestic financial system involves a more convoluted process. For example, suppose the new investment is financed by banks from capital inflows that take the form of bank deposits. In the absence of perfect domestic credit markets, banks are likely to use some of the additional deposits to finance domestic consumption which, as a general rule, is more non-tradeable-goods-intensive than investment. Thus, when all is said and done, the same amount of investment financed through the banking system is likely to entail a larger demand of consumption goods and a larger appreciation of the real exchange rate than under foreign direct investment.[5]

[5] This argument presumes some degree of credit "segmentation". Under perfect external and domestic credit markets

A more technical analysis of the data reveals a surprising degree of co-movement of variables associated with capital inflows across different countries. Calvo, Leiderman and Reinhart (1993a) report this finding for Latin America, and show that the degree of co-movement increased after 1990 compared to the debt-crisis period.[6] There are high correlation coefficients across Latin America for international reserves and real exchange rates.[7] In addition, Calvo, Leiderman and Reinhart (1993a) show that a large proportion of the variation in those series can be explained by events *outside* the region, like United States output and interest rates. According to these findings, capital inflows into Latin America expand as the United States economy enters into a recession and/or its (short-term) interest rates decline. Thus, we can conclude that there is strong support for the hypothesis that a *not insubstantial* share of the capital inflows is due to developments *outside* the receiving region.

The other side of the coin to capital inflows in developing countries are capital outflows from industrial ones. The current account of industrial countries exhibits a remarkable improvement in 1991. Since then, however, the deficit in the current account of industrial countries has gradually increased, reaching an estimated $46 billion in 1993. According to the IMF this trend will accelerate in 1994, when it will reach $72 billion (IMF, 1993, p. 162). Therefore, when the latter is coupled with reserve accumulation "fatigue" on the part of developing countries, it follows that capital flows to developing countries are likely to dry up, or at least to suffer a substantial decline, in the near future. To see this, consider the extreme case in which developing countries are unwilling to accumulate further international reserves and, thus, capital inflows into those countries are matched, dollar for dollar, by a deterioration of their current account. Abstracting from errors and omissions, the sum of the current account of industrial and developing countries has to be nil. Thus, the expected deterioration of the current account of industrial countries must be accompanied by an improvement in that of developing countries which, in turn, implies (by the reserve accumulation fatigue assumption) that capital flows into developing countries will have to fall.

Consequently, the above observations plus the consensus forecast that United States output and interest rates are heading upwards, suggest that the period of capital inflows into developing countries may be coming to an end.

C. The macroeconomics of capital flows

In the last 15 years we have seen periods of high capital mobility to developing countries, followed by a debt crisis episode that witnessed a sharp contraction of voluntary finance to the affected countries. This, in turn, was followed by renewed access to international capital flows. Moreover, such swings have been large and appear to have sizeable macroeconomic effects. In this section we will discuss the causes of such large capital flows and some key propagation mechanisms. International and domestic factors will be discussed under separate subheadings.

1. International factors

In order for capital to flow to a given country there must be incentives for suppliers to move their funds into that country, and for domestic residents to borrow them. As noted above, empirical research suggests that the current surge in capital flows is partly motivated by developments in industrial countries. A classical explanation would run as follows: a fall in interest rates of industrial countries increases the gap between the rate of return on investment projects in industrial and developing countries, prompting wealth holders to change their portfolio composition in favour of the latter.[8]

An alternative explanation for the observed impact of United States dollar denominated interest rates on capital flows dwells on the fact that, before the Brady Plan was put

it will, of course, make no difference whether investment is directly funded from abroad, or funded through domestic financial intermediaries.

6 These authors scale each series so that its variance equals one. Thus, even when the degree of co-movement is significantly positive, this does not rule out the existence of large differences in orders of magnitude across countries.

7 These highly positive correlations are especially remarkable given that they are based on monthly data which, one would expect, suffer from large and extraneous noise.

8 This explanation, however, runs into some empirical hurdles. For example, although United States dollar and yen denominated interest rates went down after 1990, Deutsche mark denominated interest rates increased sharply. Thus, interest rates have had to be adjusted for, at least, devaluation risk. In the case of Latin America, however, the use of United States dollar denominated interest rates as independent variables in a capital flows equation is less problematic, because countries in that region have shown a tendency to peg their currencies to the United States dollar.

Table 3

KEY INDICATORS FOR SELECTED LATIN AMERICAN AND ASIAN COUNTRIES

(As percent of GDP)

	Latin America										
	Argentina	*Bolivia*	*Brazil*	*Chile*	*Colombia*	*Ecuador*	*Mexico*	*Peru*	*Uruguay*	*Venezuela*	*Average of 10 countries*
Capital account [a]											
1984-1989	-1.6	0.6	-2.3	-1.7	2.0	-6.3	-0.4	-5.3	-2.5	-3.1	-2.1
1990-1992	2.2	3.3	-0.3	5.9	1.0	-5.1	6.2	-0.3	0.5	-1.0	1.2
Direct investment											
1984-1989	0.9	0.5	0.5	0.5	1.5	0.6	0.8	-	-	0.1	0.5
1990-1992	1.8	1.0	0.3	1.9	1.2	0.8	1.6	0.2	-	1.8	1.1
Investment											
1984-1989	18.1	10.1	17.2	16.0	19.7	18.7	20.1	19.4	12.2	17.7	16.9
1990-1992	15.1	13.5	15.8	20.1	17.7	20.2	21.7	16.4	13.8	14.1	16.8
Public consumption											
1984-1989	12.4	11.3	11.1	10.9	10.3	11.6	11.1	9.6	13.7	10.4	11.2
1990-1992	14.2	11.6	12.4	8.8	10.1	8.4 [b]	10.3	9.0	13.3 [b]	11.1	10.9

	Asia								
	Indonesia	*Republic of Korea*	*Malaysia*	*Philippines*	*Singapore*	*Sri Lanka*	*Taiwan Province of China*	*Thailand*	*Average of 8 countries*
Capital account									
1984-1988	2.2	-2.0	-0.4	-3.8	5.0	4.6	0.1	4.2	1.2
1989-1992	5.0	1.3	8.7	1.9	3.3	4.8	-4.9	11.0	3.9
Direct investment									
1984-1988	0.5	0.3	2.7	0.8	9.4	0.6	-0.3	0.8	1.8
1989-1992	1.2	-	6.2	1.7	11.3	0.5	-1.7	1.5	3.0
Investment									
1984-1988	23.8	28.9	26.0	18.3	38.9	23.0	19.3	21.8	25.0
1989-1992	25.4	36.3	32.8	20.8	39.0	19.5	22.7	28.2	28.1
Public consumption									
1984-1988	10.0	9.8	12.5	6.8	12.8	9.6	15.0	13.6	11.3
1989-1992	10.2	9.7	10.6	8.0	10.9	7.6	16.5	9.9	10.4

Source: IMF, *World Economic Outlook* (various issues).

a Includes errors and omissions.

b Data available only through 1991.

into effect, the interest rate on the external debt of highly indebted countries (HICs), which included several countries in Latin America, was indexed to the LIBOR. Hence, a fall in the latter may have caused an immediate "liquidity" relief for HICs.[9] However, such a relief was not enough to extricate them from the list of bad debtors, as evidenced by the fact that secondary market prices for HICs' debt remained below parity. Thus, no net new lending is necessary. To illustrate this point, consider the case in which countries allocate a given flow Y to service the external debt. The fall in the LIBOR increases secondary-market prices, but, by assumption, does not expand the funds available for debt service. In this context, new loans will have to be serviced from the same pool Y. Thus, new lending will take place only if secondary market prices fall relative to their level if there were no new loans. Hence, the emergence of new loans can be rationalized along these lines only if secondary market prices increased by less than what could be accounted for by the fall in the LIBOR.[10]

In addition to international interest rates, capital flows may be driven by the international economic cycle. A recession in industrial countries, for example, could reduce the expected rate of return on capital there, and induce capital to flow to developing countries. This inverse cycle relationship is borne out by data on the United States and Latin America. But it need not be so in general. According to conventional wisdom, for example, a recession in industrial countries is likely to bring about a recession in the "periphery" by depressing developing countries' exports. Consequently, recession in industrial countries would bring about a decline in the rate of return on capital in developing countries, making the direction of capital flows ambiguous.

In recent episodes the above-mentioned conventional relationship between output in developed and developing countries appears to have been reversed. Recession in industrial countries has recently been associated with an expansion, not a contraction, in several developing countries (Engle and Issler, 1993). A possible explanation for this new phenomenon is that capital flows themselves may have been prompted by the *expectation* that rates of return were about to become more attractive in developing countries, paradoxically, as a result of recession in developed countries (more on this below). In turn, the resulting expansion of credit may have generated the conditions for the rate of return to have risen in some developing countries. Thus, according to this interpretation, the present cycle reversal episode would reflect the existence of *multiple* equilibria. Which equilibrium will be attained may depend on "animal spirits". If depression in the industrial countries induces those spirits to funnel funds to developing countries, the latter are likely to thrive. In this connection, the renewed optimism with respect to some highly-indebted countries may have been aided by the Brady Plan.[11]

2. Domestic factors

Domestic factors have also played a key role in determining the amount and direction of capital flows. Not all regions benefited equally and some, like Africa, have been left out altogether. In Latin America, although the flows appear to have shifted all around, the main beneficiaries are countries that have, at least temporarily, stabilized their price levels. Brazil is the exception (more on this below).

The association between price stability and capital inflows is not easy to establish conceptually. According to one interpretation, capital flows to countries like Chile and Mexico reflect renewed policy credibility: inflation is a sign of political turmoil, not of cool welfare calculations. Eventually, regular taxes, as opposed to the inflation tax, will have to be put into effect to finance current government expenditure, or the latter will have to decline. Thus, in the absence of a well-structured and credible stabilization programme, it is not clear for most people what form the new taxes will take, or what government programmes will be phased out. All of which contributes to increasing the risk of investing in a high-inflation country. Thus, an effective stabilization programme lowers risk and is likely to stimulate capital inflows.

In addition, price stability may improve the operation of the domestic capital market. Consider the realistic case in which consumption credit is carried out mostly in terms of domestic currency, and in the form of constant

9 This argument does not apply to countries, like Argentina, that had failed even to pay interest on their outstanding external debt.

10 If the pool Y increased with new loans, the latter would depress secondary market prices by less than in the example given in the text. Thus the suggested test is a sufficient condition for the effect that we are discussing here, but it will no longer be a necessary one.

11 Debt forgiveness as such is not enough to explain a boom. The latter is similar to a fall in the LIBOR which, as argued above, is not reason enough to generate a boom if secondary-market prices are below their parities.

installments. Under inflation, the real value of such installments falls over time. The decline is steeper, the larger is the rate of inflation. Thus, in high-inflation situations, the first few installments must cover most of the initial value of the goods acquired in this manner, which obviously impairs the operation of the credit market. In contrast, when inflation declines, credit installments in real terms become flatter, and the consumer is thus able to spread out the expense (in real terms) over a longer period of time. Consequently, under low inflation more consumers will have access to credit; credit will increase, attracting capital inflows. The effect could be large, because consumer credit involves mostly durable goods.[12]

According to the second interpretation, stabilization programmes *themselves* are fraught with uncertainties. To be sure, lower inflation is a signal that the authorities are coming to grips with a socially costly phenomenon, but there is normally no assurance - even under totalitarian regimes - that the stabilization programme will be continued in the future. Individuals are aware of this, as reflected in the high domestic interest rates (expressed in a currency like the United States dollar) that usually prevail immediately after stabilization programmes are implemented.[13] Yet normally lack of credibility is not total and, hence, the market will attach a positive probability to the programme not collapsing immediately. As a consequence, short-term nominal interest rates are likely to fall at the beginning of a stabilization programme, while they are expected to rise in the future.

In an economy which is not fully "dollarized", market transactions require using and holding domestic monetary balances, the opportunity cost of which is the nominal interest rate. Thus, the effective cost of buying goods and services includes the opportunity cost of holding monetary balances. Consequently, in the market participants' mind, the effective cost of goods and services is expected to be higher in the future than at present. This induces individuals to substitute present for future consumption, inducing larger capital inflows. This type of model has been tested for several developing countries by Reinhart and Végh (1992) and Bufman and Leiderman (1991), with encouraging results.

Furthermore, in several countries (e.g. Argentina, Chile and Mexico) stabilization programmes have been accompanied by a substantial lowering of trade barriers. With full credibility, trade liberalization need not bring about a larger trade deficit. However, if such a policy is expected eventually to be reversed, present expenditure will tend to rise to take advantage of the expected present relatively low prices of importables. This intertemporal substitution effect is likely to be large for durable goods, and become larger the shorter is the expected trade liberalization period. Therefore, the existence of not fully credible trade liberalization programmes is another possible explanation for capital inflows.

Although the two interpretations above predict capital inflows through a deterioration in the current account, their welfare implications may be significantly different. According to the first interpretation, capital inflows are associated with an improvement in the domestic capital market. Spending would grow from socially inefficient levels and, thus, social welfare is likely to increase. In contrast, the second interpretation would entail a welfare loss. The reason for this is that lack of full credibility induces individuals to substitute present for future spending on goods and services. Such substitution is not based on fundamentals (i.e. the kind of information relevant for a social planner: production functions, utility functions and the like), but rather it is induced by lack of full credibility of policymakers and is, thus, bound to be counterproductive (Calvo and Végh, 1993).

D. Grounds for government intervention

The last section's closing paragraph discussed a case in which, as a result of lack of credibility, individuals engage in excessive borrowing, thus providing grounds for policy intervention. In the present section we will discuss the advisability of policy intervention in a more general scenario. For the sake of clarity, we will first discuss the case in which capital inflows are dominated by external factors, and later focus on the case in which domestic factors play a prominent role.

1. External factors

Capital mobility would not be a major concern if markets operated in a competitive

[12] For recent evidence on the relevance of this effect, see Copelman (1993).

[13] As recently noted (Calvo and Végh, 1993), *real* interest rates (i.e. nominal interest rate minus the domestic rate of inflation) have actually *fallen* in some exchange-rate-based stabilization programmes.

manner and individuals were able to insure themselves against all possible events, e.g. changes in the real exchange rate resulting from capital inflows. In practice, however, markets are "incomplete" for "moral hazard" and other reasons. Thus, fluctuations in the real exchange rate may lead the economy away from its "first best" solution. In particular, capital flows may provoke excessive changes in income distribution as compared with the case in which individuals could insure themselves against those fluctuations. In the latter case, for example, losers would be compensated (via the insurance contract) by winners.

More specifically, capital inflows tend to appreciate the real exchange rate and thus hurt the export sector. Occasionally, exporters can obtain insurance against fluctuations in international prices (in future commodity markets, for example), but it is much harder for them to obtain insurance against changes in the real exchange rate (which involve domestic goods and services). Thus, there is in principle room for the government to step in and make welfare enhancing transfers to the export sector, financed, for example, by a tax on non-tradeable sectors.

Since government intervention is costly, it is advisable to limit these transfers to gross appreciations or depreciations of the real exchange rate. Moreover, since this policy substitutes for missing insurance markets, transfers ought to be *temporary* and be put into effect for *unexpected* fluctuations in the real exchange rate. For example, a permanent appreciation of the real exchange rate should not generate transfers beyond the first few periods after its onset.[14] Furthermore, given that such transfers substitute for missing private-market insurance, the transfer mechanism itself should be known in advance, i.e. *ex ante*, and be fully credible. *Ex-post* transfers that are not anticipated, or not credible, *ex ante*, would help restore a desirable pattern of income distribution but would not affect factor allocation (relative to the no-insurance case). This is a highly relevant point because if insurance-type transfers are unanticipated by the private sector, real exchange rate fluctuations may still result in an unduly small export sector. Finally, if the government can set up an effective transfer mechanism, there would be no need to impose controls on capital mobility (or on any other cause of real exchange rate fluctuation).[15]

Government intervention may also be called for if capital flows interfere with the effectiveness of other government policies. An outstanding example of this type of situation is deposit insurance, i.e. the implicit or explicit promise that a certain share of deposits will be refunded, irrespective of the bank's ability to pay.

Deposit insurance, especially at commercial banks and for small depositors, is a highly popular policy in both industrial and developing countries. Even governments that have vowed not to bail out depositors in failing banks have eventually backtracked, e.g. Chile and Argentina in the early 1980s, and compensated depositors for a large share of their losses. We will not fully discuss here the rationale behind this policy, except for saying that it is likely to be another example of the government trying to fill the gap created by missing insurance markets.[16]

Capital flows interfere with deposit insurance for at least two reasons. In the first place, domestic authorities are likely not to give the same weight to domestic and foreign residents and, in particular, may want to insure the former, but not the latter. In practice, it is difficult to distinguish between these two types of depositors. Thus, capital inflows that take the form of bank deposits are likely to increase the social cost of providing deposit insurance. In the second place, government deposit insurance makes banks more prone to take risks (because downside risks are freely insured by government) and, thus, deposit insurance causes a distortion in the allocation of credit. In this context, large capital inflows through banks magnify these distortions. Notice that the first ground for intervention (i.e. lack of insurance markets) requires that capital inflows have a reasonably high probability of becoming capital outflows (if government cannot engineer a perfect transfer mechanism from winners to losers). In contrast, the second ground for intervention (i.e. domestic capital market distortions) simply requires that capital inflows intermediated through the banking system be relatively large. In both cases, however, optimal second-best policy calls for controls on

14 At a more fundamental level, one would like to know the reasons for the absence of private insurance markets: the very same reasons may prevent the government from implementing an effective transfer mechanism.

15 The above argument abstracts from externalities and increasing returns to scale. Externalities may call for government intervention in order to prevent an appreciation of the real exchange rate, not just to stabilize income distribution in response to unanticipated shocks.

16 Some economists claim that markets are missing because the private sector expects the government to fulfil their functions. If this were true, it would be first-best optimal to eliminate deposit insurance. The question that remains though, is, would the announcement that government will stay away from deposit insurance be credible?

capital flows. The first ground for intervention justifies controlling capital outflows, while the second suggests controlling capital inflows.

2. *Domestic factors*

The main, and obvious, difference between domestic and external factors is that the former can be directly affected by domestic policy. In view of the discussion in section C above, improving policy credibility - by any means not an easy task - should be given high priority. In that respect, recent experience suggests that institutional arrangements may have a significant effect on credibility.

For example, the existence of non-indexed domestic debt could undermine policy credibility. If the public does not believe that the stabilization programme will be successful, the nominal interest rate will be high. Thus, if inflation actually falls, the *ex-post* real interest rate will be high and debt service could become excessively onerous.[17] Thus, individuals would be rational in expecting a policy reversal.

One possible solution to the domestic debt problem would be to index domestic debt to the price level, as in Chile, or to "dollarize" it, as in Argentina. In this manner, holders of domestic debt are insured against currency devaluation or inflation, and the *ex-post* nominal interest rate will be high only if inflation turns out to be high. There is, however, no fool-proof solution to the problem. For example, indexation will not be effective if individuals do not trust government's willingness or ability to repay its domestic debt. Under those circumstances, interest on indexed debt may remain high in the expectation that part of the debt will be subject to *open* repudiation (as opposed to inflation's *insidious* repudiation). This may have serious consequences, because open repudiation could throw the country into a legal quagmire.[18]

Another possible solution is to involve the country's congress or parliament in some key economic policy decisions. A prominent recent example is Argentina's Convertibility Programme based on a law passed by congress, according to which the peso was pegged to the United States dollar and, *inter alia*, the central bank was prohibited from lending to the government. Of course, laws can be changed by new laws or "executive" decrees. However, laws are more difficult to change than mere regulations in the hands of the finance minister or the central bank. Thus, although trust in government may not be fully restored by these arrangements, the credibility of some key policy variables is likely to improve.[19] Obviously, however, this legislative procedure will be totally ineffective if the laws passed by congress contradict *economic* laws. Thus, for example, convertibility type programmes will be rendered useless under large deficits.

Finally, another structural reform that has received a great deal of attention is central bank independence (Cukierman *et al.*, 1992, pp. 353-398). In practice it is difficult for a central bank to resist pressures from the rest of government, unless it is shielded by its charter. Thus, since the charter of the central bank has to be approved by congress, this arrangement is a special case of the type of solution discussed in the previous paragraph.

E. *Macroeconomic policies*

In this section I will discuss several short-run macroeconomic policies - as opposed to the structural long-run policies discussed above - that are pursued, or have been suggested, in response to a "capital inflows problem" (i.e. to situations in which government intervention to counteract the effect of capital inflows would be called for).

1. *Sterilization*

This is, by far, the most popular response to capital inflows. The policy aims at insulat-

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17 The relevance of this observation does not require the stock of non-indexed domestic debt to be large. For example, suppose that before the stabilization programme is put in place inflation is running at 30 per cent per month (as in Brazil and Russia at the time of writing), and that the stabilization programme aims at lowering inflation to 5 per cent per month. If the programme is not credible, the domestic monthly interest rate will hover around 30 per cent. Thus, if the programme's target is attained, the real monthly interest rate will be around 25 per cent, or more than 1300 per cent per year !

18 Some indexation mechanisms leave a crack through which inflation can still be effective in lowering the real value of domestic debt. However, if the *ex-ante* real interest rate on indexed debt is high, hyperinflation may be called for in order to push the *ex-post* real interest rate down to (fiscally) feasible levels. For example, some economists would claim that partial indexation may have been an important factor in Argentina's 1989 hyperinflationary episode.

19 Unfortunately, to complicate matters even further, the question: does "more credible" translate into "socially better"? has no unambiguous answer (Calvo, 1987).

ing money supply and/or the exchange rate from the effect of capital inflows. Normally, the intent is to prevent capital inflows from generating inflation or appreciating the real exchange rate. For simplicity, I will conduct the discussion under the assumption of fixed nominal exchange rates.

Sterilization will not be necessary if capital inflows take the form of loans to the private sector, completely bypassing the domestic monetary system. As a general rule, however, such flows are partly intermediated through the domestic financial system, tending to increase money supply. This should, in principle, be of no concern because money is endogenous in the present setup and, therefore, cannot be the ultimate cause of inflation or real exchange rate appreciation. However, letting money grow may allow other, more basic, factors to be reflected in higher inflation.

Consider the case in which the fixed exchange rate policy is not fully credible, and the public expects an eventual devaluation of the currency. Under these circumstances, there will be a tendency for the price level to start rising before the devaluation occurs. The reason for this is that wages and prices are not fully flexible, and are set for a period of time. Thus, wages and prices will increase today in anticipation of future devaluation. Consequently, inflation will be high and the real exchange rate will appreciate relative to full credibility.

The fundamental reason for the above inflationary symptoms is, of course, lack of credibility. However, if sterilization does not take place, the price increase will be fully accommodated, while if it does, less inflation or more unemployment is likely to occur, accompanied by high domestic real interest rates. Therefore, sterilization is likely to ameliorate the inflationary effect of lack of credibility, but at the cost of higher unemployment and/or real interest rates.[20]

Recent episodes of capital inflows have been partially met by sterilization. Much of the effect of this policy appears to have been reflected in higher real interest rates, and not in higher unemployment. The latter may be costly in terms of growth but, the question arises, is it possible for the sterilization policy to be effective in lowering inflation? I will discuss this issue, first, under the assumption that sterilization takes place through open-market operations and, second, through other methods like higher banks' reserve requirements, etc.

(a) Sterilization through open-market operations

I will show that if sterilization is done through issuing government debt or central bank's certificates of deposits, then sterilization may not provide a lasting solution to inflation. As the cases of Colombia and Egypt show, some countries exhibit a large spread between domestic and international interest rates. Therefore, sterilization gives rise to a fiscal loss (quasi-fiscal loss if located at the central bank) which could be substantial.[21] The loss is equal to the product of the spread between domestic and international interest rates and the accumulation of international reserves. Thus, if the loss were to be due to some "initial" (non-recurring) capital inflow, the policy might have a chance of success, assuming, of course, that sterilization was accompanied by an offsetting fiscal surplus. However, a key difficulty with sterilization through open-market operations is that it prevents the interest rate gap from narrowing and, thus, capital continues to flow in. Reserves continue growing, leading to even higher fiscal deficits. Eventually, the fiscal deficit may become unsustainable and lead to a devaluation, validating expectations and stimulating further inflation.

The above example assumes lack of credibility. Interestingly, pursuing this policy may actually undermine credibility, even if the government was initially fully credible. For example, take the case in which a fully credible stabilization policy is undertaken and, as a consequence, there is a substantial increase in the demand for domestic money. Given fixed exchange rates, the latter may induce large, but limited, capital inflows. Suppose the central bank sterilizes those inflows and, for the sake of the argument, let us assume the existence of a high degree of capital mobility. Thus, the incipient interest rates differential will attract massive capital flows which, by assumption, are sterilized by issuing domestic debt. At some point, domestic debt will be so large that, as argued above, the public will start expecting open or insidious repudiation, and capital will stop flowing in. Thus, unless individuals are grossly misinformed, the government will have substantially lowered the chances of bringing the stabilization programme to a successful conclusion (Calvo and Végh, 1993; Fernandez, 1991; Frankel, 1993).

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20 Furthermore, high domestic interest rates may lead firms with a solid international reputation to borrow abroad, lowering the quality of domestic loans.

21 In Colombia during 1991 the quasi-fiscal deficit is estimated to have been approximately 0.8 per cent of GDP.

It has been argued that open-market sterilization cannot possibly be costly if the spread between domestic and foreign interest rates represents devaluation risk (Reisen, 1993). As the argument goes, if expectations are rational, the expected rate of return (in dollars, for example) associated with these two interest rates must be the same. Thus, on average, the fiscal authorities (including the central bank) cannot lose by sterilizing through open-market operations. There are two ways to respond to the comment.

In the first place, rationality on the part of the public does not mean that the data will not show long periods of time in which the fiscal authority runs a loss due to sterilization. This would be true, for example, in a country undergoing a "peso problem", i.e. a situation in which the currency will be subject to a one-time devaluation, but the conditional probability of it happening in the next period, if it did not happen before, is positive. Although valid, however, the latter rebuttal does not go to the heart of the criticism, because if governments were risk neutral they would essentially be indifferent about transition losses, given that they will break even in an expected value sense.

A deeper rebuttal, though, builds upon the example discussed in the previous paragraph. As shown there, sterilization is the ultimate cause behind the failure of the stabilization programme, even though the fiscal authority breaks even. Sterilization creates the conditions which lead to abandoning the stabilization programme, even though in the final analysis there are no fiscal losses !

(b) Other sterilization methods

Sterilization can take other less costly forms. One such form is raising banks' minimum reserve requirements. The larger the reserve requirement, the larger will be the interest rate on loans and/or the lower will be the interest rate on deposits, discouraging demand for, or supply of loans, and possibly lowering capital inflows and their impact on money supply. This form of sterilization has the advantage of generating no direct cost to government and, hence, does not represent a direct threat to the stabilization programme (however, the higher loan interest rate may have a negative effect on growth). However, higher reserve requirements discriminate against banks and in favour of informal intermediation. Thus, this is at best a temporary solution. In practice, there is an additional difficulty in that an unanticipated increase in reserve requirements may create serious liquidity problems for banks. Therefore, it may be preferable to increase marginal, rather than average, reserve requirements, i.e. increase reserve requirements only on deposits exceeding the initial level.

Another sterilization method popular in some Asian countries (Reisen, 1993) consists of shifting government deposits away from commercial banks and into the central bank. This policy reduces the money multiplier and, hence, money supply, at no direct cost to the fiscal authorities. As with the previous policy, however, such a shift may cause liquidity difficulties for banks and, thus, it should be phased in gradually. This method seems to have been used with some success in Asia (Reisen, 1993). Unlike the previous method, which directly interferes with the intermediation process, the present one creates a temporary liquidity shortage that could be quickly offset by additional capital inflows, undermining its effectiveness.

An important advantage of sterilization is that the funds that are attracted to the banking system are absorbed by the central bank in the form of international reserves, i.e. external liquid assets. Thus, capital outflows can be met by reducing international reserves and without disrupting the financial system.[22]

2. Fiscal policy

Here I will discuss two types of fiscal adjustment: (a) raising income taxes and/or lowering government expenditure, and (b) raising taxes on capital flows.

(a) Income taxes and government expenditure

Some Asian countries have followed aggressive fiscal adjustment policies mostly centred on a reduction of government expenditure, e.g. Malaysia, Singapore and Thailand. This policy may be effective in reducing the appreciation of the real exchange rate associated with capital inflows, because nontradeables usually represent a sizeable share of government expenditure. The effect is likely to be stronger, the shorter is the expected duration of the expenditure cut. Thus, for example, if the cut is expected to be permanent, individuals

[22] This assumes, of course, that the government refrains from using international reserves for other purposes, like repayment of external debt.

may be led to anticipate a rise in their disposable income, which is likely to be translated into an increase in private expenditure, partially offsetting the effect of the cut in government expenditure.

However, as pointed out above, real exchange rate appreciation is only one concern associated with capital inflows. Another major concern is the possible instability that variability of those flows may bring about (see section D.1). In this respect, a cut in government expenditure may be *counterproductive*. The reason is that, as pointed out in the previous paragraph, the private sector may be led to borrow more, which is likely to increase domestic intermediation, and the type of distortions discussed in section D.1. Thus, a cut in government expenditure may have to be accompanied by a temporary rise in, for example, banks' reserve requirements.

Income taxes share many of the features discussed above, except that their effect on expenditure is less direct than in the case of a cut in government expenditure. Actually, total expenditure might rise if more fiscal revenue triggered larger government expenditure. Furthermore, the effect on private expenditure might be minor. When international credit is plentiful, current income is not a major determinant of private expenditure. This is particularly true if higher income taxes are seen as a policy response to capital inflows and, therefore, are expected to be *temporary*.

In sum, fiscal tightening may be effective in ameliorating the impact of capital inflows on the real exchange rate, but may worsen financial fragility. Moreover, a reduction in government expenditure may have a bigger impact on the real exchange rate than a corresponding increase in income taxes.[23]

(b) Tax on capital flows

This type of measure was undertaken in Chile and Mexico (Ffrench-Davis *et al.*, 1993; Gurría, 1993). Capital flows may be taxed both ways or only one way. Chile, for example, chose to tax capital inflows by imposing a minimum reserve requirement on international loans intermediated through the banking system. The main disadvantage is that flows are likely to be re-routed through other forms of intermediation (e.g. over/under-invoicing of imports and exports), reducing the central bank's control on the financial system.

Some countries have tried to soften the impact of capital inflows by lowering barriers on capital outflows (e.g. Colombia, Chile). However, as shown by Laban and Larraín (1993), lifting restrictions on capital outflows may further stimulate net capital inflows. The reason being that, for the foreign investor, the easier it is to take funds out of the country, the lower may be the risks of suffering a capital loss (due to a policy switch, for example), a phenomenon that may be encapsulated as "easy go, easy come". Moreover, such a policy may aggravate the costs of a *massive* capital outflow (see section D.1).

3. Exchange rate policy

Full control of the money supply could be achieved if the exchange rate was allowed to float freely. Furthermore, by abandoning the commitment to support fixed (or semi-fixed) exchange rates, the central bank's function as "lender of last resort" is restored, helping to attenuate financial fragility. However, free floating does not prevent the real exchange rate from excessively appreciating or from exhibiting wide fluctuations. For example, the real exchange rate appreciated considerably in Argentina, Brazil and Peru during periods of relatively flexible exchange rates, and Mussa (1983) shows for industrial countries that floating rates are associated with greater real exchange rate volatility than fixed rates.

The main advantage of allowing greater exchange rate flexibility is that equilibrium changes in the real exchange rate occur more swiftly than otherwise, and do not require inflation or deflation to take place. In addition, to prevent excessive fluctuations in the real exchange rate, exchange-rate bands - as in Chile, Mexico and Israel - could be adopted.

F. Role of international cooperation

The Bretton Woods system was designed to support international trade, breaking the vicious cycles generated by beggar-thy-neighbour policies, and lessening the impact of balance-of-payments crises. The system was established during a period of relatively low private capital mobility. Thus, IMF quotas were determined to ensure that enough resources were available in order to cover possible short-term trade account imbalances.

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[23] Moreover, fiscal policy is bound to exhibit significant implementation lags, which may render it pro-cyclical.

In contrast the present situation is one of much higher private capital mobility, where trade imbalances could co-exist with a solid balance-of-payments position, as is the case in countries undergoing substantial capital inflows. Actually, many developing countries have suffered substantial deterioration in their terms of trade at the same time that they exhibited a healthy growth of international reserves.

Previous sections have highlighted the effects of international capital flows, and have discussed domestic policies that may be appropriate to deal with those flows. In the present section I will discuss the role of international cooperation.

As noted above, capital flows have real effects independently of the exchange rate regime that is being adopted. Thus, conceivably, international arrangements could aim at lowering the variance of those flows. One possibility would be either to help to prevent capital flight or to lower its variability. However, this does not seem to be a practical solution. Controls and taxes imposed by industrial countries on accounts held by foreign residents could easily be bypassed, for example, via off-shore banks.[24]

Capital flows are driven by interest rate differentials adjusted for country risk and the like. Country risk, in turn, is a function of domestic policy, but it is also a function of the legendary "animal spirits". Finally, "animal spirits" are not immune to "herding" instincts. Thus, it is conceivable that a country undergoes massive capital outflows because foreign investors decide to "pack up and go". Actually, as pointed out above, this kind of scenario may arise in a model of perfectly "rational" and well-informed individuals.

A relevant example is a bank run. If everybody believes that the banking system will break down, a run against the system will take place, and the system will break down. On the other hand, if nobody (or only a few individuals) believe that the system will collapse, no run and no collapse will take place (Diamond and Dybvig, 1983).

International cooperation may be very effective in preventing the emergence of self-fulfilling doom prophecies. This is the rationale for the "stabilization funds" set up in some Eastern European countries. In contrast, the existence of self-fulfilling prophecies does not seem to have been the rationale behind the creation of the IMF, simply because, as pointed out above, capital mobility was low or obstructed by several industrial countries.

In a world of capital mobility there is, thus, a role for a world central bank (WCB), whose basic function is that of "lender of last resort". This function becomes even more necessary for countries that peg to a major currency or are highly "dollarized" - like Argentina, Bolivia and Peru - and even for countries that operate under a system of exchange-rate bands.

A major difficulty with a WCB is that it has to be endowed with strong supervisory capabilities. National central banks that join the world system must be prepared to surrender all the relevant information to WCB supervisors. Besides, national monetary and fiscal policies should also be monitored by the WCB, and rules established specifying under what conditions national central banks will be supported by the world entity. This is a tall order set of conditions which will require strong backing from industrial countries. The funds involved are likely to be far greater than those currently available in the IMF, because the WCB will have to be in a position to act as a "lender of last resort".[25] This means that at any given point in time the WCB should be able to generate enough international liquidity to back up a large portion of a country's M2, for example. M2 is a far larger number than typical trade imbalances.

G. *Final remarks*

International capital mobility poses a major problem for developing countries. Capital flows are provoked by conditions prevailing in these countries, but also, and quite significantly, by conditions prevailing in the industrialized world. Thus, the view that economic instability in developing countries is mostly a result of faulty domestic policies is a half-truth.

The above discussion has identified several grounds that would justify government intervention, and a menu of policies that could be utilized for that purpose. On the whole, however, there is not much that authorities can achieve through intervention in the medium or in the long run, since new channels are likely to be created for circumventing government re-

[24] Opposition to these measures inside G-4 countries cannot be ignored either. For example, recently the United States financial sector successfully lobbied against tax withholding on bank accounts.

[25] Total outstanding credit from the IMF to developing countries represents less than 3 per cent of their combined GDPs.

strictions. International cooperation may help prevent crises of self-fulling expectations, but the dimension of the new, or revamped, international institutions that would be called for is simply daunting.

However, the costs of capital mobility may be exacerbated under fixed or predetermined exchange rates (like rigid *"tablitas"*) and/or substantial "dollarization". This is so because under those circumstances the central bank loses its ability to operate as "lender of last resort". Thus, a bank run may have to be met by a deep financial crisis, by an abandonment of predetermined parities, a repudiation of foreign currency denominated deposits, or some combination of the above.

Therefore, to reduce the probability of financial crises associated with capital outflows, it seems advisable either to establish a relatively flexible exchange rate system, or to encourage domestic banks to set up close links with leading international banks. Greater exchange rate flexibility would endow the central bank with some power as lender of last resort. In turn, close links with leading international banks - particularly when the reputation of the leading banks would be at stake if the domestic bank were to fail (as exemplified by subsidiaries of leading banks) - may help domestic banks to obtain "short notice" liquidity in international markets and, thus, partially substitute for the lack of a domestic lender of last resort. I believe this second alternative deserves serious consideration.

In closing, I would like to note that, although of limited effectiveness, policies to counteract the negative effects of capital mobility should be high on the policymakers' agenda. As noted in section B, the present wave of capital flows into developing countries may be coming to an end. If history is any help, these flows may change direction abruptly, and even if the process is gradual, there is no assurance that all countries will fare equally. Some countries could experience a sharp reversal of capital flows, while others saw little change.[26]

A major problem with crises caused by sizeable capital outflows is the likely poor quality of the ensuing policy response. By nature, these crises give little time to weigh the pros and cons of each policy option. In addition, government is literally accosted by lobbyists who come with self-serving - although possibly desirable from a social point of view - policy advice, and sheer political pressure. Therefore, even if governments decide to avoid interfering with capital flows, they should stage frequent "fire drills" to be able to react quickly and effectively to sizeable capital outflows, and be prepared to withstand pressure from vested interests in a strong and unified fashion.

[26] See Ford (1962) where it is shown that the reflow of capital to Europe on the eve of World War I caused a major financial crisis in Argentina, while leaving Australia and Canada relatively unscathed.

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Comments

Cristian Ossa

The paper by Ariel Buira comprises three largely independent parts.

The first part addresses the question of demand for international liquidity and examines whether there is a stable relationship between key variables, such as GDP and share of imports and the demand for international reserves.

The second part examines the sources of international liquidity. What are the close substitutes of international reserves as traditionally defined? How are international reserves distributed? And what are the effects of the malfunctioning of the system for the more vulnerable countries or countries with difficult balance of payment positions and without access to international credit?

In the third part, Buira puts forward a programme, along the lines of a traditional central bank, and discusses the role and responsibility of the IMF in carrying out this programme, which essentially consists of ensuring an adequate level of international liquidity to lubricate the world economy in a way that all countries benefit.

Buira's conclusion regarding the first point is that there is a stable demand function for international reserves in the North and the South and that international reserves would be a good proxy for international liquidity. Consequently, the reserve function could be used to estimate future international liquidity needs.

Without more detailed information regarding the econometric exercise, it is difficult to question the conclusions regarding the parameter's stability, in particular, whether such stability is more a reflection of parameters largely determined by cross-section influences than by variations over time. But my concern is more about the validity of the past relationship for future projections. Buira himself in his paper acknowledges the changes that have taken place and are still occurring in foreign exchange policies and international capital markets.

What are these changes? First: with the increasing number of countries that let their currencies float or that introduce adjustments periodically, holding reserves to defend the exchange rate, as in the past, has become a less significant objective. Second: is it not the case that the number of reserve currencies is actually increasing? Third: long ago developed countries established lines of credit among their central banks (swaps) that assured them rapid access to sizeable amounts of liquidity (as the recent example of Mexico shows, some developing countries are also beginning to enter into such arrangements). Moreover, central banks or governments that are creditworthy today have access to liquidity in the financial markets that might be a multiple of the international reserves traditionally held. Fourth: large and important players, such as transnational corporations and their subsidiaries, take care of their foreign exchange needs directly in many ways. Consequently, the transaction motive for holding reserves in many countries is somehow changing. Finally: in today's world, in some cases, disequilibrium in the balance of payments is often the result of massive private capital flows to compensate for saving and investment disequilibria, as in the case of the United States in the first half of the 1980s. To derive optimum reserve levels in such conditions from the traditional demand function would be erroneous. Sustainability of fiscal deficits and external credibility in fiscal and monetary policies become in practice two factors influencing actual and optimum reserve levels. But how do you measure the sustainability of fiscal deficits and the credibility of policies?

The question of credibility was at the core of the recent problems of European central banks, which realized that even very large amounts of reserves are insufficient to cope with determined and powerful speculators. The events of September 1992 (devaluation, among others, of the peseta and the pound, and the exit of Italy and the United Kingdom from the ERM) and of August 1993 (leading to the widening of the bands of the ERM) clearly suggest this.

On the second major issue, Buira points to the haphazard nature of the creation and distribution of international liquidity and the cost that this implies for countries that have no access to borrowed reserves in international capital markets. He concludes that many developing countries are particularly affected by the working of the system. If they need to rebuild their reserve positions because they have been exhausted, the economic cost is unusually high because it is necessarily reflected in a significant loss of output as imports are compressed. It is also argued that, if they resort to the IMF, adjustment programmes are often underfinanced and, as a consequence, they fail. The underfinancing is partly due to the inability of the IMF to provide sufficient liquidity.

Here, the arguments presented by Buira are not as convincing as in other sections. Even the severe liquidity shortages of a group of developing countries need not add up to a global liquidity problem. To establish a close relationship between sluggish growth due to import constraints, which is not necessarily a short-term phenomenon, and low reserve levels, can be misleading. Also, although one can fully subscribe to the view that some adjustment programmes might have been underfinanced and that was the cause of their failure, it does not necessarily mean that it was the liquidity gap that caused the failure.

A developing country affected by structural rigidities might easily fall into an unsustainable trade deficit or current account deficit (permanent drop of export prices). When this happens, reserves are rapidly exhausted even when the initial level was high. But if reserves are replenished from any source, including the IMF or even by grants, the fundamental problem does not disappear. International reserves will continue to be spent and there will be a need for continuous replenishment. In other words, the actual difficulty is not a reserve or a liquidity problem, but a long-term real resource problem that the country must face.

This same country under an adjustment programme has two kinds of needs. One is for a level of international reserves or access to international liquidity that allows the country to smooth out seasonal or erratic current account deficits. This is a clear responsibility of the IMF. The other is the need for real resources to effect the capital investments required for the adjustment. Indeed, in developing countries it is a rare case when only demand management will do; usually, it is critical to reallocate and increase investments and this might take quite a few years. If domestic saving efforts supported by development financing cannot fill the real resource gap, the adjustment programme is likely to fail, as the expansion of investments will not occur. But it is obvious that such failure is largely independent of the amount of reserves or liquidity (or working capital) that the country was lent or was given at the start of the adjustment programme or - if you wish - at the time the stand-by arrangement was signed.

Of course, this does not mean that the IMF should not try to provide the maximum amount of resources commensurate with the adjustment programme requirements, directly via its own facilities or indirectly by stimulating others to provide financial support for the process. Yet, such efforts, which should be made in conjunction with the World Bank and regional development banks, clearly go beyond efforts to provide adequate liquidity levels. They lie more in the realm of development financing than in the area of responsibility of a monetary institution.

In his final section, Buira identifies the current weaknesses of the present system and advocates a programme under the responsibility of the Fund to overcome them. He points to five major concerns or weaknesses:

(1) The growth of international liquidity is haphazard.

(2) Its distribution is inefficient and inequitable.

(3) The IMF is not playing its assigned role of adequate creation and distribution of international liquidity; as a consequence, adjustment programmes are underfinanced and often fail.

(4) The SDR is not fulfilling its role as principal reserve asset.

(5) Finally, while there is a stable demand function for international reserves, no institution formulates or is responsible for policies that ensure adequate levels of international liquidity.

Buira thus concludes that the Fund should operate along the lines of a central bank and be effectively in charge of the following tasks. The Fund should, first, estimate every year overall international liquidity needs, including the needs of different groups of countries. Then, the international community through the IMF should consider appropriate measures to adjust the supply of international liquidity to levels consistent with growth and stability in the world economy.

For the purpose of creating the required additional liquidity, the IMF would allocate

SDRs to its members in proportion to their quotas. Countries without liquidity needs would make their SDRs available to developing countries facing liquidity shortages or lack of access to credit. The end result would be a more equitable and faster growing world economy.

I would not like to take issue with the steps and the goals advocated by Buira. I think they are likely to be shared by many if not all of us. I would rather concentrate my comments on identifying some problems related to implementing each of the steps.

The first step advocated is the annual preparation by the IMF of estimates regarding the optimal level of reserves for the world economy in the next few years. This step assumes the existence of a stable relationship for the future between demand for reserves and some key variables, an assumption that Buira himself questions. But for the second step, let us accept that there actually is a stable international demand for reserves and that the IMF staff will present to the Board estimates of future international reserve needs, assuming GDP and import growth.

But who is going to vouch for these estimates? The recent experience of GDP forecasts for the developed market economies has shown a clear upward bias since 1990. This led some major countries to express, in the context of the Interim Committee meetings, serious reservations about such GDP estimates (see, for example, the Statement of the Secretary of the Treasury of the United States in the Interim Committee in 1991 in Bangkok). Under such conditions, I see that it would be difficult for Executive Directors to agree every year on the amount of additional international reserves required at the global level.

Moreover, how can we ensure a consistency of views even at the country level? If central banks and ministries of finance are often at odds on domestic monetary policy, will they agree on an international monetary programme? More and more central banks are autonomous entities and that will have a bearing on the implementation of any international monetary programme. Will central banks always follow directives adopted by ministries of finance in the context of the IMF Board, particularly when such directives do not coincide with central banks' views?

Even if there is an agreement on the corresponding amount, it will be difficult to ensure that it will be achieved. Recent experience with monetary targeting at the country level has proved that success is often quite elusive, and one should not expect that it will be easier at the international level. Besides, instruments might be insufficient. After all, at present, SDRs are barely 2 per cent of total international reserves. If, in the eventual calculation, we come to a result where, after taking into account all other factors that determine international reserves, even considering full cooperation of individual central banks, there is still a gap of 4 per cent in total international reserves, SDRs would have to be expanded by 200 per cent to fill the gap. Is that possible politically or institutionally?

In sum, although one can agree with Buira on the objectives, the steps suggested to achieve them appear largely utopian at this juncture. A much improved system to monitor and ensure an adequate level of global liquidity might require another effort of the magnitude deployed at Bretton Woods 50 years ago.

Two points emphasized by Buira, however, remain crucial for sustained growth in developing countries. One is the provision of adequate levels of development finance to help to ensure the investments required for successful adjustment in countries facing long-term disequilibria. Here, both the IMF and the World Bank have a critical role to play.

The other is an automatic or semiautomatic response to the liquidity needs of countries facing self-correcting or temporary disequilibria. This critical function of the IMF has been losing ground vis-à-vis other tasks of the institution despite its eminently monetary character. Yet, the need for such a response has not diminished. On the contrary, as developing countries have opened and liberalized their economies and key parameters in the world economy remain unstable, the need for more automatic provision of liquidity in adequate amounts - under appropriate circumstances - has increased. This is an area that, as suggested by Buira, requires much more attention. The IMF has a clear mandate to act in this area as it is one of the main purposes stipulated in Article I of the Agreement.[1] Making progress towards this objective does not require institutional changes. It is a question of the policies and political will of key members to adapt to the requirements of the mid-1990s.

[1] Article I of the Bretton Woods Agreement states as one of the main purposes of the IMF: "to give confidence to members by making the resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity".

Faika El-Refaie

Allow me at the outset of my comments to congratulate Ariel Buira for his excellent paper which I consider a quite stimulating and thought-provoking piece of research. My comments are confined to major issues and are intended to cast light on the principal ones, as well as to raise certain queries related to the paper's theme and conclusions.

In his presentation, Buira adopted a topic-by-topic approach. Accordingly the paper was divided into three main sections, which my comments will follow: the demand for international reserves (IR), the analysis of the sources of international liquidity (IL) and the role played by the IMF in adjustment programmes, and the main aspects of the distribution of IL, attempting to answer the question of whether or not the current system is efficient and equitable.

A. The demand for international reserves and liquidity

Buira has given a general definition of IL, quoting Marcus Fleming, as the internationally acceptable means of payment *immediately available to the authorities* of any individual country for financing balance-of-payments deficits or for exchange rate stabilization. However he ended up by saying that "this concept is traditional and does not consider resources to which the country may have *potential access*, such as credits from international agencies, monetary authorities of other countries, banks and other private sources. But because IL in its broad definition is virtually impossible to measure, IR is normally used as an approximation".

It is technically important to define what IL means as against IR.

- We may define IR as unconditional international means of payments immediately available to the monetary authority. In this sense it serves as a tool for stabilization policy against short-term and cyclical imbalances.

- IL, on the other hand, is a broader concept which has a medium/long-term horizon related not only to short-term adjustment, but also to growth and development. It comprises unconditional financial resources for balance-of-payments support.

The distinction between the two concepts is important because one is an *ex-post* and the other is an *ex-ante* concept related to potential sources of financing.

It is difficult, therefore, to accept the idea that the two concepts are normally used as approximation for each other, because they differ in nature, scope and purpose, a matter which has implications for the philosopy of the Bretton Woods institutions and on how they function individually, and on what basis they coordinate among themselves. The aim of a discussion of this sort is to highlight the significance of mobilization of long-term foreign capital for economic development and growth. Foreign direct investment, issuance of securities (bonds and stocks) are important sources of financing in addition to official grants and loans, and commercial bank borrowing. Countries having little or no access to capital markets and direct investment suffer from a severe shortage of the liquidity necessary for development. Enhancement of IL through bilateral and multilateral aid is required until such time that a country reaches the stage of attracting direct foreign investment, and can borrow from the international capital markets, i.e. have access to other sources of IL.

If this view is adopted, Buira's analysis would lead to a further contribution to the debate on the management of the world economy's need for IL and not only for IR. The role of the IMF and the World Bank in influencing the availability of IL is critical, especially as they are:

- the only institutions that can create additional liquidity, i.e. through new allocations of SDRs by the IMF; and

- the most appropriate institutions to serve as "catalysts", so that countries can obtain official or private financial resources to fulfil their demands for IL.

It is in this capacity and because more than half of their members suffer from profound problems requiring years of adjustment and suitable financing, that the Bretton Woods institutions should reconsider their philosophy in order effectively to carry out their tasks in *enhancing* and making available *adequate* IL,

necessary for promoting trade, growth and development. The issue is not only enhancing IR but also promoting other sources of financing.

Looking ahead, according to the latest projections of the IMF *World Economic Outlook* of April 1994, industrial countries' rates of output growth will double in 1995 (2.6 per cent) compared to 1993 (1.3 per cent), while those for developing countries will deteriorate (5.8 per cent against 5.9 per cent).

Industrial countries' import volume will have a rate of increase five times higher in 1995 (5 per cent) than in 1993 (around 1 per cent), while for developing countries, this will tend to decline (9.1 per cent against 9.8 per cent). This trend suggests that the developing countries' relative position will drastically deteriorate in the future. Targeting higher rates of growth for developing countries is critically important in the assessment of the global need of IL.

In his discussion of better management of IL Buira tries to prove that there still exists a stable relationship between the demand for IR and output and trade, on which a forecast could be made and a set of measures introduced so that the required liquidity could be put into operation. Apart from the issue of how stable this relationship is, and the difference between IR and IL, it would have been useful if such measurement had been done at subgroup levels for developing countries, instead of taking them in one group. This is crucial because the demand relationship for IR varies between the subgroups, depending on the degree of flexibility on the capital account (borrowing bilaterally and/or from the market and direct investment). The measurement of the demand for IR for different subgroups of developing countries would also have implications for the distribution of IR. It does not suffice to forecast the world demand for IR; it is also important to determine its distribution and the demand for other sources of external financing (IL). This issue relates the availability of liquidity to development and growth, a matter which is crucial for the overall stability and integrity of the world economy.

B. *Sources of international liquidity and the role of the IMF in adjustment programmes*

In reviewing the means of financing balance-of-payments deficits Buira distinguished between three groups of countries:

(1) Reserve currency countries where balance-of-payments imbalances can be settled with freedom and over a reasonable time span without undertaking adjustment policies.

(2) Other developed countries which encounter few difficulties in satisfying their demand for international means of payment, as they have wide access to secondary sources of liquidity and because of the lines of credit among their central banks (swaps) that assume sizeable proportions in cases of contingency, thus allowing the adjustment process to be carried out smoothly and at relatively low cost.

(3) Developing countries, especially the group of low income countries which account for 60 per cent of the world's population, which are vulnerable to external payments problems and have little chance to settle their external imbalances without undertaking severe and painful adjustment policies.

Buira pointed out that the United States has made the greatest use of this recourse. The United States balance-of-payments outcome depends on its economic policies, which are naturally aimed at correcting internal imbalances. Thus, the United States contribution to IL need not coincide with the world's needs.

This is a crucial point that requires consideration. The world economy is in need of an arrangement whereby international liquidity can be created bearing in mind the interests of all parties, rather than simply being bound to the policies of any individual country.

The distinction also raises a question concerning "convertibility", as, in the absence of "swap" arrangements with other central banks, convertibility for a developing country would be a burden rather than a help. A world-wide scheme to ensure stability in exchange rates is required, with the SDRs playing their role.

In discussing the IMF programmes, Buira indicated that, partly as a result of constraints on financing, the implementation of an economic programme negotiated with the Fund did not guarantee a succesful adjustment.

Being in full agreement with this statement, I may quote Egypt's experience as a typical example. In fact, the structural adjustment and stabilization programme in Egypt has suffered several drawbacks during 1978-1989 because of this very reason. After 1990 the programme succeeded with the great support of outright debt reduction and rescheduling. In

this respect, there is a role for the Fund and the Bank to play to bring about debt forgiveness for the lower income countries in Africa and elsewhere, and to enable these economies to adopt stronger programmes of adjustment in a shorter time span. A medium-term comprehensive strategy should be envisaged for this purpose jointly by the Fund and the Bank. This is especially crucial because of the severe under-financing that such economies are facing and their difficulty in obtaining access to capital markets; and because these economies suffer from having to implement particularly painful adjustment programmes, while developed countries can avoid such adjustment by enjoying the benefit of international seigniorage.

Buira criticizes the Fund for changing its philosophy radically since the early 1980s, where a typical IMF programme prescribes measures that require a compression of domestic demand regardless of the problem's origin: temporary or structural. I would like to comment on this as I am confident that Buira will agree with me that most if not all, of the developing and developed countries are facing structural imbalances in one degree or another and that temporary external problems are now rare cases.

I strongly advocate Buira's conclusion that IR suffer from maldistribution and that there is no reason to expect, under the present state of affairs, that the growing demand for reserves will be satisfied by an equivalent expansion of supply except by chance. Buira mentioned that this problem stemmed from the absence of an international institution that weights and provides for the liquidity needs of the world economy as a whole and of its distribution, and that there was a need to develop mechanisms that would provide certainty that the future evolution of world reserves would be consistent with healthy growth of GDP and international trade.

He suggests that the IMF can do this through the allocation of SDRs and industrial countries could donate their allocations to international institutions in order to make them available to those developing countries facing difficulties of access to other sources of finance.

The idea of SDR allocation with post-allocation redistribution (PAR) is not new; it has been under consideration for several years and was part of the IMF Managing Director's statement before its Board in April last year. In fact, discussions in the Board have gone as far as to question whether the PAR should be compulsory or voluntary, and whether it should be related to quotas or according to needs.

Moreover, a recent proposal was under consideration by the IMF which refers to the feasibility of improving the distribution of SDRs by combining a concellation of all existing SDRs with a new SDR allocation to all participants on the basis of their present quotas. The first amendment of the IMF articles of agreement (Article XVIII, section 1.(a)), which first brought the SDR into the international payments system, stipulates that periodic allocation stands on its own as final and not subject to contingencies or adjustments. The proposal will have a negative impact on old participants, including developing countries.

It is interesting to note at this point that during the past five basic periods (1970-1993) only two allocations have been effected, in 1970 and 1979. As a result, net cumulative allocation (NCA) up to end-March 1993 reached SDR 21.4 billion, of which SDR 6.8 billion went to developing countries. Outstanding actual holdings of these countries reached SDR 2.8 billion. In contrast, industrial countries NCA reached SDR 14.6 billion and their holdings SDR 10.7 billion.. This means that industrial countries have used SDRs virtually as much as the developing countries during the life of the SDR and up to the present. On the whole, SDRs have played only a marginal role. They constituted no more than 2 per cent of total international reserves as of April 1993; 2.8 per cent for industrial countries and 0.9 per cent for developing countries. Thus, developments over the two decades since the introduction of the SDR have shown a wide gap between aspirations and reality. What was targeted was for the SDRs to become the principal reserve asset and the unit of account, so as to foster the flow of international trade in goods and services and achieve real growth with stability in the world economy.

There are several problems in relation to the subject of IL which require reconsideration. In the domain of the IMF these are:

- *The size of the IMF:* The IMF capital was equivalent to only 2.7 per cent of world trade at the end of 1992. Therefore, the quotas of members, and especially those of the developing countries, are very small. There is an obvious need to increase the IMF capital in order to be consistent with its new mission and responsibilities, not only to finance temporary balance-of-payments problems, but also to address structural imbalances through adjustment.

- *The distribution of quotas* in the IMF requires serious consideration, taking into account the new trends and changes in the different groups of developing countries.

As the Managing Director of the IMF stated in an interview with the *IMF Survey* on 21 March 1994: "The world is no longer simply divided between donors and recipients, North and South; rather the South is increasingly among the donors. Quite a different world from the one at the beginning of the 1980s". On the basis of this fact, the distribution of quotas and, accordingly, the relative voting powers, need serious reconsideration.

- *Access to quotas:* The access limits to the IMF credit tranches, as well as the overall limits as percentages of quotas, were drastically reduced in the past few years. The reductions were justified by the need to safeguard the liquidity position of the IMF. Thus, instead of a call for the need to replenish the capital and/or initiate other sources of financing within the IMF to meet the demand for IL, the role of the IMF was restricted through lower access limits at the time as conditionality was becoming harder than ever. Along with the increase in capital, there is a need to raise the IMF credit limits to match the liquidity needs in connection with structural adjustment and stabilization programmes.

- *Enlarged access policy:* Further to the Ninth General Review of quotas, the IMF terminated its policy of enlarged access. However, this arrangement had enabled the Fund to provide in a timely manner the financial resources that a member needed to implement its adjustment and reform programme, albeit at higher interest rates and with shorter amortization periods. In case an increase in the IMF's capital is not feasible, the alternative would be for the IMF to consider a resumption of the enlarged access policy.

- *Exchange rate re-alignment:* Fluctuations in the exchange rates, especially of key currencies, have been wide and had serious destabilizing effects on the world economy and the economic performance of individual countries. To minimize such fluctuations and reduce their harmful effects on trade, investment and growth, it is important that the sixth basic period (1992-1996) of the SDR review witness a new era which could lead to the initiation of a system where the SDR plays its role as a basket to which individual currencies are pegged, thus regaining "the grid of parities" scheme that prevailed before the creation of SDRs. This would also enable the world economy to gain the possible benefit of the international agreement on trade in goods and services.

- *SDR allocation:* There can be no doubt that new mechanisms are required in order to enhance growth in the world economy and create an international economic environment in which all will prosper. In this respect, there is an urgent need for a sizeable new SDR allocation with PAR. The latter should not be bilateral and voluntary. Rather, I suggest that the PAR resources be gathered in a pool under a plan managed by the IMF.

  The Fund could use the PAR pool to enhance the sources of the Systemic Transformation Facility (STF) with two objectives: (a) to make available adequate SDRs to new members who have not participated in the scheme in the past; and (b) to broaden the STF scope to support developing countries which follow programmes of adjustment that transform their economies from inward-looking socialist to outward-looking market-oriented economies. It could also encompass donations to countries which will be affected by the lifting of price supports of agricultural products in Europe under the GATT agreement. In addition, such a pool could be used to finance debt reductions for the low income countries. In this way, the allocation of SDRs would enhance international payments and growth without jeopardizing the international monetary system or leading to inflationary pressures. Another implication of this PAR pool would be the replacement of the system of bilateral financial cooperation with a multilateral one.

  Coherent coordination between the Fund, the Bank and the newly established World Trade Organization (WTO) should be contemplated as well. Actually, the pool may be better managed by the World Bank.

In his conclusion, Buira suggests that the IMF estimate international liquidity needs and consider what measures would be appropriate to adjust the supply of IL to levels consistent with the growth and stability in the world economy.

If my understanding of Buira's view is right, the proposal is meant to turn the IMF more or less into a world central bank. We would all wish this to become a reality, but the question is not that simple. In establishing its estimates, the IMF has to know individual countries' rates of growth and inflation. Would

the IMF accept what the countries themselves decide or will the IMF have its own views? And what about the policies that individual countries should follow to achieve the targets? At present, the IMF can influence the policies of borrowing countries, but the macroeconomic policies of developed countries are beyond the effective surveillance and control of the IMF. There is obviously a need for innovative arrangements to establish an appropriate mechanism in that respect, including the restructuring and reorientation of the two Bretton Woods institutions towards a better global management of the world economy.

Yilmaz Akyüz

Latin America (LA) has been receiving massive private capital inflows, but these are not translated into investment and growth. I agree with Calvo on the unsustainability of the recent pace of capital flows to the region. I also agree with the need to control private capital flows of a short-term nature. However, my reasons therefor are somewhat different from his and can be summarized as follows.

First of all, the sustainability of capital flows to LA is quite different from that of capital flows to Asia because the origin and nature of these flows are quite different and hence they are driven by different dynamics. In LA they are driven primarily by a speculative bandwagon whereas in Asia by investment and growth.

Consequently, it would not be methodologically correct to put these different flows in the same pot and treat them equally in the context of the possible evolution of North-South trade balances. A deterioration of the trade balance in the North does not necessarily mean that the trade balance of every region of the rest of the world will move so as to offset it. It is thus possible for Asia to continue to run deficits and receive capital flows while LA is forced to make a swift payments adjustment. This was, after all, the situation in the 1980s. Disparities have always existed within the South in their ability to attract capital flows, and indeed, sub-Saharan Africa has not shared in the recent revival of capital flows.

A related question is the causality between external deficits and capital flows. Relying on the ex-post trade balance identity between the North and the South misses the point that capital flows today are largely autonomous. As LA knows to its cost, there is a considerable difference between having to make a swift external adjustment as a result of a slowdown or even a reversal in capital flows, and a situation where an improvement in the trade balance is unrelated to capital movements - e.g. on account of increased competitiveness, greater export capacity and so on. The *ex-post* trade balance identity does not show this difference.

I believe that the recent pace of capital flows to LA is not sustainable, whether or not there are higher interest rates and strong recovery in the United States, and whether or not trade balances in the North deteriorate. I base this judgement on the nature and effects of these inflows.

To judge the nature of capital flows it is important to know both how the capital is being raised abroad (ie. its origin) and how it is being used in the recipient country (its use). As for the origin of these flows, it is important to distinguish that part which is of a one-off nature, such as repatriated flight capital and capital attracted by privatization. Again, capital flows to equity markets represent partly a portfolio diversification by international investors exploring opportunities in the so-called "newly emerging capital markets" and attracted also by low asset values. For the recent pace of equity investment to continue, the corporate sector in LA would need to grow very rapidly, requiring a rate of investment far above that observed in recent years.

It is usually the use made of capital flows that determines their degree of volatility. FDI and enterprise borrowing abroad for investment in productive capacity is generally less susceptible to reversal than inflows directed at the equity market or acquired for refinancing or relending in the domestic money market or depositing in domestic financial institutions. While not all recent capital flows into LA have been for short-term uses, a considerable proportion does appear to have been for this purpose.

Such inflows usually occur in response to a nominal interest rate differential that markets do not expect to be fully matched by a nominal exchange rate depreciation. Such differentials often follow the liberalization of domestic fi-

nancial markets in developing countries, since inflation rates in these countries are usually much higher than those in the reserve-currency countries and inflation differentials are readily reflected in nominal interest rate differentials. Similarly, an expectation that equity prices will rise faster than domestic currency depreciation can prompt an inflow of capital.

The crucial role in this process is played by exchange rate expectations. Such inflows are typically initially a response to a favourable shift in market sentiment regarding the recipient country. After this initial shift, a bandwagon develops and creates a speculative bubble whereby people lend or invest simply because everybody else is doing so. The expectations underlying this process become self-fulfilling, since the inflow of funds, if large enough, can itself maintain the value of the currency and boost equity prices. However, when the bubble bursts and the currency comes under pressure, even very large interest rate differentials may be unable to check the capital outflow.

Such a bandwagon effect has been evident in LA, not only within each country, but also across countries. Calvo's finding of a high degree of co-movement of variables associated with capital inflows across different countries is a strong evidence to this effect. However, this is no cause for surprise. In a sense this is reminiscent of the "contagion" of the early 1980s, when bank lending virtually to every country in the region was cut after the Mexican crisis. Now capital has been flowing to almost every country, including those with serious macroeconomic imbalances, while the recipient countries differ in their fiscal posture, and exchange rate, trade and financial policies.

Calvo attempts to model the determinants of private capital flows to LA and to predict how they will move in coming years in order to assess if they can be sustained. Such models suffer from the same shortcomings as empirical exchange rate models which very often fail to relate exchange rate movements systematically to a set of variables that are widely assumed to be relevant. While they may give a relatively good fit within their sample periods, their predictive efficiency is very poor, particularly in respect of the turning points. This results from the fact that expectations regarding returns on financial assets, including the prospects of capital gains, play a major role in determining the direction of capital flows, and that such expectations are highly volatile and subject to bandwagon movements.

The role of external factors in capital flows to LA seems to be a little exaggerated. Lower United States interest rates have certainly helped to raise the arbitrage margin in LA. However, it has to be borne in mind that, while short-term rates declined in the United States, long-term rates remained quite high, and that short-term rates rose considerably in Europe. Besides, in some countries the arbitrage margins with the dollar-denominated assets are so large that a change of a few percentage points in the United States cannot make much difference. In any event, such margins are not sufficient on their own to attract capital flows. Indeed, even higher margins had emerged in some countries in Latin America during the 1980s when capital was flowing out. However, this does not mean that higher United States interest rates now will have no effect: they can certainly prick the speculative bubble and set a bandwagon movement in reverse.

In any case, whatever happens to the United States rates, the particular configuration of exchange rates, interest rates and stock prices underlying the recent surge in capital flows cannot be expected to last. An important part of the arbitrage margin has been due to currency appreciation, which, if continued, would eventually lead to a payments crisis as trade deficits mount. If, on the other hand, the currency appreciation is suddenly reversed, the arbitrage margin will disappear, possibly triggering a sharp drop in short-term capital flows. Thus, the best strategy would be to let nominal exchange rates slide gradually while controlling short-term capital inflows. Chile has achieved considerable success in this respect.

The vulnerability of LA to reversal of capital flows arises from the fact that, as Calvo points out, they are not translated into a higher rate of investment, particularly of the kind capable of generating foreign exchange. This is perhaps the main difference with Asia, and clearly shown by his table 3. Higher productive investment is not possible when domestic interest rates are prohibitive and long-term investment with funds borrowed abroad at lower rates carries a high exchange risk. In other words the high interest rates and/or currency appreciation that attract short-term capital also deter investment. In such a case, the scope for responding to a drop in capital flows by export expansion is limited and external adjustment usually requires cutting imports by reducing growth and domestic absorption, i.e. reversing the earlier benefits of the capital inflow.

M.A. Uduebo

The logic of Guillermo Calvo's analytic reasoning is well grounded in theory, and his presentation is balanced and lucid, drawing copiously on the vast body of empirical literature on the subject. I am largely in agreement with the thrust of his analysis and policy recommendations. However, there are a number of fundamental issues I would like to comment on.

In his paper, Calvo stated that private capital inflows into developing countries have recorded a substantial increase since the beginning of this decade. This high degree of capital mobility has been induced by a host of external and internal factors. He singled out interest rate differentials as the most important explanatory variable for the observed capital flows. Admittedly, the expected rate of return on investment is a necessary, but not a sufficient, condition for capital flows. For example, it would have been interesting to see the results of the empirical studies cited by Calvo if the African region had been included in the sample. Since the mid-1980s to date, most African countries have embarked on macroeconomic stabilization programmes and structural reforms resulting in heavily depreciated exchange rates and very high interest rates. Available evidence during the period shows that private capital inflows have been largely unresponsive to changes in interest rates. Foreign direct investment in Africa has been very limited, as the behaviour of the multinational corporations is guided by more factors than the simple theoretical and straightforward calculation of rates of return differentials at the margin. Political calculations may appear to provide the proximate explanation for the limited private capital flows to Africa.

I share completely Calvo's viewpoint on the need for government intervention through imposition of controls in order to minimize the negative destabilizing effects of capital inflows. The need for government to intervene in the market when capital flows result, for example, in wide gyrations in real exchange rates or interfere with other domestic policies, cannot be over-emphasized. It is common knowledge that government machinery in developing countries cannot evolve a perfect transfer from gainers to losers. Optimal second-best policy therefore calls for controls to stem transitory and unexpected volatility in real exchange rates, while massive capital outflows may call for permanent controls.

Calvo also touched on an important issue, that is, the need to improve credibility in government policy. This is a major problem that has bedeviled policy implementation in many developing countries. Inconsistent government policies may undermine credibility in the system. For example, say the government was pursuing exchange rate stability as a policy objective and simultaneously running excessive budget deficits. If the economic agents do not trust the government ability or willingness to stabilize the domestic currency, they will adjust their portfolios by switching from domestic assets to foreign assets, as the domestic currency continues to depreciate. Thus, improving credibility should be accorded high priority.

This issue brings to the fore the recent debate on institutional reforms that would grant some degree of autonomy to central banks, so as to allow them to operate unfettered as true "bankers of last resort", thus ensuring some measure of credibility in their policies. This proposal has some merit. The episodic monetary disorders in developing countries are traceable largely to central banks' accommodation of government fiscal deficits. The evidence indicates that in most countries where the central banks have been delinked from the treasury, the achievement of macroeconomic stability and hence credibility in policy measures have been more pronounced. Once the central bank is expressly prohibited by its enabling statute from lending to the government (as in the case of Argentina and Chile) or is allowed to extend credit to the government only within specified limits (as in the case of Germany, Switzerland, the Netherlands and New Zealand), it can effectively resist pressure from the government to lend to it and thus be able to perform better its main function of ensuring price stability.

Calvo surveyed the wide spectrum of macroeconomic policies for dealing with the problems associated with private capital inflows, that is, appreciation of the real exchange rate and economic instability. His conclusions are telling but one is left uncertain as to which policy tool may be more effective to deal with these problems. It is, however, interesting to note that fiscal policy based on reducing government expenditure is the only tool considered most effective. This incorrectly assumes that

governments can forcibly cut expenditure, which may not necessarily be the case in many developing countries. The policy choice is not a straightforward option between policy A or B. The important thing is to find an optimum mix among the menu of policies that will work for a particular country at any given point in time. For example, a mix of stabilization measures and allowing the exchange rate to fluctuate in a non-dollarized economy may be desirable. In Nigeria we have found that reduction in government expenditure is sometimes politically inexpedient and so we have tried to deal with the problem through shifting deposits from commercial banks to the central bank, as well as through the "open market" sterilization of capital inflows. Some measure of success has been achieved.

I also subscribe to Calvo's view that international cooperation could be effective in mitigating the problems of currency runs and financial disorders associated with massive capital outflows. In this connection, he suggested the establishment of a world central bank to play this role. Obviously, this suggestion suffers from many drawbacks. It implies that national governments that accede to the membership of such an institution must be prepared to surrender their national sovereignty, which may entail the loss of political and economic decision-making to a supra- national authority. For many developing countries, the spectre of recolonization may weigh against their decision to join such a world system. Second, it is highly doubtful that in the prevailing international economic situation, the enormous resources that such an institution would require to function effectively as a "lender of last resort" would be forthcoming. The establishment of such an institution is simply not "on the cards". I believe that the scope of the IMF can be expanded and the institution endowed with substantial resources, so as to be in a position to perform the role of "lender of last resort" on a global scale.

Miguel Urrutia Montoya

Throughout these meetings, the subject of the problems derived from capital flows has cropped up several times. These problems can be so delicate that, as Shahen Abrahamian mentioned in this most interesting exposition, "it is not clear why capital account convertibility should be an objective of policy".

The debt crisis of the 1980s showed that there are major imperfections in the international capital markets. The origins of these imperfections are many; among the most important, we can mention information failures, moral hazard issues, the unfortunate correlation between commodity prices and industrialized countries' interest rates and the fact that banks lend to countries mainly when their balance of payments accounts are solid, and not when they really need the money.

For these and other reasons, capital flows have long been a major destabilizing factor in the world economy. They were very destabilizing in the 1980s, as they were in the 1880s. In many industrialized countries, the development of central banks and bank regulations were, in the past, aimed at mitigating the effects of volatility in capital flows.

Considering the persistency, the strength and the extent of this phenomenon, should not the Bretton Woods institutions focus a number of studies on the subject of the imperfections of the private international capital markets? Such studies, as Guillermo Calvo suggests, might not only improve policy advice, but ideally might lead to the creation of institutional schemes to prevent or overcome market failures in this area.

At the present time, the accepted theory is that all capital controls are useless, because they become, quite quickly, ineffective. I think this is a half-truth. One could argue that a large portion of capital flows can be controlled. In that case, rules and regulations could be helpful.

Experience clearly shows that regulations are ineffective in keeping nationals from exporting capital when they lose confidence in their local currencies. In a similar fashion, it can also be extremely difficult to avoid capital repatriation by nationals. Under-invoicing of exports or over-invoicing of imports and parallel markets make capital flight easy. However, some controls are useful. Certainly, for political purposes, there is a big difference between losing three billion in three days and losing a similar amount in three months.

Nevertheless, it is clearly possible to avoid market failures that involve destabilizing flows from regulated financial institutions.

Moreover, these are the agents that can make the largest short-term capital transfers. In this case controls are effective. Banks will not be willing to make irregular loans if they risk the possibility of not being reimbursed for illegal operations when a country's balance of payments goes into a crisis.

In industrialized countries, financial intermediaries and regulatory agencies are also interested in diminishing the costs associated with the instability in capital flows. Obviously, international agencies could play a valuable role in helping to solve market failures derived from imperfect information.

Azizali Mohammed has suggested that the IMF could develop facilities to deal with the instability of capital flows. In fact, this is something that national central banks in industrialized countries have been trying to do for some time, either by themselves or through coordinated activities with other central banks. I think that it is certainly worth putting this whole issue on the research agenda, and further exploring alternative institutional solutions. As Calvo highlights in his paper, "this is an area where international cooperation could be highly effective", mainly because the issue has the characteristic of affecting almost all nations nowadays, and, therefore, the advantage that both industrialized and developing countries would benefit from steps towards its solution.

III. DEVELOPMENT FINANCE

6

FOREIGN RESOURCE FLOWS AND FINANCING OF DEVELOPMENT IN SUB-SAHARAN AFRICA

*Benno J. Ndulu**

ABSTRACT

The paper reviews the role of external financing in development in sub-Saharan Africa, paying particular attention to the structural constraints which economies in the region face. The central role of external finance is identified as relieving the foreign exchange constraints to production and investment. The review of the trends shows that net foreign resource transfers into Africa have declined steeply in the last twelve years relative to GDP. A rapid rise in the debt servicing burden from the very large debt overhang is the key explanation. Losses from the deterioration of the external terms of trade further compounded the problem. The paper recommends action in four areas: the write-down of the debt stock to provide relief to the future servicing burden; diversification from debt instruments to foreign direct investment; enhancing effectiveness in the utilization and disbursement of official development assistance; and the provision of timely official credit to help ride out temporary shocks.

A. *Introduction*

Economies in sub-Saharan Africa (SSA) continue to experience slow growth and deteriorating living standards and quality of life, in spite of considerable investment in the 1970s which compared reasonably well with other developing countries; attempts at structural transformation, mainly via import substitution, during the same period; and reforms in macroeconomic, trade and sectoral policies in the 1980s and early 1990s.

African economies are being left behind in the process of convergence in world incomes. Real per capita gross domestic product growth in sub-Saharan Africa has averaged about 0.2 per cent per annum over the last 25 years, in contrast to an average of 2.5 per cent for the rest of the developing economies (Easterly and Levine, 1993). What is even more disturbing is the extent of the deterioration of performance in the last decade. The growth rate declined from an annual average of 1.9 per cent during 1965-1980 to -1.7 per cent in the 1980s. Gains in health and education standards achieved in the 1970s have been threatened with reversals in the 1980s as investment in, and maintenance of, social services were disproportionately starved of funding in order to restore fiscal balances. This deterioration is taking place in the face of the growing and very strong empirical evidence of the positive effects on growth from improvement in human capital in the forms of educational attainment and health (Barro and Lee, 1993; Easterly and Levine, 1992).

The explanations behind this disturbing performance have focused on three main factors: inadequate human, technological and institutional capacities; high vulnerability to exogenous shocks; and policy misdirection.

* I wish to acknowledge the very competent assistance of Aida Kimemia of AERC in pulling together and organizing the large amount of data used in this paper.

The three factors determine the extent of mobilization of resources for development, effectiveness in their use and distribution of benefits from development in the countries concerned.

In the 1960s and the 1970s the focus was on structural transformation and the provision of basic needs, characterized by enthusiastic efforts in import substitution and social services programmes. To achieve the goals, emphasis was placed on investment in these sectors, with the considerable support of foreign resources in the form of project aid. Not much attention was paid to complementary factors to ensure the achievement of reasonable levels of productivity from this investment. Utilization of the capacity installed required complementary investments in infrastructure and skill formation, as well as imported intermediate inputs most often inadequately supplied due to lack of local resources. The under-provision of these was partly a result of a lopsided allocation of available resources towards capacity expansion, exacerbated by the rigid tying of external finance to project aid. Equally absent during this period was the concern for maintaining a stable macroeconomic environment and incentives to ensure high productivity from investment and a healthy export performance. Agriculture, the mainstay of African economies in terms of income generation, food supply, employment and export earnings, was starved of investment and heavily taxed to support import substitution.

The crisis of the 1980s brought the above initiatives to a halt as unsustainable resource gaps emerged, made worse by a deterioration in the terms of trade and a sharp rise in the real interest on external debt. Table 1 presents the evolution of these resource gaps and points to the unsustainable levels reached in the 1980s. The initial response to the crisis was that of closing the resource gaps (stabilization) at the expense of growth, through reduction of imports and aggregate expenditure. This was buttressed by high conditionality for access to resources from the international financial institutions, particularly the IMF, under stabilization programmes. The cost of stabilization in terms of growth and its failure to close the gaps on a sustainable basis, were partly responsible for a broad adoption of an "adjustment with growth" approach, which emphasized the importance of both financing and policy reforms in reviving growth and achieving macroeconomic stability on a sustainable basis. Where significant social costs to adjustment exist, both theory and experience suggest the need for adopting a longer time frame for the adjustment process and the critical need for financing in order partially to alleviate adjustment costs and provide an impetus for reviving growth on a sustainable basis (Gavin, 1991). Adjustment and financing are hence considered complementary. In any case the credibility of the reform process itself relies on adequate external finance to alleviate resource constraints and provide reasonable assurance of its continuation (Helleiner, 1993a and 1993b).

In light of the above, this paper takes as its point of departure the current broad consensus that adjustment/reforms and financing are complementary. In this regard both the magnitude of net resource flows as well as their efficient utilization do matter. The effective use of these resources depends partly on the policy environment in recipient countries and partly on the disbursement modalities (and related conditions) of donors/creditors. Although ODA accounts for more than 80 per cent of total net foreign resource transfers into SSA, private credit, and more importantly foreign direct investment, are considered as an important potential source of financing that need to be taken into account in the future in a process of diversification of sources of external finance.

The next section considers in more detail the role of external finance in the development process, highlights the critical need for it and considers the likely areas of highest effectiveness. Section C reviews the magnitude, structure and historical profile of resource flows to SSA, emphasizing net transfers and factors behind their changes over time. Offsetting factors to these flows, such as terms of trade deterioration, will be considered here. Section D focuses on factors affecting the adequacy and effectiveness of external resource flows in supporting development, including the role of debt relief and policy reforms. Section E concludes with suggestions for improving the effectiveness of foreign resource flows in financing development, as well as raising their levels and diversifying their sources.

B. The role of external finance in SSA's growth and development

Three major factors explain the critical role of foreign resource flows in the growth and the development of SSA economies.

First, the economic structure of these countries is characterized by high dependence on imports for investment, production and consumption on the one hand, and on the undiversified basket of primary commodity exports which are subject to continued weakening

Table 1

KEY MACROECONOMIC BALANCES (AVERAGES)

(Percentage)

	1976-1979	*1980-1985*	*1986-1991*
Sub-Saharan Africa			
I/GDP	22.3	20.8	15.1
S/GDP	9.4	5.6	13.3
GDP growth	3.9	2.4	1.9
Resource balance/GDP	-3.6	-2.8	-3.5
Fiscal deficit/GDP	-5.4	-6.2	-5.2

Source: World Bank, *African Development Indicators.*
Note: I = gross domestic investment. GDP = gross domestic product. S = gross domestic savings. Fiscal deficit includes grants.

of world markets on the other. Empirical analysis reveals strong relationships between incomes and imports, with income elasticities well in excess of one in SSA (Lopez and Thomas, 1988). It also shows a positive and statistically significant relationship between increased imports and growth (Faini *et al.*, 1991; Lopez and Thomas, 1988; Ndulu, 1991). The fact that over 75 per cent of imports of these economies are production-related (capital, fuel, intermediates) suggests that long-term growth depends on imports. Moreover, Africa's import/GDP ratios are significantly higher than those of other developing regions, averaging 25 per cent compared to 18 per cent respectively during 1965-1986 (Lopez and Thomas, 1988).

The foreign exchange gap is widely considered to be the most constraining on growth and development in SSA, and one that would require the most support to alleviate in the process of transforming these economies to more sustainable structures over the long term. Foreign resource inflows are needed to support, not only the expansion of productive capacity, but also the utilization of installed capacity and growth in the medium term. The lack of foreign exchange severely constrained growth in the 1980s as African economies found it increasingly difficult to raise funds from international capital markets, and as increased debt servicing requirements absorbed a large proportion of their foreign exchange receipts.

Second, the continued deterioration and high volatility in the external terms of trade led to losses in real income, exarcebated the foreign exchange gap via reduced real export earnings, and caused significant managerial stresses in the development process as a result of the instability of earnings. Losses in real income arising from the deterioration in the external terms of trade averaged 3.1 per cent of GDP annually in the past 20 years (table 7). In terms of real export earnings losses due to terms of trade deterioration averaged 1.3 per cent of GDP during the 1980s. These are measured for the median country in SSA and do not reflect the wide variations of the misfortunes faced by individual countries. For example Helleiner (1993a) shows very high losses in real export earnings, ranging between 9.5 per cent for Mauritania, 16.1 per cent for Côte d'Ivoire and 30.1 per cent for Gabon between 1980 and 1990, against a mean loss of 8.0 per cent and median loss of 5.6 per cent of GDP among 20 SSA countries.

The stop and go situations arising from the instability of income and real export earnings, unless countered by financing to ride out transient shocks, can interfere with the development process, as witnessed in the 1980s when forced import compression and steep cutbacks in fiscal expenditure to close resource gaps seriously reduced growth and investment (Ndulu, 1991). Discontinuities in the flows of intermediate and capital goods, both of which are highly sensitive to import volumes, were clearly damaging to the process of growth (Helleiner, 1986). Further complications to economic management related to the instability and weakening trend of world market prices for primary commodities arise from the fact that the burden of adjustment falls disproportionately on the poor section of society, the greater part of it being engaged in agricultural production. In the absence of price stabilization schemes, poverty alleviation schemes become intractable to manage. The role of external fi-

Table 2

EVOLUTION OF DEBT STOCK RATIOS, 1970-1991

(Percentage)

	1970-1975	*1976-1979*	*1980-1985*	*1986-1991*
Sub-Saharan Africa				
EDT/GNP	16.1	25.1	42.1	98.0
EDT/XGS	73.5	96.3	176.3	339.4
Low-income sub-Saharan Africa [a]				
EDT/GNP	15.3	22.5	38.9	104.6
EDT/XGS	76.2	98.5	205.3	463.3

Source: World Bank, *World Debt Tables.*
Note: EDT = estimated total of debt stock. GNP = gross national product. XGS = exports of goods and non-factor services.
a Low-income countries include Benin, Burkina Faso, Burundi, Central African Republic, Chad, Comoros, Equatorial Guinea, Ethiopia, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritania, Niger, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Somalia, Sudan, Togo, Uganda, United Republic of Tanzania, Zaire and Zambia.

nance in this case would be to offset losses in income from terms of trade deterioration, but even more important to provide access to a first line of liquidity to help ride out temporary and reversible shocks. The latter point assumes particular significance in the light of Africa's limited access to international commercial credit, with official sources hardly providing financial assistance on a timely basis.

Third, the large overhang of external debt in these economies diverts a large proportion of scarce resources from supporting current development efforts to debt servicing. This makes achieving external viability elusive, which in turn affects the creditworthiness of these economies to commercial lenders, reduces investment confidence locally and induces capital flight, since a large debt stock prompts anticipation of future burdens to private incomes through taxation, including inflation tax, in order to service debt. Although our analysis takes a regional approach, it is important to emphasize the diversity of debt burden situations among SSA countries (Culpeper, 1988; Loxley 1992).

The debt/GDP ratio of SSA as a whole has more than doubled from 42.1 per cent in the first half of the 1980s to 98 per cent during 1986-1991. For low income SSA this ratio increased by almost 170 per cent over the six years (table 2). This high ratio reflects a solvency problem arising from the stock-flow disequilibrium between foreign obligations and current incomes. Moreover a worsening liquidity problem is also evident from the rising debt service to export ratio. This has tripled from 7.3 per cent in 1976-1979 to 22.7 per cent in 1986-1991 for SSA as a whole, and almost quadrupled from 6.4 per cent to 24.1 per cent for low income countries of SSA over the same period (table 4). Moreover, in view of the fact that this debt was being serviced at real depreciating exchange rates in a large number of these economies during the second half of the 1980s and early 1990s, a sizeable outward real transfer of resources was effected at the expense of alternative productive uses locally.

Due to the fact that more than 90 per cent of the debt is either public or publicly guaranteed, the debt servicing burden falls almost entirely on fiscal resources. This links the pressures of external balance arising from debt overhang to fiscal balances and requires simultaneous cuts in fiscal expenditures to reduce exposure (Fanelli *et al.*, 1992). Such cuts have often fallen disproportionately on expenditures for social development, thereby constraining development in human capacity.

The large debt overhang led to reduced net real resource flows, prompted capital flight and inability to diversify sources of financing, particularly foreign direct investment, and generated pressure on fiscal balances. Moreover negotiations for debt relief absorb far too much of the scarce capacity and time of key economic decision-makers in African governments, which

Table 3

EVOLUTION OF THE STRUCTURE OF DEBT STOCK, 1970-1991

(Percentage of EDT)

	1970-1975	*1976-1979*	*1980-1985*	*1986-1991*
Sub-Saharan Africa				
Short-term EDT	0.4	15.1	15.3	11.3
Long-term EDT	97.4	80.3	77.9	84.1
Concessional EDT	50.8	33.2	26.9	30.6
Multilateral EDT	16.0	14.4	149.9	20.5
Low-income sub-Saharan Africa [a]				
Short-term EDT	0.4	15.5	15.8	10.4
Concessional EDT	52.8	36.9	30.3	34.2
Multilateral EDT	16.1	15.2	15.4	22.0

Source: World Bank, *World Debt Tables.*
Note: EDT = estimated total debt stock.
a See footnote *a* to table 2.

could be deployed to other pressing managerial functions (Killick, 1993).

C. *The magnitudes, sources and forms of external resource flows in SSA*

ODA is by far the most important source of external resources for development finance in SSA. It accounts for more than 80 per cent of total net inflows. SSA now receives 35 per cent of total ODA to developing countries, up from less than 10 per cent in 1960 and far exceeding its population share of 12 per cent in the developing world (Helleiner, 1993a, p.3). On the other hand Africa's share of net foreign direct investment (FDI), a growing source of external finance to the developing world, is miniscule. Between 1986 and 1992, for example, SSA including South Africa received only 5.6 per cent of total net FDI to developing countries (World Bank, 1992). As a proportion of GDP the median net foreign direct investment into SSA (excluding South Africa) averaged 1.0 per cent in the 1980s, down from an average of 2.3 per cent during 1970-1975. Dominant recipients of FDI were the Seychelles, Botswana, Swaziland, Nigeria, the Congo and Liberia. For the low income SSA countries the average was much lower, at 0.3 per cent, down from an average of 0.8 per cent in the 1970s (table 6). SSA's high share of the declining ODA limits the likelihood of much further growth of this source of development finance, while at the same time SSA has not positioned itself to benefit from the more robust source of FDI, as indicated by the declining rate of net inflow relative to GDP.

This phenomenon can also be viewed from the perspective of the financial forms external resource inflows assume. The most dominant form of external development finance into SSA is debt creation, both official and commercial debt. For low income SSA, net transfers from official and commercial creditors and donors has averaged 1.8 per cent of GDP during the 1980s, compared to 0.3 per cent in the case of net FDI (table 6). Credit and grants thus account for 86 per cent of net external resource inflows to these countries. For SSA as a whole this share is 61 per cent. The problems related to increased external indebtedness in the presence of the already large debt overhang were raised earlier; they point to the need either to seek relief or diversify away from this form of financing. Moreover, FDI is normally not only associated with certain advantages, such as technological transfers and market access, but appears relatively attractive also because it involves a risk sharing relationship with foreign investors, typically not existing in the formal contractual arrangements for foreign loans (Fry, 1993), and is not directly linked to fiscal stress as in the case of official debt. On both counts diversification of sources away from debt becomes a worthwhile effort to pursue.

It is most likely, however, that in the medium term ODA will remain the most important source of external development finance for SSA. Thus, its adequacy and effectiveness in disbursement and utilization is of critical significance for SSA's development. The concern for effectiveness arises from the observation made earlier of declining availability of ODA and SSA's already high share of it. We take up the issue of effectiveness in more detail below.

It is the net transfers from ODA that are of utmost importance for development finance. Net transfers, being gross flows less amortization and interest payments, are affected by the terms of contracted debt, including applicable interest rates, maturity, grace period and grant content. From table 6 we see that net transfers as a proportion of GDP have shown a persistent decline since the second half of the 1970s. While in the first half of the 1980s the decline was mainly a result of both reduced gross inflows and a rise in the real interest rate on external debt (see table 5), in the second half of the 1980s and early 1990s the decline appears to be dominated by the effects of debt overhang as large debts contracted in the 1970s fell due for repayment.

Clearly, the terms of new debt contracted in the late 1980s and early 1990s were relatively better, as indicated by lower interest rates, longer maturities and grace periods, as well as higher grant elements, particularly for low income SSA. However, since multilateral debt is not subject to relief, and such debt significantly increased its presence in the 1980s related to stabilization and adjustment programmes (table 6), a significant source of the increase in the debt service ratios from 7.3 per cent of exports in 1976-1979 to 22.7 per cent in 1986-1991 (table 4), and the decline in the net transfers could be attributed to these programmes. In fact as table 6 shows, for example, net flows and indeed net transfers from the IMF were negative in the second half of the 1980s. Twenty-one out of 39 countries for which we obtained data had negative transfers vis-à-vis the IMF. This is in spite of better terms offered under ESAF for new debt to low income countries carrying out adjustment programmes.

The foregoing seems to suggest that dealing with the problem of the debt overhang through a reduction in the accumulated stock, rather than tinkering at the margin with terms of new debt, is the more effective route for enhancing net transfers in the future.

The adequacy of external resource flows may further have to be viewed in the context of losses from the deteriorating external terms of trade pointed out earlier. Of particular interest here is their impact on real foreign exchange earnings from exports, which partly offset net external resource transfers. We make this assessment by netting out such losses from net real transfers of external resources. The annual losses in real purchasing power of exports in SSA during the 1980s averaged 1.3 per cent of GDP annually for a median country in SSA (table 7). When compared with the annual average ratio of net transfers to GDP of 1.85 per cent, the losses did offset more than 70 per cent of the net transfers. Thus if the current net transfers are considered to be at a desirable level in the absence of shocks, they would have to be increased to 3.2 per cent of GDP in the presence of these losses.

Turning to FDI as a source of external flows, we noted earlier its low contribution to development finance, particularly for low income SSA countries. More recently, however, in the developing economies the privatization of state-owned enterprises has been identified as an important potential channel for attracting foreign direct investment. Such investment has come either in the form of direct purchase of enterprises or through portfolio equity investments. What matters most in relation to our concern of external financial flows is that these transactions should generate additional foreign resources. Therefore the focus will be on the foreign exchange content of these transactions.

Although 184 out of a total of 456 privatizations of state-owned enterprises were made in SSA between 1980 and 1987, revenues from these privatizations were very low. Sader (1993) analysed the foreign investment impact of privatization in developing countries during 1988-1992 by assessing the foreign exchange content of the privatization transactions. While such transactions in Latin America, South-East Asia and Eastern Europe yielded significant inflows of foreign investment, the impact in SSA was negligible. First, as a proportion of total revenue from these transactions, SSA's was only 0.4 per cent of the total for developing countries, involving revenue of $250 million from a sale of 80 enterprises (8 in Benin, 37 in Ghana, 29 in Nigeria and 6 in Togo). Out of these 80 privatizations only 21 had foreign participation and yielded 37 per cent total revenue from the transactions in foreign exchange. Over this period foreign exchange revenues from privatization accounted for only 1.4 per cent of total FDI in SSA.

The above would suggest that although privatization still needs to be pursued in earnest in SSA and on superficial consideration promises a more readily available channel for promoting FDI, the basic constraints to other

Table 4

EXTERNAL DEBT SERVICE RATIOS IN THE 1980s (from annual data)

(Percentage)

	1970-1975	1976-1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Sub-Saharan Africa														
TDS/XGS	7.7	7.3	10.8	15.4	18.5	21.6	24.4	26.8	28.1	22.0	24.6	21.7	19.9	19.8
TDS/GNP	1.6	1.8	2.5	2.9	3.2	3.7	4.5	5.3	4.9	4.6	5.3	5.0	5.6	5.5
INT/XGS	2.3	2.5	5.7	8.2	10.0	10.6	11.6	11.1	11.6	9.1	11.4	10.2	8.9	9.9
INT/GNP	0.5	0.6	1.7	2.1	2.2	2.3	2.7	2.7	2.7	2.5	3.1	3.0	3.0	3.2
Low-income sub-Saharan Africa [a]														
TDS/XGS	7.9	6.4	9.0	13.9	18.5	22.2	27.5	29.1	28.8	21.0	26.4	24.6	21.5	22.3
TDS/GNP	1.5	1.4	1.7	2.2	2.4	2.7	3.7	4.4	3.6	3.4	4.6	4.4	5.3	5.6
INT/XGS	2.3	2.2	5.0	7.7	10.1	11.5	21.8	11.9	11.3	9.3	13.3	12.0	10.2	12.1
INT/GNP	0.4	0.5	1.4	1.7	1.8	1.9	2.3	2.2	2.0	2.1	3.0	2.8	3.0	3.4

Source: World Bank, *World Debt Tables.*

Note: TDS = total debt service. XGS = exports of goods and non-factor services. GNP = gross national product. INT = interest payments.

a See footnote *a* to table 2.

forms of FDI still hold. These include maintaining a stable macroeconomic environment, a legal framework that protects property rights and enforces contracts, a supportive infrastructure, improved access to loan capital and equity finance and a less cumbersome tax system. A rush for expensive discriminatory incentives for foreign investors may at worst be counter-productive (Fry, 1993). It is important to note that putting in place an environment conducive to attracting FDI is a process that takes time and would require financial support, particularly for infrastructural investments. Moreover, reduction in debt overhang, as pointed out earlier, is a necessary condition for creating confidence in potential investors. On both counts ODA has an important role to play.

D. *Effectiveness in the disbursement and utilization of external financial resources*

The need to enhance the effectiveness of the use and disbursement of external resources cannot be overemphasized. This is particularly important in view of the scarcity of ODA and the importance more generally attached to improving efficiency in order to promote growth, macroeconomic stability and development. Three main issues will be taken up in this context: the first is that of an appropriate policy environment conducive to the efficient utilization of resources; the second is modifications of approaches to donor finance to enhance its effectiveness in supporting development; and the third, which links the first two issues, is the relative importance of conditionality and local ownership of domestic policy reforms aimed at raising the efficiency of resource use in general and that of external resources in particular.

Empirical evidence now abounds to show that economic policy distortions have undesirable and deleterious effects on growth and that these have been much more acute in SSA than in other developing regions (Barro and Lee, 1993; Easterly and Levine, 1993). These distortions are related to macroeconomic instability, incentives for production and trade, and fiscal imbalances. A large number of countries in SSA pursuing economic reforms have earnestly been engaged over the last eight years in stabilization, adjustment and sectoral reforms to redress these distortions. Of particular significance have been measures to promote the production of tradeables and conserve the scarce foreign exchange available via exchange rate policy and reforms in the exchange regimes. Some reasonable success has been registered in restoring macroeconomic stability and promotion of export growth, although external viability remains by and large elusive.

It is important to emphasize here that, although these measures are critical for efficient resource allocation and increased domestic resource mobilization, they constitute only part of an effective development environment. Other important elements of the development environment include the setting up and strengthening of efficient markets, strengthening institutional and human capacity for effective economic management, improved governance that fosters initiative and accountability for resources and action, and a legal framework that protects property rights and enforces contracts. These have currently assumed an important place in the development agenda among donors and recipients alike (World Bank, 1989) and should complement policy changes in raising the effective utilization of resources, both domestic and external, committed to development.

The approaches to donor finance (ODA) in SSA have taken three main forms, with different degrees of effectiveness. The first is project aid, which was the most dominant form of ODA in the 1960s and 1970s. External resources were largely committed to the capital expenditure of the project, which also attracted some local counterpart funds. Operational and maintenance finance was the responsibility of the recipient. A major problem with this form of support was in the utilization of the installed capacity, which depended on the more constrained domestically mobilized resources. The very low utilization of capacity, particularly of industrial enterprises, is to a significant extent attributable to the mismatch between the external and domestic availability of finance for the projects. The large drop in investment productivity from 83.8 per cent between 1961 and 1973 to only 6.2 per cent during 1980-1987 (World Bank, 1989) is significantly explained by underutilization and non-utilization of installed capacity. To a considerable extent the debt servicing problems of the 1980s were linked to the fact that the large industrial capacities created in the 1970s through increased indebtedness, never yielded the expected returns, and the related debt fell due for servicing without proceeds from the funded projects.

The second is programme support, mainly in the form of import support tied to the country of origin in the case of bilateral donors and imports via an open general licence system for multilateral funds. This approach was mainly adopted in the 1980s in response to severe import compression and balance-of-

Table 5

AVERAGE TERMS OF NEW DEBT

	1970-1975	1976-1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Sub-Saharan Africa														
(i) *Official creditors*														
Interest (per cent)	3.1	4.1	4.2	5.2	5.0	5.8	4.1	4.3	4.1	3.4	3.4	3.6	3.7	3.5
Maturity (years)	28.9	25.3	24.8	24.5	26.4	24.2	26.7	29.0	28.1	28.9	27.8	28.3	27.8	30.1
Grace period (years)	8.6	6.6	6.7	6.3	7.1	6.3	6.5	7.1	7.0	7.5	7.5	8.0	7.8	7.9
Grant element (per cent)	54.1	43.3	42.1	35.5	38.3	32.5	42.9	44.4	44.5	49.9	50.5	50.6	49.7	51.8
(ii) *Private creditors*														
Interest (per cent)	7.6	8.7	10.1	10.2	10.3	9.6	8.7	9.0	8.3	8.0	7.1	8.3	8.2	7.5
Maturity (years)	9.1	8.5	9.3	9.3	9.9	8.6	8.8	9.1	9.4	8.3	10.0	9.0	12.0	7.6
Grace period (years)	2.5	2.8	3.3	4.0	3.5	2.5	1.8	2.6	2.6	2.4	2.6	2.5	2.7	1.8
Grant element (per cent)	8.8	4.3	0.0	1.9	-1.1	1.7	5.1	3.8	6.3	7.1	12.4	5.8	7.5	7.0
Low-income sub-Saharan Africa [a]														
(i) *Official creditors*														
Interest (per cent)	2.9	3.6	4.0	4.5	4.4	4.8	3.9	3.3	3.6	2.9	2.7	3.0	2.8	2.9
Maturity (years)	29.8	26.5	26.0	26.6	27.7	26.2	27.4	32.4	30.5	30.8	30.8	30.3	31.0	33.3
Grace period (years)	8.8	6.9	7.0	6.7	7.4	6.7	6.6	7.8	7.3	7.8	8.2	8.4	8.5	8.6
Grant element (per cent)	55.5	47.3	44.6	41.5	42.8	41.0	44.7	53.8	49.4	54.7	57.9	56.1	58.5	58.8
(ii) *Private creditors*														
Interest (per cent)	7.6	8.6	9.5	9.4	9.8	9.6	8.7	7.9	8.7	8.2	7.9	8.3	8.2	7.9
Maturity (years)	8.9	8.7	9.2	9.6	9.1	8.5	9.3	11.4	9.7	9.0	10.3	8.5	12.4	10.9
Grace period (years)	2.5	2.7	2.7	4.5	3.2	2.7	1.7	3.0	2.8	2.4	3.1	2.2	2.8	3.5
Grant element (per cent)	9.0	4.3	2.2	6.2	0.2	1.4	4.2	8.1	4.1	6.6	8.5	4.8	7.2	8.8

Source: World Bank, *World Debt Tables*.
a See footnote *a* to table 2.

payments problems faced by the SSA countries. The imports included intermediates and spare parts to enable utilization of installed capacity. This greatly improved the effectiveness of resources since it enabled utilization of previous investments. However, problems with this approach exist. The sourcing of imports is tied to the country of origin, limiting in some cases cost effectiveness in sourcing; there is a tendency to direct imports to support projects previously financed by the same donor, irrespective of whether these are the best candidates for support efficiency-wise; and there were complex and multiple donor accounting requirements to ascertain whether procurement was for intended goods and from agreed sources. There are ways to rationalize the required documentation, but the efficiency implications of tied sourcing and local user destination need to be addressed. Increased support through the open general licence system will certainly raise effectiveness and will be consistent with the more liberalized, market based foreign exchange allocation system currently being put in place.

The third is debt relief, the most fungible of the approaches and the most amenable to being consistent with policy reforms. In addition, due to the poor prospects of a significant increase in new resources from ODA, debt relief releases foreign exchange receipts from the servicing of debt to supporting current development activities, and provides a larger scope for the indirect provision of development finance. As argued earlier, the reduction of the overhang of external debt is the most effective way of providing debt relief. In addition to freeing up limited own and new donor resources from debt servicing for use in current development activities, it helps create conditions for restoring business confidence and expanding private investment.

The last issue, but certainly not the least in importance for raising the effectiveness of aid, is that of the ownership of reform and development initiative. It is now widely accepted that for economic reforms and development initiative to be sustained, local ownership is of paramount importance. High conditionality was adopted as a key instrument for initiating stabilization and adjustment programmes. Sustaining reforms and creating conditions for longer-term development require the commitment, not only of the recipient governments, but of the population at large. Creating a local constituency for sustained development is thus a much broader undertaking involving the donors, the recipient governments and the local population, who make up the actors and beneficiaries of the development process.

Internally, a governance structure that encourages participation, accountability, freedom of action and transparency, is conducive to promoting local initiative, flexibility in responding to changing conditions, institutional innovation, and a broad vetting of the economic costs and a reduction in the transaction and risk costs often associated with a non-transparent system of governance.

Donor participation in this process of determining development priorities and the means to achieve them needs to assume a posture of partnership with all the local actors, and not simply with the governments. Moreover, donors have an important role in supporting institutional innovation, the development of the required technical skills to manage the development process, and the development of efficient markets, drawing from their own vast experience. The use of conditionality to achieve this broader approach to sustained development would be consistent with a partnership posture.

The above does raise two important issues with respect to the broadening of channels of support and aid coordination. The traditional channel of donor support has been the central government. With a widening of the actors involved in development management and activities, donors may want to consider the possible use of multiple channels of support, so as to broaden access to resources and reduce transmission delays to ultimate recipients. Of course, the most effective way to achieve broader access and reach targets efficiently is the adoption of general programme support; in this way, most resources could be disbursed increasingly through more market oriented channels. Specific targets, such as programmes for assisting vulnerable groups, could be treated as special cases. The need for programmatic perspectives in development policy makes donor coordination important, so as to ensure consistency among the different levels of policies and activities (macro, meso, micro) and across sectoral programmes.

E. Conclusion: suggestions for enhancing net flows and their effectiveness

The foregoing discussion prompts us to make some suggestions for enhancing the adequacy of external resource flows and their effectiveness in supporting development in sub-Saharan Africa. These fall under three broad categories: enhancing net external re-

Table 6

EXTERNAL NET RESOURCE FLOWS, 1970-1990

(Percentage)

	1970-1975	1976-1979	1980-1985	1986-1991
Sub-Saharan Africa				
NFL/GDP	2.2	3.3	3.4	3.8
NTRNS/GDP	1.7	2.7	2.1	1.6
FDI/GDP	2.3	1.7	0.9	1.1
IMF/NFL	12.4	10.1	13.0	-0.9
MLT/NFL	19.2	19.6	28.4	55.5
BLT/NFL	42.2	32.4	34.2	31.5
Low-income sub-Saharan Africa [a]				
NFL/GDP	2.0	2.8	2.9	3.6
NTRNS/GDP	1.6	2.3	1.8	1.7
FDI/GDP	0.7	0.8	0.3	0.3

Source: World Bank, *World Debt Tables*, *African Economic and Financial Data.*

Note: NFL = net flows, being gross flows less amoritization of debt. GDP = gross domestic product. NTRNS = net transfers, being NFL less interest payments. FDI = net foreign direct investment. IMF = IMF net flows. MLT = multilateral net flows. BLT = bilateral net flows.

a See footnote *a* to table 2.

source inflows, measures for dealing with external shocks and improving the effective utilization of external resources.

1. Enhancing net external resource inflows

(a) Debt relief

In view of the poor prospects for increasing new resources from ODA, debt relief is potentially the most important approach for raising net transfers into SSA. The reduction of the stock of debt and donor support for the servicing of multilateral debt are the two most effective ways of providing debt relief to SSA.

The granting of exceptional terms for debt relief introduced in December 1991 for severely indebted low income countries provided a possibility of debt reduction through conversion programmes for both ODA (no limit) and non-ODA (with limits) debt, in addition to very favourable rescheduling of consolidated ODA debt (World Bank, 1992). The write-down of eligible Paris Club debt under the "enhanced Toronto terms" is a further improvement on the previous treatment. By mid-1993, 11 SSA countries benefited from these measures under the Paris Club terms (Helleiner, 1993b). Two countries, Benin and Nicaragua, are under consideration for a 50 per cent write-down of their entire Paris Club eligible stock. In this regard, the cut-off date which determines the eligibility of stock for write-down is very important for the actual magnitude of the relief. For SSA countries in particular, the 1980s have seen their debt stocks rise rapidly, favouring a shifting of the date as far forward as possible. Collective support for this possible precedent will open up opportunities for other severely indebted low income countries, a large number of them being in SSA.

A high proportion of scheduled debt service, particularly in low income SSA countries engaged in adjustment programmes, is to international financial institutions. These institutions consider themselves unable to offer debt relief beyond that which they are currently offering to low income adjusting countries through the provision of new credit at more concessional terms (e.g. under ESAF and IDA). The concessional terms offered under ESAF, for example, provide debt relief via a de facto refinancing of maturing standard IMF drawings at a lower interest rate (0.5 per cent) and with a longer repayment period, including

Table 7

EXTERNAL NET TRANSFERS ADJUSTED FOR TERMS OF TRADE LOSSES

(Percentage)

	1970-1975	1976-1979	1980-1985	1986-1991
Sub-Saharan Africa				
TOTGAIN/GDP (mean)	-1.4	1.8	2.1	-4.0
TOTGAIN/GDP (median)	5.3	3.5	-1.2	-1.4
TOTSHK	-3.9	-3.2	-2.8	-2.5
(NTRNS + TOTGAIN)/GDP	0.3	4.5	0.0	-2.4
Low-income sub-Saharan Africa [a]				
TOTGAIN/GDP (mean)	-0.2	2.9	-2.0	-3.4
TOTGAIN/GDP (median)	7.7	3.5	-1.1	-1.4
(NTRNS + TOTGAIN)/GDP	1.4	5.2	-0.2	-1.7

Source: World Bank, *World Debt Tables*, *African Economic and Financial Data*.

Note: TOTSHK for year t is calculated as $[(PX_t/PX_{base}-1)*(X/GDP)_{t-1}]-[(PM_t/PM_{base}-1)*(M/GDP)_{t-1}]$ where PX and PM are export and import price indices respectively deflated by the United States GNP deflator; PX_{base} and PM_{base} are the average PX and PM respectively for the preceding three years; X and M are respectively the exports and imports of goods and non-factor services.

TOTSHK was constructed from a sample of 32 countries.

TOTGAIN = −(KX*100)/TOT−KX) where KX is exports of goods and non-factor services in constant prices and TOT is the terms of trade index.

NTRNS = net transfers.

a See footnote *a* to table 2.

half grace period (Green, 1993). IDA terms have also provided a similar relief to the World Bank debt overhang (Helleiner, 1993b). While expansion and improvement in these new facilities is indeed very welcome, there is a need for SSA countries to seek contributions from donors in the form of "free/untied" foreign exchange grants which directly or indirectly can be used for servicing debt obligations to international financial institutions.

The scope for SSA countries to reduce their debt stock through the secondary market for debt is rather limited (ACMS, 1992; Raheem, 1993). A few countries besides Nigeria have actually been involved in such debt conversion schemes, mainly in the form of debt-equity swaps. The limitations arise from the fact that the commercial debt eligible for conversion is relatively small, 20 per cent of total debt stock, and is concentrated in a few countries. Moreover, success in conversion in the form of debt-equity swap is dependent on conditions for attracting foreign direct investment which are yet to be established, as discussed earlier. However, debt buy-backs at significant discounts are more promising and could be pursued along the lines of the Brady-style, menu-based, debt reduction schemes. Collectively SSA countries could negotiate for the renewal and the enlargement of the present IDA debt buy-back facility by increasing its resources, allowing a broader menu-based debt reduction, and earmarking a share of these resources for African commercial debt (ACMS, 1992).

(b) Diversification of sources of external finance

FDI and access to international commercial credit are two potential sources, in addition to ODA, that SSA needs to pursue. Relative to other developing regions, SSA has very limited access to commercial credit and attracts a miniscule share of foreign direct investment, as shown earlier. The conditions for attracting foreign investment need to be created. Ongoing policy reforms aimed at achieving macroeconomic stability and raising the profitability of investment constitute an important measure for creating a conducive environment for investors. In this regard the stability of the exchange rate, a reduction in exchange controls and trade fa-

cilitation are important. As pointed out earlier, the reduction in debt overhang is necessary for promoting investor confidence. In addition, a reliable infrastructure, improved access to financial services, a legal framework that protects property rights and a less cumbersome tax system, are necessary for attracting foreign investment.

2. *Access to first-line liquidity against temporary shocks*

The traditional advice in dealing with external shocks is to finance temporary, and adjust to permanent, disturbances. Recent studies, including Gavin (1991) and Elbadawi (1992), have shown that even in the case of longer-term disturbances, adjustment and financing are complementary. Preserving stability and predictability is deemed particularly important in small open economies undertaking deep economic reforms (Green, 1993).

SSA countries' access to international commercial credit to help ride out temporary and unanticipated shocks is virtually non-existent. Official sources for such credit are hardly available on a timely basis. The IMF instituted in 1974 an Oil Facility/Trust Fund to help countries ride out a temporary reversible shock with fairly open and concessional terms. Since the 1980s all financing facilities have been tied to high conditionality and are subject to negotiation lags; hence they cannot be availed of on a timely basis in relation to the occurrence of shocks. Moreover macro-budgeting under consultative arrangements makes no provision for contingencies (Green, 1993). This leaves a vacuum for access contingency finance to deal with cash flow problems arising from unanticipated and reversible exogenous shocks.

There is a critical need for the re-establishment of an official facility for first line liquidity access. Such a facility should not be overburdened by high conditionality and negotiation lags which would invalidate the compensatory and contingency functions of the facility. The restoration of the 1974 Oil Facility/Trust Fund with a broader coverage of temporary shocks for eligibility and operating under more open terms should be considered.

3. *Improving the effective utilization of external resource support for development*

It is now widely accepted that macroeconomic stability and the realignment of incentive structures for enhancing efficiency in resource allocation are of fundamental importance to ensuring the effectiveness of development finance. The ongoing and wide-ranging policy reforms in SSA are partly aimed at that.

More effort, however, needs to be made in other complementary areas in order to create an environment for sustainable development. These were mentioned earlier to include the creation of efficient markets, strengthening the capacity for prudent economic management, a legal framework that protects property rights and enforces contracts, and a governance structure that promotes initiative through broader participation and accountability for resource use. In most SSA countries efforts to introduce these measures have just begun. External assistance, particularly in know-how, could play a significant role in their successful implementation, since in most cases there is little local experience to call upon in implementing the suggested new institutional forms. A significant role exists for the state in restructuring institutions and supporting the creation of, and providing the regulatory framework for, the efficient operation of markets. Bilateral donors being themselves arms of governments, can provide invaluable advice in this endeavour from their own experiences.

In order for ongoing efforts in economic reforms and development initiatives to be sustainable, a local constituency for change needs to be in place. Such a constituency extends beyond the government to include the larger population of actors in and beneficiaries of the development process. Donors need to forge a partnership with this broader constituency. Conditionality should reinforce this partnership.

A shift to programme and sectoral aid provides for better coordination with the overall development programme adopted. Donor choices and assessment of the impact of individual donor support could still be made in the context of broader programmes.

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7

FINANCING ECONOMIC DEVELOPMENT IN LOW-INCOME COUNTRIES

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ABSTRACT

Recent performance of the low-income countries (LYCs), the majority of which are in sub-Saharan Africa, has been dismal. Moreover, this cannot be simply laid at the door of poor internal policies. Adjusting LYCs have tended to do better, but they have had financial and technical assistance. It would have been a disaster for international collaboration if non-reformers were out-performing reformers.

Excessive dependence on a very small number of primary commodities for foreign exchange earnings, and fluctuations and trends in the real prices of key commodities, point to the need for both more international reserves and development finance.

The Bretton Woods institutions (BWIs) officially blame domestic policies for the poor state of affairs, perhaps because to do otherwise would expose the inadequacy of the finance provided, even for the adjustment programmes supported by the BWIs. Meanwhile, there is no clear empirical support for the catalytic role of IMF resources in the adjustment process. Perhaps for the same reason of inadequate finance, the BWIs, especially the Fund, persist in underestimating the time needed for sustainable adjustment. The result is a recurrence of optimistic assessments, premature claims of success and a polemical style of presentation.

Reconstructing Europe took at least a decade and brought home the fact that the successful resolution of balance-of-payments difficulties required the establishment of necessary preconditions. Foremost of these was expanded production and increased productivity, with preference given to export growth.

Economic development is more complex and requires more resources of time and finance than reconstruction. It also requires the establishment of the necessary conditions for the resolution of the associated balance-of-payments problems.

Economic development has hardly been seen in the international context as a mutually beneficial objective. Indeed the basis for aid to LYCs is unclear, beyond the tenet of the rich helping the poor.

In the pursuit of their objectives the BWIs consult, cooperate and collaborate with each other. In the process, as a result of the preferences of the major shareholder members, the BWIs work in a form of partnership, with the Fund as the senior member. However, the Fund is unwilling or unable to deal with problems of economic development. This is unsatisfactory. A way forward is to return these institutions to their original objectives. As far as LYCs are concerned, the Fund should concentrate on stabilization, that is effective demand management. The Bank should be responsible for structural adjustment, with sustainable growth as its primary objective.

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* For this paper extensive use has been made of Horsefield (1969) and de Vries (1976 and 1983). Full responsibility is accepted for the use of the material in this paper and its interpretation.

It is argued that there is a deflationary bias in the international adjustment process, sustained by the resurgence of monetarism and fear of inflation. The protectionist tendencies and threats of trade wars, particularly in the industrial countries, are reflections of this bias.

Economic development of LYCs can provide the needed locomotive for world trade and growth. A link, albeit indirect, between SDR creation and development finance is suggested as a means to this end. As the Expert Group appointed by UNCTAD in 1965 concluded: such a link is both feasible and desirable.

A. Introduction

Despite the enormous opportunities created by advances in technology for the successful development of the currently defined low-income developing countries (LYCs),[1] a combination of inappropriately designed policies and inadequacy of resources condemns more than one billion people, a fifth of the world's population, to live in absolute poverty. There are 73 LYCs, of which 38 are in sub-Saharan Africa. Of the rest, 20 are in Asia, 11 in Latin America and the Caribbean, two in the Middle East and North Africa and two in Europe and Central Asia. Measured by income per capita the economic performance of the LYCs over the last 25 years has been disappointing. In the face of rapid population growth this has resulted in stagnant or declining standards of living.

Moreover, the global economic environment is worsening and certainly not conducive, and perhaps even hostile, to growth, as shown by recent trends and future prospects for aid flows and international trade. Trends in aid flows are particularly disturbing. Figures from the World Bank show a decline in official financial assistance for 1992 coming on top of that of 1991. Furthermore, the prospects for aid flows are not promising in view of negative public attitudes in many donor countries, competition for funds from Eastern Europe, and demands for social spending in the donor countries themselves.

The most dispiriting thing about Africa, writes *The Economist* (1994) is that even if its economy were to grow at the rate confidently projected by the World Bank for the rest of the 1990s, Africans would still have to wait for another 40 years to clamber back to the incomes they had in the mid-1970s. It continues:

> As recently as the mid-1980s, Africa's disastrous performance could be blamed chiefly on the folly of its leaders' economic policies. In recent years, however, parts of Africa have been trying to introduce their most radical adjustments since independence. Some thirty African countries have abandoned their experiments with socialism - usually after a sharp arm-twist by foreign creditors - in favour of the free-market creed preached by the World Bank and the IMF.

There is nothing remarkable about the advice given, but in practice, it has implied reforms for Africa every bit as wrenching as those underway in Eastern Europe. *The Economist* then asks: To the extent that it has been practised by Africa's Governments, has any of it worked?

According to *The Economist*, Britain's Oxfam told the World Bank and IMF in September 1993 that adjustment can only be judged a complete failure. The Managing Director of the IMF has stated that it is easy to understand why many feel tempted to despair about the prospects. He added that the setbacks - worsening of the global economic environment, slowdown in some industrial countries - compounded the existing external difficulties, including the shortage of external financing and slow progress toward resolving the debt problem (Camdessus, 1992, p. 19).

The Economist alleges that in private the World Bank is deeply gloomy about Africa, but that it desperately needs to see success, just as aid agencies tend to see failure. As to why World Bank growth forecasts invariably prove optimistic, it quotes an unnamed Bank official: "Knowing what the truth is ... self-deception has become a way of life". The BWIs, at least in public, continue to put the blame on the folly of the leaders' policies, or at best poor implementation of their advice.

The Managing Director of the Fund asserts that external assistance and cooperation are essential, but they should be seen as complementary to, not subsititutes for, good domestic policies. In the current controversy over assistance to Russia, for instance, he has insisted that the money made available has not

1 LYCs are those receiving IDA credits during the IDA-9 period and/or those eligible for ESAF resources. These are countries with GNP per capita of $610 or less in 1990.

been negligible and that those claiming the contrary do so "with more eloquence than respect for the truth" (IMF Survey, 1994). In answering those who have criticised the Fund for not disbursing enough, he defended Fund conditionality:

> As far as the IMF is concerned, the financial assistance it can provide is necessarily tied to the countries' policies. This is part of the rules by which the IMF is governed - rules agreed by the entire membership, but sometimes forgotten in capitals (IMF Survey, 1994).

The remarks by the Managing Director drew a strong response from Jeffrey Sachs who, until January 1994, served as economic advisor to the Russian Government. Writing in the *Washington Post*, Sachs referred to the Western aid figure given by the Managing Director as remarkable "mainly because it is phony". In his words:

> As the International Monetary Fund tries to conceal its massive failures in Russia, its obfuscations grow more desperate. In the end, the western aid effort has been disgraceful: almost no grants, self-serving short-term trade credits, virtually no support from the IMF and the World Bank, little effort to make aid co-ordinated and effective, and continued preening about our help. Not only was the aid derisory but also the contrast between the rhetoric and reality helped to poison the relationship between Russia and the West ... In any event, by his own lack of 'respect for truth' Camdessus continues to lull the West and further provoke Russia's enemies of reform (Sachs, 1994).

As to the claim of the catalytic effect on financial flows of the seal of approval of the BWIs that the IMF regularly claims, Tony Killick has this to say:

> Econometric studies have found no systematic correlation between IMF programmes and capital inflows. Experiences vary widely. In some cases there clearly is a catalytic effect. In others, IMF money has, in effect, been used to increase debt service payments. In probably a majority of cases there has been little net effect on capital account (to say nothing of the persistent net return flow from LYCs to the IMF in recent years). *Programmes predicated on a strong catalytic effect are thus apt to be unrealistic, of which there are a good many examples, resulting in unanticipated adjustment costs and programme dislocation* (emphasis added) (Killick, 1993, p. 103).

The President of the World Bank is among those who have recently voiced concern over aid prospects:

> While budgetary constraints are severe in many countries, aid is everywhere a small fraction of public expenditures and political leadership is needed to ensure that the slow growth in donor countries does not provide a convenient excuse for cutting aid budgets (Preston, 1993, p. 11).

External financing needs in medium-term projections prepared by the staffs of the Bretton Woods institutions are determined by the assumptions made about the strength of policy reforms, world demand and the terms of trade. This means that the estimates change with the number of countries undertaking reforms backed by these institutions.

It is clear that economic development cannot be promoted by merely throwing scarce resources at non-reforming countries. It is also clear that, from the record to date, a reconsideration of the link between supporting finance and policy reform in LYCs is necessary. The Bretton Woods institutions should refuse to play the "paper conditionality" game and stand to be judged by the quality of their lending, not the volume.

The problem of inadequate development finance has its origin in the widely held view that LYCs are more of a burden, with little, if any, contribution to make to the solution of the problems of developed industrial economies. Admittedly, there are many in the industrial world who support economic development for moral and humanitarian reasons. But were the development of LYCs to count for much more than that, external financing needs would not be handled the way they are now. Questions of adequacy would be addressed. Resources may not be negligible, they may even be substantial, but are they adequate?

The perceptions of mutuality of interests that influenced and informed the founders of the BWIs included the disastrous experience of global depression of the 1930s, the collapse of international trading and financing systems, the pursuit of competitive devaluation, the escalation of tariffs and trade barriers and the apparent success of Soviet central planning in transforming a backward agricultural economy into an industrial State capable of defeating Germany. So it was that victor and vanquished alike knew what was at stake, hanging together or separately.

Assertions are sometimes made that demographic, political and technological trends make development no longer the concern pri-

marily of poor countries, but an urgent priority for rich countries as well. Ninety-five per cent of the growth in the world's labour force may take place in the developing world over the next quarter of a century. With the end of the Cold War, economic and environmental issues will no doubt occupy the centre of the diplomatic stage and naturally will increasingly involve the developing nations. Improvements in transportation and communications will bring the rich and poor countries into greater contact with each other. Television's impact on the LYCs and sharp increases in refugee flows may be harbingers of things to come. There is a lot in all of this, but will it be seen in industrial country capitals as convincing proof of the mutuality of gains from the economic development of LYCs?

This is not to deny the fact of interdependence. It is only to say that such assertions are not seen as self-evident, nor are they held widely. Above all, they do not appear to be the views of the BWIs or of large enough political constituencies in the industrial countries.

The LYCs, especially those of sub-Saharan Africa, have not succeeded in diversifying their export commodity bases and, as a result, reliance on primary commodities as the main source of export earnings has not diminished since independence. At the same time, real commodity prices - defined as the IMF all non-fuel commodity price index deflated by the IMF index of manufacturing export unit values of industrial countries - have persisted in their secular decline, dating from the middle of the last century. Furthermore, there is evidence of renewed weakness. Thus, after a short-lived recovery in 1984, real commodity prices have fallen by 45 per cent, which translates into a sharp deterioration in the terms of trade of low-income commodity exporters.

In 1992, the real commodity price index reached its lowest level in over 90 years. A recent IMF staff study concluded that the evolution of real commodity prices would appear to lend support to the Prebisch-Singer hypothesis (Reinhart and Wickham, 1994). For low-income countries like Ghana, that depend heavily on exports of beverages, the debate over the empirical validity of that hypothesis is largely academic. The recent weakness, it concludes, is "primarily of a secular persistent nature, and not the product of a large but temporary deviation from trend".

In addition to these secular trends, the study also found that the volatility in commodity prices has risen steadily and considerably since the 1970s. Large shocks became more commonplace with the breakdown of the Bretton Woods system and the oil crises. Volatility seems to have continued to increase through the 1980s and into the early 1990s.

In the face of these adverse developments in world market prices of commodities, of such critical importance to low-income developing countries, a rational reaction would be to increase levels of precautionary savings as insurance. This is the more so given the fact that commodity diversification is only a long-term solution, which may even be undesirable where it is not in conformity with the country's comparative advantage. Moreover, hedging instruments are not typically available in commodity markets in which low-income developing countries have significant exposure.

These findings underline the urgency of paying closer attention to the reserve needs of LYCs, and not focusing exclusively on their long-term economic development financing needs.

B. *Reconstruction and development*

In the immediate postwar period many industrial countries remained devastated and had to undergo extensive reconstruction. These countries were in the grip of serious inflation. Shortages of goods and services were widespread and international trade was badly distorted. Difficulties of production and transport and other prevalent obstacles to a smooth supply of goods were by far the most serious impediments to an expansion of exports. These industrial countries faced massive problems of reconstruction, though not of development.

The disequilibrium in their balances of payments, while large, was considered to be due more to special factors connected with the war. These were factors, which in a relatively short time, would be overcome. They were not problems of fundamental disparities in costs and prices.

Whether the simultaneous pursuit by several industrial countries of domestic policies to achieve full employment or price stability would be consistent with a satisfactory array of balance-of-payments positions, was unknown. Nor was this what mattered the most. Payments imbalances remained throughout the reconstruction period and beyond. Trade and payments problems were not going to put a deflationary spin on the world economy and lead the postwar world back into depression. Keynes and his colleagues saw the adjustment

problem as primarily how to avoid insufficiencies in aggregate demand.

The IMF recognized that the balance-of-payments problems of these members were not easy to resolve. A premature attempt to force the acceptance of exchange and trade practices suited for a balanced world economy could do much harm and even endanger the attainment of stated objectives. On the other hand, the Fund must have been aware of the danger that members might abandon the objective of eventually freeing their international transactions from restrictions. The Fund was faced with a dilemma: if it were unrealistic for it to call for the abandonment of restrictions, was it also not capitulation for it to succumb entirely to adverse economic conditions?

This dilemma gave birth to the philosophy of establishing the preconditions for the relaxation of restrictions. A critical component of the "preconditions" was the restoration of productive capacity, in addition to the adoption of proper credit and fiscal policies for the elimination of inflation, and in particular, for investment which would impact promptly upon the balance of payments. The philosophy worked, but it took a decade of reconstruction. Balance-of-payments pressures were contained in the meantime by import and exchange restrictions and, in many countries, official development assistance.

The Fund's original Articles of Agreement did not distinguish between developed and developing countries, despite the attempts by the Indian delegation to make development a purpose of the Fund and, failing that, to have the introductory Article take cognizance of the needs of the economically backward countries.

Officials of the industrial countries had feared that any reference to developing countries might imply that economic development was a purpose of the Fund, with the result that the Fund's resources would be overtaxed. There is a dilemma here that must be faced, because a conceptual framework unable to distinguish between the issues raised by underdevelopment and those of reconstruction, can only perpetuate underdevelopment.

The philosophy of establishing the preconditions made it possible to provide the necessary environment for reconstruction and for the Marshall Plan to be successful. It did take time and resources, both in adequate amounts. It was the growth and expansion of trade that enabled trade and payments restrictions to be eliminated, not the other way round.

Economic development requires a similar approach to succeed. Economic development is a much more difficult proposition than reconstruction. The charting of new waters, a journey into the unknown: that is the challenge of development. Successful reconstruction facilitated the correction of trade deficits. It is successful development that will also facilitate the correction of the structural trade deficits of the developing countries.

So, as with reconstruction, a critical component of the necessary preconditions for the elimination of the payments imbalances associated with economic development must be the development and expansion of productive capacity; and in this, preference must be given to investment that can have a fairly quick impact on the balance of payments. This was the essence of successful reconstruction, it is consistent with the East Asian experience, and it is what will make for successful economic development.

The process of economic development will need more resources than had been required for reconstruction. It will in all probability take decades, whereas reconstruction took only years. One thing is certain, deflation with beggar-my-neighbour policies can only lead to rising indebtedness and a perpetuation of underdevelopment. Occasionally, with a commodity boom or the discovery of deposits of a new mineral, some LYCs might escape into a middle income status, but that will be due to favourable circumstances, and in spite of, not because of, structural adjustment programmes.

C. *A dual indirect link*

It is not true that the essential and exclusive need of developing countries is for additional long-term aid rather than for liquidity. Generally, larger reserves are needed by countries with wide volatility in the real prices of their export commodities. There is no evidence, however, of increased precautionary savings for Africa. In the face of commodity price trends, the failure to diversify, and the high volatility in real prices of their export commodities, the conclusion emerges that the reserves holdings of these LYCs are inadequate. The real losses that may be incurred by these LYCs on account of their inadequate reserves could be substantial. Adverse external shocks, to which they are frequently subject, may have their consequences magnified because of inability to deal with them promptly.

International trade volumes may be subject to starts and stops, as restrictions are relaxed or imposed, or exchange rates may

fluctuate widely. No matter the mechanism by which imports are suddenly reduced, if the reductions are sufficiently large, serious economic dislocations are the result.

At the same time, the holding of reserves is only one of the competing uses of the limited real resources at the disposal of the typical LYC. In a rich country, the maintenance or even increase of reserves need not entail a great deal of sacrifice. In LYCs, the maintenance of reserves may be at the expense of urgently needed imports of capital goods for economic growth. It may even entail considerable hardship due to a shortage of basic goods, such as food or medicines.

The decision to increase reserves has as its counterpart an equivalent amount of uncommitted savings. Increasing reserves may be difficult or impossible in the short run. Crop failures and adverse terms of trade - common occurrences in LYCs - may so severely reduce the flow of domestic savings that it becomes necessary for LYCs to rely largely - or, for some of them, wholly - on foreign inflows to meet their large current account deficits.

After addressing the liquidity and development needs of developing countries, many have recommended the establishment of a link between the creation of international liquidity and the provision of development finance. This is both feasible and desirable.

The IMF has considered this issue on more than one occasion and has not quite been able to accept it. The nearest to acceptance was the establishment of the Extended Fund Facility (EFF) in 1974. Indeed, the EFF has been called the "link within the Fund". The sentence in its preamble, "the facility in its formulation and implementation is likely to be beneficial to developing countries", is unique to Fund decisions, marking, as it does, the first time that the existence of a developing member category had been so explicitly recognized.

The main initial objection to the link was that it risked weakening confidence in the SDR as the prospective primary reserve asset of the system. A second objection was the risk of inflation. Since 1970 SDRs have been allocated to members, and whatever problems the SDR may have in becoming the primary reserve asset, they cannot be blamed on any linkage with the provision of development finance. The inflationary psychology of the postwar era that continues to hamper the international adjustment process, again has nothing to do with SDR allocations.

The dual indirect link, as proposed, is designed to achieve two main objectives. It should serve as a mechanism for increasing the reserves of LYCs. It should also, through IDA, serve as a means of providing needed development finance.

It proceeds in two stages. In stage one, the absolute size of additional liquidity to be created and individual member allocations are determined on the basis of quotas. All this is exactly as has been done to date. The only break with current practice is in stage two, where all except the LYCs transfer their allocations to IDA. These transferred SDRs would be the source of development finance for LYC economic development. In effect, the seigniorage from the issue of SDRs becomes a primary source of finance for developing today's poorest countries. The main considerations are the following:

(1) Economic growth is a key prerequisite of economic development.

(2) LYC holdings of reserves are inadequate and require augmentation.

(3) International trade expansion and economic growth based on successful reconstruction has reached its limits and yet deflation cannot replace growth as the primary mechanism for international adjustment.

(4) With appropriate finance, rapid economic development is not only desirable but feasible; moreover, it could be the missing locomotive for world trade expansion and economic growth.

D. *The Bretton Woods institutions: forms and degree of collaboration*

At Bretton Woods, three institutions were to have been created for effective international cooperation. It was envisaged that these institutions would consult, cooperate and collaborate with each other. This is because, although these institutions were to deal with different aspects of international economic cooperation, economic problems themselves touch each other at innumerable points and the search for solutions would require some degree of collaboration. In the event, only the IMF and the IBRD were created.

The IMF was designed to help maintain exchange rate stability by providing the resources for meeting temporary adverse balances on current account, while giving the member concerned needed time to take appropriate measures to adjust its balance of payments.

The IMF, in short, was to foster a "liberal trade and payments regime".

The IBRD was expected to be provided with the means and powers adequate to provide the capital necessary to:

(1) Aid in the economic reconstruction of the war-ravaged industrial countries of Europe as a means of facilitating a rapid and smooth transition from a war-time to a peace-time economy.

(2) Supply short-term capital to increase the volume of foreign trade, where such capital was not available at reasonable rates from private sources.

(3) Encourage economic development through the expansion of production and productive capacity.

In dealing with the problem of persistent favourable or unfavourable balances on current account, the Fund and Bank would have to pursue related policies. The pursuit of related policies would also be required in dealing with the problems of reconstruction and development. The principles and traditions of the Fund, however, make it unable to deal with problems of economic development. The EFF provides useful insights into Fund/Bank collaboration.

The EFF was an acceptance of the fact that the typical LYC economy required more time than can be provided under the stand-by arrangements to effect necessary adjustments to altered circumstances. The management and staff held the conviction that three years should be the maximum time for drawings under the EFF. It was thought best not to plan a programme that extended too far into the future. The staff defined "too far" as longer than three years.

At the heart of programmes under the EFF were to be measures affecting the balance of payments. The fiscal, monetary and exchange rate policies to be introduced were all designed to strengthen the external payments positions. It was definitely not meant to be a development programme of the kind worked out with the World Bank.

In spite of these differences, the management and staff recognized that the introduction of the EFF required strong collaboration between the Fund and the World Bank. Fund staff would have to be in close and continuing contact with the staff of the World Bank, particularly on the appropriateness of the financial targets. The Fund staff would also have to draw on the expertise of the World Bank staff concerning the member's development programme and priorities. Ways to effect the necessary collaboration with the World Bank were, however, not specified and were left to be worked out as the facility was used.

The first arrangement under the EFF with Kenya once more confirmed the traditional experience of countries dependent on the export of primary commodities, namely that the basic conditions governing the domestic production of, and the world market prices for, these exports, determined the external position of these countries much more than did any financial and economic planning. Similar experiences in subsequent EFF programmes showed that external factors were no less important than changes in domestic policy, and that the latter often required more than three years to implement.

The EFF, heralded as a new longer-term financial arrangement in the Fund to assist its developing members, did not bring a widespread demand for the Fund's resources. The developing members found its conditionalities too strict and unduly severe. At the same time, the Fund found itself uncomfortably drawn into the quagmire of economic development, in spite of all the precautions taken to avoid such an occurrence.

Adjustment of the exchange rate and of prices charged by public utilities and enterprises, as well as a reduction in budget subsidies, depress real wages or the standards of living of the poorest groups, thereby accentuating unequal income distribution and conflicting with the promotion of social equity. Here, the staff of the Fund was faulted even by the staff of the Bank, with its emphasis at the time on "basic needs", similar to its current concerns with poverty alleviation. Bank loans are increasingly being directed to projects for "helping the poorest of the poor", through supplying food and other necessities for subsistence and for making income distribution in LYCs less unequal. The financial policies for balance-of-payments adjustment advocated by the Fund are seen by some officials as running counter to the aims of the Bank.

The process of collaboration between the Fund and the Bank is made difficult, not only because they have distinctly different objectives; it is also because their objectives often clash. If economic growth and development are the primary objectives of the one, financial stabilization as a means to foster a liberal trade regime is the hallmark of the other. Marrying the two has been a most difficult task.

The views and preferences of the dominant members mould and shape these institutions and the relationship between them.

These preferences have tended to be inclined towards the parsimony and short-termism of the Fund. The result has been the pre-eminence of the Fund in an unequal relationship in which the Bank is the junior partner. From the viewpoint of LYCs, however, this state of affairs is unfortunate, because it has placed stabilization above development. The senior partner has little knowledge of, or interest in, economic development. This situation has been widely recognized.

The way out of this unsatisfactory state of affairs is to return the two institutions as closely as possible to their original objectives. It is essential to maintain the integrity of both, with the Fund concentrating on balance-of-payments financing for relatively "short-term" adjustment, and the Bank concentrating on financing for economic development on a longer-term basis.

This will mean that, where a country determines that it is faced with a "temporary" adverse payments imbalance, it will seek cooperation with the Fund in the design of a stabilization programme. This could be under a stand-by arrangement, or a SAF/ESAF successor, or EFF, depending on assessment of duration and level of development. The Bank will be explicitly required to confirm that the programme is consistent with medium-term growth objectives.

Fund policy will leave decisions on the details of the execution of policy measures (for example, how credit should be allocated, and specific tax and other measures applied, and where public expenditure should be reduced) to the authorities of the adjusting member. It is precisely its insistence, in practice, on doing otherwise that involves it directly in microeconomic policy measures closely related to the member's social and political choices. Here, the Bank is better placed to work with the member.

Economic development should remain the responsibility of the Bank. In matters pertaining to this, the Bank should be the dominant of the two BWIs. It should work with the member concerned and collaborate with the Fund to ensure that the underlying macroeconomic framework is sound. Where a stable macroeconomic environment proves difficult to attain in practice, an explicit stabilization programme should be called for. A stable economy and a sustainable balance of payments are prerequisites for economic growth.

A further problem to be addressed is the adversarial relationship often found to exist between adjusting countries and the BWIs. Adjustment programmes with BWIs often take the form of legal contracts between a creditor and debtor. Coercive conditionalities are imposed, often with no more justification than what is required for the programme to "fly with senior management and the Board". In this way, borrowing members, especially among the LYCs, are often required to endure a degree of BWI involvement in policy making that would not be tolerated for a moment by OECD countries.

The LYCs should be required to play a greater role than heretofore in the design and implementation of adjustment programmes. In order to do this effectively, there is a need to accelerate the development of appropriate local capacities along the lines recently outlined by the Bank's Vice-President for Africa. It will also require a critical reappraisal of the importance of, for example, tertiary education in the LYCs.

E. Ownership of the process

The economic development process has political and social dimensions as well as economic. These other dimensions make it futile, if not impossible, for the process to be tele-guided by external agencies. The difficulty here is different from that associated with inadequacy of knowledge or lack of finance. On the latter point, as Moen Qureshi has pointed out, "there are countries that received adjustment loans but have nothing to show for them; it has largely been money down the drain" (Thomas *et al.*, 1991, p. 541).

It is more to do with the processes of design and implementation of programmes as an exercise in applied macroeconomics. The fact is that macroeconomics is an imprecise tool. To quote Qureshi again:

> It is a very imperfect craft, born of an inexact science and practised on a patient whose diseases are very hard to diagnose (Thomas *et al.*, 1991, p. 541).

Often, a number of arguably desirable objectives like "good governance" or "poverty alleviation" are included in BWI-backed adjustment programmes. The problem, recognized but invariably ignored by the BWIs, is that imposed policies simply do not succeed.

What often derails adjustment programmes is not the outcry of the vulnerable poor, but the opposition of powerful special interests. In the reform process, as in politics, the vocal and organized have the edge. Poverty alleviation is a worthy objective, and it may

even be accepted as of legitimate concern to donors. The reality everywhere is that it is hardly a proven means of recruiting political support. Were it otherwise, mobilizing resources for the economic development of LYCs would not be so daunting.

History, culture and politics are more important in this regard and the authorities of the adjusting country are best placed to judge how to mobilize the needed support to ensure acceptance and sustainability. The authorities must be satisfied that the policy actions and measures represent an appropriate, realistic and feasible course of action.

Home-grown programmes have the advantage of taking fuller cognizance of national goals, priorities and possibilities. Ideally, and for sustainability, programmes should be consensual, based on wide consultation and popular education. More typically, the authorities will need to take full account of the associated social costs and political opposition and devise appropriate responses to avoid the emergence of unmanageable social tensions.

The BWIs are duty bound to advise on any problems they see, with alternate courses of action or speed of reform. Economic development, however, will take time and cannot be achieved by stealth or taking the opposition by storm. A preference for the "big bang" approach on the grounds that it reduces the potential for later slippage, is a serious misconception of politics. The BWIs should keep their policy advice as much as possible to economics, leaving income distribution and other socio-politically complex issues to the authorities. Involvement in these areas makes the management tasks of the authorities more difficult and can be even counterproductive.

There is considerable empirical support for the ownership factor in successful adjustment: Ghanaian officials have presented the Economic Recovery Programme (ERP) as an exercise in international cooperation, but have been uncompromising in their insistence on their ownership. Stanley Fischer, perhaps reflecting more of what ought to be, if not exactly what generally is, commented on the ownership issue this way:

> With respect to the mutual problems between the countries receiving adjustment loans and the World Bank, the crucial issue is 'ownership' of the adjustment programme. For some countries, ownership is virtually all that is needed. If a country 'owns' a programme and has the administrative capability necessary to design and implement it, we at the World Bank do not have to do very much. We can discuss the programme with the country and see it get under way, but then should relax. If a country has the commitment but does not have the administrative capacity, we can take a more active role. In those cases, slightly more detailed adjustment lending and greater specification of conditions may be useful (Thomas *et al.*, 1991, pp. 527-528).

In practice, the problem lies with leaving it to the staff of the BWIs to determine how much of the "administrative capability necessary to design and implement" a programme the country possesses. Related to this, how much of the design should be in the hands of the BWIs? The experience with adjustment programmes, and the often wide differences between adjusting countries and the BWIs over the principle and application of conditionality, would suggest the need for the involvement of a third party, for example, an independent institute for growth-oriented adjustment.

Conditionality is essentially coercive and as a result undermines ownership. Officials of adjusting countries, who must implement the measures and live with the consequences, naturally resent BWI staff exercising authority without responsibility. It is generally accepted that the BWIs, as lenders and representatives of the donors, should want to see to it that resources are wisely used, and used as agreed. What is more difficult to accept, is for the BWIs to insist on being sole judges, not only as to whether resources are being used properly and in accordance with provisions, but also whether the borrower is cooperating satisfactorily enough to deserve continued donor support.

The proposed institute for growth-oriented adjustment would, upon request, help a reforming country to identify needed expertise for initial stocktaking and design of a programme which could form the basis of negotiation with the BWIs. It would also, where necessary, serve as or provide a moderator, should differences arise between the reforming country and the BWIs, to determine a fair balance between effort by the country and by the donor community. This would particularly deal with the question of adequacy of finance in support of the reform effort.

F. Summary and conclusions

The LYCs typically depend on a limited number of commodities for their export earnings and have highly import-dependent economies. The real prices of the commodities of most importance to them have shown an al-

most steady secular declining tendency since the middle of the last century. Moreover, in recent years the trend has become steeper. These prices have also exhibited wide fluctuations.

Under these circumstances, it might be expected that LYCs would have high precautionary savings. No significant differences, however, have been found empirically in the reserves/import ratios between developing and industrial countries. Perhaps this is due to the pressure from competing uses - imports of investment goods and goods related to basic needs - and the poverty of these countries. Inadequate reserves have left these countries extremely vulnerable to external shocks, whose effects get magnified because of the inability of LYCs to take prompt action when required. There is a need to improve their reserve holdings without postponing economic development, or creating further hardship through shortages of basic needs like food and medicines.

Economic development has been called the most pressing challenge facing the human race. Substantial resources have been marshalled for this purpose, but there has been only one Marshall Plan and that was for the reconstruction of Europe. The reconstruction of Europe, even with the extraordinarily large resources involved, none the less took over a decade to be completed. But it was done, largely because depression in one country and its spread to other countries, beggar-my-neighbour and other restrictive trade and payments practices, and ultimately the ravages of war, brought home the stark reality that problems of the industrial world are best resolved through consultation, cooperation and collaboration. Grants-in-aid to a debtor country, rare if it existed before, became an instrument of international financial relations. It was also recognized that successful adjustment required the establishment of the necessary prior conditions. An important characteristic of the adjustment process of the first two decades of the postwar years was that it depended on economic growth.

So long as economic growth and trade expansion were assured, the adjustment process worked well. Inflation rather than recession was, however, identified as the macroeconomic problem of the postwar era. From the end of the 1960s, growth has faltered and recessionary tendencies have become dominant. The oil crisis and short-lived commodity booms have, however, contributed to the persistence of a dominant inflationary psychology, even when, as a result of structural changes, deflation, rising unemployment, a resurgence of protectionism and beggar-my-neighbour policies are in the ascendancy in industrial countries.

Meanwhile, debt service burdens and terms-of-trade losses, including some induced by, or associated with, the adjustment process itself, continue to play havoc with developing economies. At the same time, the current climate for aid is difficult and the prospects are gloomy. A key mechanism for the proper functioning of the international adjustment mechanism is increasing flows of long-term capital exports and development aid. Uncertainty in this regard paradoxically makes this rather a destabilizing factor.

The slow pace of recovery from the world recession has meant that many countries continue to suffer from a substantial underutilization of economic resources, including high levels of unemployment; and the current account balances of industrial countries are again in serious disequilibrium. As a result, foreign exchange markets for major currencies have become unstable, exacerbating other economic problems.

The developing countries continue to encounter difficulties: inadequate real gains in the prevailing low levels of per capita income, external financial problems and burdensome debt positions, adverse impact on export earnings owing to protectionist tendencies abroad, and problems of exchange rate management arising from divergent and sometimes rapid movements of exchange rates for major currencies.

World economic problems continue to make for difficult and potentially dangerous outcomes. The existing international adjustment process is not functioning as it might because of the paradox of a dominant inflationary psychology coupled with a deflationary bias in the system. Together, they are responsible for the absence of an expansionary trade stimulus and the inadequacy of resources: finance, technical assistance, and time needed to promote economic development on a sustainable basis.

The international adjustment process depends for its proper functioning on countries with large surpluses - Japan and until recently Germany - stimulating their economies, so that together with the United States (which, in spite of its payments deficit, is expected to follow somewhat expansionary policies) they might help the world economy to grow and trade to expand.

In practice, the balance of expansionary and contractionary forces appears to be a net deflationary stimulus to the world economy.

This position contrasts with what appears to be the dominant view. Inflation has been seen to be the major economic problem of the postwar period. The first *Annual Report* of the Fund in 1946 already identified inflation as a general world economic problem, and as early as 1948 the Fund was encouraging governments to take appropriate measures for its prevention.

While Fund officials recognize that diagnosis of the balance of expansionary and contractionary forces in the world economy is difficult, inflation has generally been considered the most likely danger. As a result, even in periods when the possibility of an international recession has been seen as high, the Fund has none the less emphasized the need to deal with inflation. On the other hand, countries with payments surpluses have been either reluctant or unable to follow expansionary policies. A few examples to illustrate this will suffice:

(1) German officials have judged that measures to accelerate domestic growth would not be helpful in bringing about recovery of the world economy. Its officials have doubted whether expansionary policies would stimulate greater growth in the German economy.

(2) Private domestic investment, they have argued, is less a function of easy monetary policies than of buoyant demand for German exports.

(3) As far as government investment expenditures were concerned, there was little scope for further increases, because a modern infrastructure already existed in Germany.

(4) Paradoxically, the large fiscal expansion resulting from German unification had a perverse effect on Germany's European trading partners. Fears of inflation had led the Bundesbank to tighten its monetary policy. The commitment to fixed parities in the EMS in the face of sharply rising German interest rates called for real interest rate increases in these other countries which, without the benefit of the stimulus of fiscal expansion, resulted in a sharp slow down in their economies.

(5) German officials also had reservations about the usefulness of cutting taxes as a way to stimulate growth.

(6) Hysteresis effects: an economy which for more than two decades had been accustomed to producing external surpluses cannot easily adjust to current account equilibrium. As everywhere, structural changes take time and organizational imagination.

(7) French officials have argued that, in order to stimulate private investment, restoring business confidence is paramount; sharp real United States dollar depreciations unfavourably affected business confidence and private investment. There is some empirical support for this. For example, it has been estimated that a 10 per cent real depreciation of the United States dollar may be expected to lead to declines equivalent to 1.4 per cent in non-United States OECD GNP in the first year, and as much as 4.8 per cent in the third year.

(8) The Japanese authorities have argued that they were already doing as much as they could to expand domestic demand, stabilize employment, and cut back Japan's current account surplus.

The overall effect of all this, together with what may be reasonable estimates of feasible increases in long-term capital exports and development aid from surplus countries, does not appear to constitute much, if any, stimulus that can ensure the proper functioning of the international adjustment process.

If the United States is to follow the standard route of appropriate aggregate demand management policies together with real dollar depreciation, then in the face of little or no expansionary stimulus from the surplus countries, the net effect is a deflationary bias in the system as a whole.

What is required is a "new" market large enough to enable the United States to adjust through growth and employment generation. Increases in United States net exports are in this case not so much by import retrenchment as by export growth. The required market could be created through the process of economic development of the developing countries. Moreover, this new, and as yet to be developed, market can also provide the external demand required to stimulate private investment, and with that, domestic absorption in OECD surplus countries, a factor necessary for the proper functioning of the international adjustment process. On the other hand, financing problems - inadequate reserves, high levels of debt, onerous debt servicing burdens, dwindling ODA flows and low domestic savings - continue to hamper the emergence of this market.

The "dual indirect link" provides a mechanism for the development of this market through the economic development of the LYCs, financed with seigniorage from the use of the SDR as a reserve asset and as a medium

of international transactions. Seigniorage has been a source of transfer of real resources from the poorer to the richest nations of the world. Such a redistribution of income - an undesirable by-product of the gold exchange standard - is neither efficient nor equitable. The link seeks to rectify the situation by putting seigniorage to work for the benefit of all.

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Comments

M.A. Uduebo

Benno Ndulu's presentation is illuminating and I share his concerns. He raises several interesting and relevant issues and once again brings into focus the consequences of the capital shortage in sub-Saharan Africa, its implications for the development process and what needs to be done in order to address the problem. I will therefore not go over the same terrain elaborately covered in Ndulu's presentation. I will limit myself to the consideration of two interrelated issues, namely, what are the prospects for capital flows to sub-Saharan Africa, and what policy measures are needed for relaxing the foreign exchange constraint in sub-Saharan Africa.

To put it bluntly, the prospects of external resource flows to sub-Saharan Africa for the rest of this decade appear bleak. The reasons are manifold:

(1) Against the background of excruciating external debt overhang and erosion of creditworthiness, a resumption of voluntary commercial bank lending is not a realistic prospect for most sub-Saharan African countries. Indeed, net resource flows from this source are still negative for many developing countries. Factors that may continue to constrain commercial bank lending to sub-Saharan Africa include the need to avoid repetition of the overlending of the 1970s and early 1980s, constraints imposed by prudential guidelines, provisioning requirements for loans to borrowing countries with past debt service difficulties and the shift in recent times by banks to short-term trade and project financing and fee-based transactions.

(2) Foreign direct investment and access to international capital and bond markets have traditionally been concentrated in a few of the larger and richer developing countries. The underdeveloped nature of capital markets and political uncertainties in most sub-Saharan African countries act as a barrier to private capital flows. Other factors conducive to private capital flows, but generally inadequate, include maintenance of macroeconomic stability, exchange and trade policy liberalization, private sector development and rationalization of investment regimes.

(3) Contrary to the assurances of the G-7 countries, competition for real resources by the Eastern European countries will greatly diminish the amount of external resources that can be transferred to the developing countries.

(4) Repatriation of flight capital cannot be relied on for development finance, especially in countries notorious for inconsistent economic and financial policies.

(5) Official development assistance (ODA) may not increase substantially and, in any case, cannot be expected to fill the resource gap in sub-Saharan Africa. A major hindrance to this flow is rooted in the budget constraints of the governments in the industrial countries. As stated above, the governments in the industrial countries may not give high priority to the developing countries. In this context, it is germane to note that over a decade after the Development Assistance Committee internationally agreed the ODA/GNP target of 0.7 per cent, only a few countries have met or surpassed the target.

(6) Credits from the multilateral financial institutions are for most countries a residual element. Given their expanded operations in countries in transition, it is doubtful if the multilateral financial institutions can channel sufficient resources for development finance on the scale required in sub-Saharan Africa. However, their role in catalyzing and coordinating other official and private flows, and support in reform efforts and debt relief, will continue to be beneficial to sub-Saharan African countries.

What should be done to relax the external resource constraint in sub-Saharan Africa? The starting point is to recognize the fact that the problem derives from both external and inter-

nal factors, and that what is required is a collaborative and comprehensive global approach to the problem. The centrepiece of this approach will be recognition of the fact that the recovery of growth is a *sine qua non* for relaxing the external resource constraint in sub-Saharan Africa.

Sub-Saharan African countries will need to pursue sound and credible macroeconomic policies. Credible adjustment programmes may help to catalyze additional external development finance. Reduction in government deficits, an increase in domestic savings and efficiency in resource utilization are among the policy measures that will be required for attracting more external resources. This of course implies "good governance". The need to develop vibrant domestic capital markets where they do not exist, or to strengthen them where they already exist, cannot be overemphasized. Moreover, trade and payments liberalization would seem desirable.

The central banks also have an important role to play in the process. Monetary emissions should be kept in check, thus ensuring that monetary policy is consistent with fiscal policy. Also, they need to ensure that the exchange rate is in line with economic fundamentals; that is, ensuring that there are no wide swings in the real exchange rates. In addition, the central banks should provide the lead in the development of domestic capital markets and the promotion of financial liberalization.

The developing countries will also need to intensify their economic cooperation efforts. In this context, consideration should be given to the linking of clearing and payments arrangements in the developing regions so as to expand intraregional trade and economize on the use of scarce foreign exchange resources. The proposal to establish a South-South Investment Bank merits serious consideration.

The industrial countries will need to adopt a more purposive policy supportive of development in sub-Saharan Africa. To say the least, the debt overhang cannot be divorced from the resource constraints facing many countries in the region. Substantial debt relief in the form of outright cancellation provides the single most effective and direct method for relaxing the resource constraints in sub-Saharan Africa, at least in the medium term. It is also of paramount importance that the industrial countries remove restrictive regulatory and tax laws which impede the flow of capital to developing countries. In addition, providing improved market access for developing countries' exports will enhance their foreign exchange earnings and reduce their dependence on foreign aid. Finally, the multilateral financial institutions and the regional development banks also have a role to play in providing substantial resources for poverty-related investment and liberalizing access to their resources.

In conclusion, and in realization of the poor economic performance of sub-Saharan African countries in recent decades, in contrast with the improved performance of developing countries in other regions, the countries of sub-Saharan Africa need to strive urgently to reverse their persistent poor economic performance. Increased resource flows to the sub-Saharan African countries are desirable, but may not be the panacea for their problems. The countries need to reexamine the policies (political and economic) they pursued in the past with a view to charting a new corrective course of action for the future. It is only the African countries themselves that can effectively turn around the prevailing poor performance of their economies.

Norman Girvan

The Bretton Woods institutions were not designed to serve the needs of developing countries, and even less so of *small* developing countries, which constitute the majority. My brief comments relate to the conditionalities of these institutions and their associated mode of operation, as they impact on small developing economies.

The conceptual framework by which the Bretton Woods institutions operate, which Joseph Abbey has properly criticized in his paper, can be characterized as a combination of the neo-liberal paradigm with the tenets of monetarism. I believe that a good case can be made that the conditionalities derived from this framework fall even more harshly on small developing economies than on others. The reasons are as follows:

(1) Small developing economies are, on the whole, more trade dependent, more dependent on primary products in their total exports and have higher export concen-

tration by product and by market than large developing economies (and for that matter than small *developed* economies).

(2) These characteristics render such economies more vulnerable to external shocks, and less capable of responding to changes in relative prices in accordance with the mechanisms of the neo-liberal paradigm. Hence small economies find exchange rate devaluation of especially limited effectiveness in expanding export sales and in switching domestic expenditure from imports to domestic output, which is in relatively inelastic supply.

(3) Consequently, changes in relative prices have a smaller positive impact on export and domestic production and on the current account of the balance of payments, than in large economies.

(4) Under these conditions, the burden of adjustment tends to fall to a greater degree on demand/real income compression in small economies. This is accomplished by a combination of the income effect of relative price changes, and fiscal deflation.

The above conditions probably hold for most developing countries to a greater or lesser degree: small economies are not a "special" case but an *extreme* case, because of their size and structure. All developing countries have a strong case for conditionalities which are carefully customized to the specific and detailed characteristics of each individual economy, but the small countries have an especially strong stake in this.

Policy prescriptions need to relax the restrictive assumptions of the neo-liberal paradigm regarding the responsiveness of economic agents to relative price changes. There needs to be a great deal of prior research on the structure of production, the nature of domestic and external markets and the capacities and orientation of the state and the private sectors in the particular country. On the basis of this kind of data and analysis, the programme should be developed through a series of detailed consultations and dialogue with a broad spectrum of social partners whose active cooperation is necessary for its successful implementation and operation. As Abbey has pointed out, local ownership of the economic programme is indispensable for its success.

Mbaya Kankwenda

This conference takes place on the occasion of the 50th anniversary of the Bretton Woods institutions and this is a critical moment characterized by the following factors:

- post-cold war period and its implications worldwide;
- political transition towards western democracy for most of the developing countries, associated with their economic transition towards a market economy;
- struggle among industrialized countries to control the world's natural resources, information systems, space technology and, most importantly, the world market;
- deteriorating poverty situation worldwide.

The Bretton Woods institutions have played a significant role in this evolution. I think that it is important at this juncture to take a look at this historical role as far as developing countries are concerned and foresee what could be the future performance to be expected from them.

For this purpose, I would like to refer to the African continent where 31 (almost 70 per cent) of the least developed countries are to be found, and where the Bretton Woods institutions have played a key role in worsening the situation.

After three decades of assisted development, Africa now finds itself in a crisis of unprecedented and unacceptable magnitude. Its manifestation is the dramatic decline in economic indicators and trends and, in a particularly tragic and flagrant manner, the suffering, the enormous difficulties and the poverty of the vast majority of African people.

The diagnosis of failure of the development policies tried in Africa has been made by all the institutions which have attended the bedside of the sick continent. This failure has had adverse consequences for the access of African populations to basic social services: education, health, etc. Africa is ill and must be taken to the "*marabout*" !

An analysis of the crisis which is limited to the macroeconomic dimension or the size of

particular economic sectors, even if done correctly, cannot take the true measure of this crisis and its repercussions at other levels, nor can it prescribe an effective and lasting remedy. This is why, despite the interventions of the "external partners" of African countries at the bilateral, and especially at the multilateral, levels the crisis is still present, worsening from year to year and defying the efforts of both African decision makers and their analysts. The problem is not exclusively an economic one and must therefore be approached differently.

Faced with the severity of the African crisis, many individuals and institutions have analysed the situation and, commendably, have issued warnings or proposed solutions. A number of different fora have been organized and there is a steady stream of studies and reports, fed by the daily evolution of the situation in the African countries.

The proliferation of documents on and meetings in Africa during the past decade has become paralysing for Africa itself. It is experiencing the nemesis of the medical profession, i.e. the institutions called upon to heal are themselves causing the illness. They retard the development of the continent, which seems to be led by others rather than travelling under its own volition. The situation is such that it would seem as though Africans were being refused the right to define their future for themselves, or to show the extent to which they can travel alone in order to become true partners.

The Bretton Woods institutions have multiplied their production of reports, initiatives and programmes on Africa. Never has a continent been subjected to such intellectual aggression and such an outpouring of discourses about it. The refusal, or at least a reduction of this invasion of infantilism, must be the point of departure in order to place the discussion back in the court of Africans.

During the first two development decades, the prescriptions of the Bretton Woods institutions were to discourage any attempt at planning which smacked of "socialism" and to encourage a policy of virtual laissez-faire. Development was the result of individual investment projects. Consequently, they advised the strengthening of the capacity to analyse projects, without any other perspective than that of the microeconomic. Investment codes and the national commissions responsible for them sprung up here and there, not as a tool of controlled development, but rather as a selection mechanism for investments which could take advantage of the incentives offered by the codes.

African managers and civil servants underwent training courses organized for this purpose. Experts in the analysis and evaluation of projects proliferated by way of various cooperation projects, selling investment projects, capital, technology and advisers in project negotiations. This entire wave came down to Africa.

There was praise for the merits of the system: it was thought that a take-off could be perceived here, and that a miracle was taking place there. The Bretton Woods institutions, in particular, concluded good political, economic and financial deals; they succeeded in selling (and they were not alone in doing so) any type of shoddy goods packaged as development. They were firm in their support for political regimes which accepted their prescriptions.

But the system began to break down. Projects were no longer selling well; Africa was becoming less and less capable of purchasing the appearance of development and of paying its debts; its exports were no longer profitable; the world market, for which it had been encouraged to produce, was no longer as profitable for Africa; the miracles and the economic take-offs that had been glimpsed ceased to exist.

Twenty years of selling capital, investment projects and technology finally revealed their true essence: a commerce in the appearances of development. But appearances only deceive for a certain time.

It was against this background that the Bretton Woods institutions, as a "*marabout* of development", were called upon during the third decade to prescribe new remedies, without departing from their traditional canons and paradigms. Although it did not cease, the sale of projects was obliged to yield considerable space to a sectoral or global vision, and to ensure that it was compatible with that vision. We shall therefore have to focus on the elaboration of that vision.

The *marabout* is thus concerned with the prescription of sectoral and macroeconomic policies which create new prospects for the sale of projects. The policies orient the development market in the direction desired by the *marabout*, who is not content with merely dispensing prescriptions: he finances (by loans or gifts) his prescriptions and derives economic, financial and political benefits from them.

The development policies defined by the Bretton Woods institutions are the goods which Africa must purchase, largely with the money of the *marabout* himself, through a mechanism

of "I lend/give you my money if you buy my ideas, which are the only road to salvation".

The merchandise is diversified, changes its form, passes from the stage of projects to policies, but the relationship is fundamentally that of the merchant to the buyer and not that of the *marabout* from one kingdom to that same kingdom. It may be that in addition to the products sold, the merchant gives a "*matabish*". While he does not thereby become a *marabout* himself, he consolidates his hold on his clientele.

The third decade also failed to bring solutions. Development has still not been achieved. It was also during this decade that the crisis of Africa worsened, despite the presence of the *marabout* and his prescriptions. Calling into question the prescriptions of the *marabout* leads not only to the questioning of the political regimes which purchase the *marabout's* merchandise, but also of the *marabout* himself.

If it is possible to sell the products and appearances of development, development itself cannot be purchased. Moreover, the great *marabout* or great sorcerer of the village, belongs to the village, and his prescriptions are of concern to it. This is why outside of the kingdom there is no true *marabout* of development, but only merchants. The authentic *marabouts* of development are only to be found within the kingdom.

Thirty years of cooperation have not placed Africa on the path of development. Reports, conferences, initiatives and programmes have succeeded each other without resolving the problems. No doubt, the responsibility is to be shared. In the following we will review the responsibilities of the machine of the *marabout*, without seeking to absolve Africans of their responsibilities.

I would like to draw your attention to the following points:

(1) Development aid is always preceded, accompanied and followed by a system of production of skills in the development experiences of the country concerned: situation, strategies, policies, programmes and results. "Donors" have taken over this system, particularly through their multilateral institutions: the World Bank and the IMF. In doing so, they have taken control of another power. They have become points of reference to the detriment of Africa and to its own intellectual production, which becomes suspect and ill-considered. Information gives power to the Bretton Woods institutions and this contributes to sterilizing the capitalization of knowledge for development in Africa. The latter does not even have the right to define its own development strategy.

(2) The Bretton Woods institutions have a power of doctrinal inspiration; they inspire development ideas and policies. They define them and ensure their implementation in all areas: macroeconomic reforms, public investment, agriculture, industry, transport, communications, energy, education, health, the environment, the struggle against poverty, etc. Governments in reality act as the agents for the execution of doctrines and programmes inspired and defined by the Bretton Woods institutions.

(3) The Bretton Woods institutions have the power of coordination of the system of aid to the developing countries. They take the initiative with development programmes, the nature of development goods to be sold and the approach to be followed; they coordinate and supervise the intervention of other actors of the system. They dispatch periodic missions to monitor and supervise the policies implemented, consolidate reports and inform the other elements of the system about the progress in the country concerned.

Financially speaking, Africa has become a net capital exporter, despite the stabilization and adjustment programmes led by the Bretton Woods institutions. Moreover, the African debt structure has changed. Multilateral debt, which cannot be rescheduled or cancelled, has become the most important burden hindering African development. One can raise a question: are the Bretton Woods institutions doing business in Africa or are they developing this continent?

Taking these points into account, one can say that the Bretton Woods institutions are not a developing tool for Africa. I may seem to exaggerate, but the reality is that they are rather a strong instrument for industrialized countries to control development strategies in the developing world, to expand and control their markets, and to integrate these countries into the world economy with a specific function.

The reform policies have not yielded the expected results. Projects have not always been carefully conceived, but have often been accepted to justify the portfolio of loans which are increasingly and at a worrisome pace becoming failures. Some of these, particularly in the field of water and dams, have not been well received by the displaced populations.

The diagnostic of the failure of reform policies as presented by the *marabout* stresses the fact that these policies have been poorly implemented by African governments. This is explained on the one hand by the fact that they have no capacity of their own to analyse, formulate and implement domestic policies. On the other hand, it is explained by the fact that populations have not been associated with, or at least sensitized enough to, the implementation of these policies, so that they might understand their justification and accept their effects. The first reason has given rise to the initiative to strengthen management capacity in Africa. Resources are mobilized through the system to sustain this new prescription, which is presented as an accompanying measure. It is believed that there is no capacity in the area of development management in Africa.

Yet the developed market economies are in crisis today, and the Bretton Woods institutions do not consider that this is because these countries lack human and institutional capacities to formulate and implement economic and social policies.

African managers, however, have studied in the same institutions of higher learning as their European or North American colleagues. The capacity which they lack is not that required for the formulation of development policies, but that for the formulation of economic policies for integration into the market and the world economic system. In other words, policies which can attract financing by the system of development merchandising would only generate such financing if those who formulated the policies had something to gain from its provision.

The Bretton Woods institutions' reasoning is simple: African managers tend to question the path to development. The path to development which is advocated is the correct one. What is required is to know how to manage it in accordance with its basic canons and to acquire/define the instruments of management. Consequently, if African governments do not do what the *marabout* thinks is good for them, this is because they are ignorant or incapable. The *marabout* thus has the role if not the mission of giving them this capacity.

But who will determine the moment at which this capacity is acquired so that countries would have less need of the *marabout*? What are the criteria for such success? In reality, the *marabout* needs his *"imams"* and *"muezzins"* within: those who will disseminate his development message, who will have the force of influence and who will ensure the application of his prescriptions. In other words, those who will bear the *marabout's* umbrella, which will protect the system of development merchandising.

From another perspective, the questioning by the African peoples of reform policies, and with those policies the regimes which adopted them and the *marabouts*/merchants who prescribed them, has begun to give cause for alarm.

This is why the demand for democratization, which is synonymous with the socialization of development and the empowerment of civil society, was quickly seen as a demand for the participation of the populations concerned in the process of decision-making in the fields of politics and economic policy. The recognition of political pluralism thereby made it possible to raise the lid on a boiling cauldron in order to let in air and lessen the likely explosion. This is why those who advocate adjustment went so far as to hold it up as a new conditionality for their aid, in order to impose it on their allies, that is to say the ruling classes in Africa who have not understood this.

The calling into question of the current development model and its political component has thus been reduced to its apparent manifestation: the demand for democratization in the form of political, trade union or press pluralism. Hence, the democratization of adjustment becomes, in addition to the strengthening of management capacities, an important element of the strategy of the *marabout* in Africa for the decade of the 1990s.

The system of development merchandizing recognizes the right of peoples to self-determination and independence and the right of countries to political equality. But the right to economic development, i.e. the right to decide the path of development, taking into account one's own analysis of the conditions at the point of departure and the objectives to be pursued, the right of a country freely to conceive its own future, to decide on production, distribution and trade within the country and with the world at large on just bases, that right has not (yet) been recognized. The Bretton Woods institutions are more than financial institutions; moreover, they do not finance development in smaller and poorer countries.

The above-mentioned right is, however, the point of departure for any successful development policy. Africa needs its own *marabouts*, whose only task is to seek social and individual fulfillment within the kingdom, and not external *marabouts* and merchants of development.

The Bretton Woods institutions have largely contributed to this situation. Financing and adjustment have worked hand-in-hand in Africa, but not for the effective purpose of African development. Three decades of Bretton Woods support have demonstrated this. When celebrating the 50th anniversary of these institutions, we should ask whether developing countries need them, and, if so, what will be the agenda for change, both at the regional and at the global levels, in order to launch efficient and effective financial development institutions.

Yilmaz Akyüz

In sub-Saharan Africa (SSA) growth continues to be constrained by the debt problem and external financial stringency, and there is widespread concern that adjustment is not succeeding. At the heart of this failure there are two main factors: inadequacy of the external funding of adjustment programmes and policy shortcomings. Ndulu's paper addresses both problems.

There can be little doubt that the funding of African adjustment and development has to continue to rely on official transfers. Historical experience shows that private FDI lags behind rather than leads growth in developing countries. Similarly, most SSA countries can expect little in the way of lending by private capital markets, export credits or portfolio investment.

While official resource transfers are the main source of external funding of structural adjustment programmes (SAPs) in SSA, official debt is the main drag on adjustment, since most of Africa's external debt is owed to official creditors. This interrelation indeed calls for an integrated approach whereby debt relief initiatives and new aid can be coordinated so as to provide the net transfer of external resources needed to support adjustment efforts.

Policy shortcomings are closely related to external funding. Increasingly, the purpose of aid has become simply to induce policy change to the neglect of its primary role, i.e. to finance growth and investment. The financial squeeze has been reflected not only in the persistence of the region's debt crisis, but also in problems of designing appropriate adjustment programmes. As a rule, any policy instrument can be expected to have, in addition to a positive effect on its main target, a number of negative side effects, and when the instrument is applied beyond a certain point, the gains diminish while the side effects mount. Financial stringency tends to push policies beyond their optimum point of application as domestic policy effort has to make up for lack of funds. This has indeed resulted in too much pressure being put on the exchange rate instrument, with severe repercussions on activity and prices. Moreover, it has resulted in excessive budget stringency, necessitating sharp cuts in public investment.

There can be no doubt that the process of adjustment and development in Africa is inevitably slow and that no miracles can be expected. However, there is considerable scope to improve both domestic and international policies in order to reverse the trend of growing poverty and halt the increasing marginalization of Africa. On the international front there is need to support the SAPs with greater transfer of external resources on a continued and predictable basis in order to meet the continued terms of trade losses and increase import and investment capacity. As Ndulu points out, the most important role in this respect can be played by debt reduction. On the domestic policy front, a pragmatic rather than a doctrinaire approach is required. The debate concerning the best ways of adapting adjustment programmes to the needs and realities of these countries needs to be an open one. I fully agree with the author that this requires, among other things, greater participation of African governments in the initiation and design of SAPs as well as their ownership of the programmes and a strong commitment to their implementation.

IV. ISSUES IN TRANSITION AND ADJUSTMENT AND THE INTERNATIONAL FINANCIAL INSTITUTIONS

8

STRUCTURAL ADJUSTMENT AND REFORM IN DEVELOPING COUNTRIES

*Montek S. Ahluwalia**

The past 10 years have seen a remarkable convergence of views among all segments of the development community - policy makers, academics and the major multilateral institutions - on what policies are good for development. The convergence is reflected in the near universal trend towards trade liberalization and greater openness to foreign investment, greater reliance upon market forces in both the real and financial sectors, and a reduction in the role of the public sector in favour of the private sector, all underpinned by a sustained pursuit of macroeconomic stability through low fiscal deficits. These are the common ingredients of programmes of structural adjustment and economic reform being implemented all over the developing world.

Impressive though the convergence is, it is not quite the consensus which is sometimes claimed. There are variations between countries in the intensity with which different elements are pursued, and there are unsettled issues about the optimal pace and sequencing of reforms. The experience with reforms in several countries has also created greater awareness of some of the problems that may arise in the course of implementation, and these have implications for the design of reform programmes. This paper attempts to define the areas of consensus and identify some of the issues which remain unsettled and controversial.

A. Factors underlying convergence

It is useful to begin with a brief review of how the convergence on policy came about. Several factors were at work affecting each of the constituents of the development community, and these have obviously interacted with each other, making it difficult to disentangle their separate contributions.

1. The retreat from structuralism

The convergence was clearly influenced by a shift in intellectual opinion away from the earlier structuralist view of development, which emphasized structural constraints and rigidities in developing countries and therefore underplayed the role of price and market signals, towards the view that many of these rigidities are the result of policy distortions which can be overcome through policy reform. In fact much of what is today called "structural reform" is essentially a market based response aimed at overcoming constraints which earlier structuralists thought could not be overcome except through much longer-term developmental processes.[1]

The earlier structuralist focus on the inherently unfavourable external environment, and consequent export pessimism, for developing countries had given rise to the concept of a "foreign exchange constraint" and a consequential "foreign exchange gap". This provided the early intellectual justification for official resource transfers to developing countries which were expected to have large multiplier effects by relaxing the foreign exchange constraint. By the end of the 1970s, as a result of influential studies by Little, Scitovsky and Scott (1970), Balassa (1971), Bhagwati (1978), Krueger (1978), the structuralist view had given way to the perception that foreign exchange

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1 Helleiner (1994) rightly points out the "debasement" of the term structural reform, which is increasingly employed "to denote whatever policy package that a government receiving a World Bank 'structural adjustment loan' was either being asked to undertake or actually did". There is no doubt that the term has acquired flavour of the Humpty Dumpty dictum: "When I use a word it means just what I choose it to mean - neither more nor less."

scarcity was largely a consequence of the anti-export bias of protectionist policies, which led to poor export performance. The multiplier effect of injecting foreign exchange through concessional resource transfers was seen to be less important than the potential multipliers from expanding exports, which operated through faster absorption of technology and the impact of greater competitive pressure arising from exposure to world markets.

Where structuralists emphasized the need for massive domestic investment to build capacity, especially in infrastructure, but also in industry generally, using the State as an entrepreneurial agent to stimulate investment, later academic work focused much more attention on efficiency of resource use and factor productivity growth as key elements in economic dynamism. The focus on efficiency as a source of growth forced consideration of the economic environment most likely to encourage efficiency. In this context, several studies, e.g. Krueger and Tuncer (1982), Nishimizu and Robinson (1984) and Nishimizu and Page (1991), emphasized greater export orientation and lower levels of protection as key determinants of efficiency. The focus on efficiency has over the years also led to a much greater concern about human resource development, which was typically neglected in the earlier capital investment oriented approach.

The concern with efficiency also moderated the earlier enthusiasm about public sector investment as an engine of growth, since experience in most countries showed the public sector to suffer from low levels of efficiency and inadequate profitability. Individual examples of efficient public sector units could always be found, ranging from the celebrated example of the Pohang steel plant in the Republic of Korea to individual examples in other countries such as India, Indonesia and Mexico. However, the performance of the public sector as a whole in most developing countries clearly suffered from serious weaknesses, which militated against efficiency and growth.

2. *The Fund/Bank role*

The International Monetary Fund and the World Bank have been actively involved in the convergence and are often credited with its principal authorship. Williamson (1991), with embarrassing geocentrism, has even christened the convergence as the "Washington consensus". There is no doubt that over the past 10 years, the two institutions, which had somewhat distinct approaches earlier, have unified these approaches and become influential advocates of structural reforms in developing countries.

The advocacy of structural reforms by the Bretton Woods twins came about in the aftermath of the second oil shock and was intensified with the consequent large external imbalances faced by many countries. The traditional Fund approach of correcting balance-of-payments disequilibria through reduction in aggregate expenditure levels, supplemented by exchange rate depreciation, was increasingly seen to be ineffective in view of the size of the external adjustment needed in most debt burdened countries. It was recognized that reliance on this approach alone could produce stagflationary outcomes with a disruption in the growth process. The traditional Bank approach, focusing on providing long-term project finance, and thus indirectly filling critical foreign exchange gaps, was equally circumscribed in dealing with the post-debt crisis situation, because of the limited volume of resources which could be mobilized by the Bank and other aid donors in response to the greatly expanded need. The technical work of both the Bank and Fund staff during the 1980s repeatedly endorsed the need for larger concessional resource flows and easier debt reschedulement for developing countries. However, political realities were such that additional resources were not made available.

Adjustment to the post-debt crisis world without significant access to additional resources implied that growth would suffer significantly unless substantial improvements in efficiency could somehow be triggered. It is in this context that the Fund and the Bank embarked upon a joint advocacy of stabilization aimed at achieving macroeconomic stability in the short term, combined with structural reforms aimed at accelerating growth through supply side responses. The focus on structural reforms was partly a reaction to the widespread intellectual awareness of the importance and extent of policy distortions, but it was also partly a response to the inability to restore growth through provision of additional external resources. To some extent, therefore, structural reform had to be invented because it had become necessary.

The rationale for structural reforms as advocated by the World Bank and the IMF has been spelt out in an impressive range of research studies based on experience in a number of countries. *The World Development Report 1991* provided a summary statement of the World Bank's case for structural reforms. It has also provoked counter-statements by neo-structuralist critics such as Fanelli, Frenkel and Taylor (1993) and Singh (1992). An earlier

and more detailed critique of the Fund-Bank approach to macroeconomic policy is presented in Taylor (1988).

3. *Policy makers in developing countries*

Policy makers in the developing countries were obviously influenced by the retreat from structuralism in the academic world and could hardly ignore the consensus emerging in the multilateral institutions. But they were also changing their views on the basis of their own experience in the 1970s and 1980s. Latin America's experience was dominated by the difficulties in adjusting to the oil shock in the 1970s and the subsequent, and related, debt crisis of the 1980s. The failure of the partial liberalization experiments of the Southern Cone countries in the 1970s, and the equally disappointing results from the heterodox stabilization packages in Brazil, Argentina and Peru in the first half of the 1980s, created conditions which forced a rethinking of earlier strategies. In this they were undoubtedly influenced by the exemplary performance of East Asian countries, which were able to bring about much greater export orientation in their economies and were also able to maintain a high degree of macroeconomic stability, all of which led to spectacular growth rates of GDP as well as employment.

South Asian countries did not perform badly in the 1980s, but here too, the stellar performance of East Asia, including the performance of China as a late reformer, led to a reorientation of strategy away from excessive government control and high protection. A process of rethinking on economic policies began in India in the 1980s when several steps were taken to reduce government controls and liberalize foreign trade, although it was not until 1991 that India embarked on a programme of accelerated reform. Policies in Bangladesh, Pakistan and Sri Lanka were also moving in the same direction. The collapse of the centrally planned economies at the turn of the 1990s, and their wholesale adoption of market orientation and global integration, became an additional factor strengthening the push towards deregulation, greater openness and adoption of market-friendly policies.

An important feature of the process of convergence is the modification of puristic or ideological positions on all sides. Among academics, including even structuralists, there is widespread recognition of the need to move away from earlier policies of excessive protection, persistent interference with market mechanisms and unquestioning belief in the efficacy of state intervention in achieving its stated and usually well meant objectives. In turn, the structuralist critique of the conventional Fund-Bank programmes has created greater awareness in these institutions of the possible adverse effects of reforms in certain circumstances, calling for greater care in the design of the reform programme. Experience with structural reform programmes in many countries has also produced a more realistic assessment of the pace at which results can be expected. The experience of successful performers in East Asia has also influenced the convergence in important ways. While these economies have been highly successful in achieving outward orientation and high export growth, many of them are also economies where the Government has played an active role in many aspects of the economy, including especially the provision of basic education and health. Recognition of the positive role of government, and its implications for the design of a reform programme, are important elements of the current convergence.

B. *Some general issues: place, sequencing and credibility*

A characterstic feature of structural adjustment and reform programmes implemented by most developing countries in the past 10 years is that the agenda of reform is wide-ranging, covering macroeconomic as well as microeconomic or sectoral issues. The typical reform programme includes the following elements:

- macroeconomic stabilization;
- domestic deregulation of investment, production and prices;
- liberalization of foreign trade;
- privatization of the public sector;
- financial sector reforms;
- tax reforms;
- labour market reforms; and
- social safety nets.

Managing policy changes in so many dimensions poses special problems, especially when the reforms are obviously interrelated in the sense that the effectiveness of each element in the package depends upon other elements being successfully implemented. This interrelationship raises several issues concerning the design of the programme.

The first issue relates to the pace of reform or the choice between a "big bang" approach, also known as "shock therapy" in its Eastern European incarnation, in which all the reforms are implemented in a very short time, and a more cautious "gradualist" strategy. Opinions vary on the advantages of the two approaches and a good case can be made for either, depending upon particular circumstances. In the idealized frictionless world of neo-classical theory and without political and social constraints, it may be optimal to implement the entire package immediately and achieve the adjustment to the new equilibrium in the quickest possible time, so that the benefits of the reforms are evident as soon as possible. In practice there are lags in adjustment which affect the speed with which the economy will respond to different initiatives. If benefits take time to surface, the constituency in support of reforms will also take time to emerge. The choice of pace of reform is also influenced by political constraints arising from the fact that all structural reforms involve some distributional changes in favour of some groups and against others, and there are limits on the extent of distributional change that can be tolerated. Such changes may not be adverse in a normative sense. For example, a reduction in protection and a shift in incentives towards exports may benefit labour-intensive export industries and low-wage labour employed in these industries, at the expense of highly protected capital-intensive industries with high-wage organized labour. Such a shift may even represent an improvement in total employment and income distribution. However, distributional changes are bound to be resisted and especially so in democracies with active and participative political purposes. Such considerations could justify a gradualist strategy in which reforms are phased over several years, in order to limit the distributional burdens on particular groups in the initial years, until the benefit of the reforms in other dimensions become fully evident and generate the necessary support.

Earlier writers, e.g. Little, Scitovsky and Scott (1970), had recommended gradualism as a logical strategy to minimize adjustment costs and ensure that the reforms were allowed to proceed at an acceptable pace. More recently there has been greater support for a more rapid implementation of reforms on the grounds that it does not allow time for opposition to build up, and also because it gives a clearer signal about future policies. Bruno (1992) has also argued for a rapid pace of implementation to counter "reform fatigue", which can otherwise build up. In practice the choice of pace is less a choice between polar opposites and more a decision of where to locate in a spectrum of possibilities. Experience with the "big bang" approach in Eastern Europe has been far from salutary. By contrast, the much more successful performance in East Asia is typically associated with reforms implemented in a measured way over a longer period. The balance of advantage would therefore seem to lie in a phased implementation of reforms, where the pace is sufficiently fast to ensure reasonable results without risking excessive disruption in the short run.

The second issue in managing reforms relates to optimal sequencing, which is especially important if the pace of reforms is gradualist. If the reforms are interdependent, but their implementation is stretched out over time, then certain elements of the reforms may not be successful unless accompanied, or even preceded, by action in other areas. This raises typical second-best type problems, since an otherwise sensible reform may not only be ineffective, but may actually prove counterproductive, if other elements are not in place. Trade policy reform aimed at reallocating productive resources in line with comparative advantage will not be effective if controls over production and investment prevent such reallocation from taking place. The problem of sequencing was first perceived in the context of the Southern Cone experiments in relation to the sequencing of capital account liberalization, but it is extremely relevant in all reform programmes. These issues are comprehensively reviewed in Edwards (1992) and Funke (1993). Not surprisingly, this is an area which throws up many more interesting questions than definitive answers.

The third issue that stares reformers in the face as they engage in the complex balancing act of gradualism combined with optimal sequencing, is that the reforms must pass the test of credibility. Economic restructuring can succeed only if economic agents, especially investors, believe that the reforms are enduring and will not be reversed. Investors will be willing to take long-term decisions in response to new policy signals only if the new signals are seen to be permanent and irreversible. To some extent the issue of credibility is linked with the choice regarding the pace of reform. A faster pace of reform can, under certain circumstances, add to credibility if the results achieved in the short term are sufficiently favourable to vindicate the reforms and ensure against reversibility. On the other hand, a gradualist approach can, under certain circumstances, generate greater credibility if it avoids unnecessarily disruptive situations in the short run, and allows time for beneficiaries of reforms to emerge with a clear vested interest in their continuation.

It is obviously not possible to prescribe general rules for the design of a programme of structural adjustment and reform which will ensure appropriate pace and sequencing of reforms and also ensure credibility. These are choices that have to be made in the particular context of each country, taking account not only of economic circumstances, but also of political and social constraints. These issues are examined further in subsequent sections of this paper.

C. Macroeconomic stabilization and the fiscal deficit

Most countries undertaking structural adjustment have done so in the context of severe macroeconomic imbalances reflected in unsustainable balance-of-payments deficits or high rates of inflation or both. Macroeconomic stabilization has therefore figured high on the agenda of reform in most cases. This is not only to achieve the immediate objectives of controlling inflation and managing the balance of payments, but also to create conditions conducive to the resumption of sustainable growth. Macroeconomic stability is also a precondition for the effectiveness of other reform initiatives. Trade liberalization without macroeconomic stability can lead to unmanageable pressures on the current account, and financial liberalization before macroeconomic stabilization can lead to unsustainable increases in interest rates and banking crises. For all these reasons, macroeconomic stabilization is generally regarded as the centre piece of a successful reform strategy.

Although there is complete consensus on the need for macroeconomic stability, the implementation of stabilization programmes creates several problems. Macroeconomic imbalances typically arise when the level of aggregate demand is not sustainable generating inflationary pressures and spilling over into current account deficits. The origin of the imbalance may lie in excessive expansion of domestic demand (i.e. overheating) or in an exogenous shock which worsens the current account deficit and makes the pre-existing level of aggregate demand unsustainable. In either case, if the situation is not self-correcting, and the increased current account deficit cannot be financed, the only way to restore macroeconomic balance in the short run is to reduce aggregate demand. Stabilization policies therefore aim at reducing aggregate demand through a combination of tight fiscal and monetary policy, and this inevitably imposes a burden on some sections of society. Resentment of this burden is a common factor underlying the unpopularity of most of the stabilization programmes. This is especially so if the burden is seen to be unfairly shared among different sections. Apart from the initial and unavoidable burden of reduced demand, stabilization programmes are also criticized because of other reasons. Two problems which are particularly important in this context are the recessionary effect of stabilization on output levels and therefore on employment in certain circumstances, and the depressive effect on investment levels, which hurts medium-term growth prospects.

1. Stabilization and recession

Conventional stabilization programmes are often criticized on the grounds that the reduction in aggregate demand envisaged has a recessionary impact on output and employment, which in turn means that the burden of adjustment falls more heavily on the poorer sections. This problem is perhaps less serious when stabilization is aimed at correcting an imbalance arising from a runaway expansion in domestic demand (overheating) because demand reducing policies in these circumstances may help to contain inflation (and help the balance of payments) without depressing domestic output or employment. However, a recessionary impact is more likely to occur when stabilization is triggered by the need to correct an externally induced deterioration in the current account deficit. In such cases the aim of reducing aggregate demand is to bring the deficit down to sustainable levels. If export demand elasticities are infinite and if domestically produced importables are perfect substitutes for imports, it can be shown that the reduction in aggregate demand will not depress production levels in the tradeable goods sectors, but will only lead to higher exports or lower imports, which improves the current account deficit. However, even on these assumptions the reduction in demand will reduce output of the non-tradeable goods sector. With more realistic assumptions of less than infinite export elasticites, and less than perfect substitutability between domestic goods and imports, the reduction in aggregate demand will create some slack in the tradeable goods sector, too.

The textbook solution to this problem lies in exchange rate depreciation, which is a critical component of stabilization programmes. The depreciation is expected to improve the competitiveness of the tradeable goods sectors and thus encourage expansion of these sectors. This expansion in response to exchange rate

depreciation is expected to counter the initial deflationary impact of demand reduction. The effectiveness of exchange rate depreciation in triggering an expansion in the tradeable goods sectors is therefore critical for countering the recessionary effect of demand reduction, but this process may not always work smoothly and swiftly.

One factor limiting the speed of adjustment in certain circumstances is that short-run export elasticities of demand may be much smaller than elasticities in the medium run. This is especially likely if the economy is not highly diversified and export-oriented. There may be many domestic products which are potentially exportable but are not immediately so because of quality and technology gaps which take time to bridge. In such situations it may not be possible to achieve large enough export responses in the short run except at large price reductions which imply correspondingly large depreciation.

An adjustment process which requires a very large depreciation poses its own problems. In the first place, a large depreciation is likely to feed back into domestic prices and this can create a destabilizing wage-price spiral. It can also generate negative macroeconomic feedback via the fiscal deficit in situations where the Government has a large external debt or has directly or indirectly taken on the exchange risk in foreign borrowing. In such cases a depreciation designed to complement demand restraint by encouraging tradeable goods expansion may actually undermine the initial demand restraining objective, by worsening the fiscal deficit.

These considerations suggest that some loss of output and even employment in the short run may occur as part of stabilization in certain circumstances. The extent to which this will happen depends upon the size of the initial imbalance and the effectiveness of exchange rate policy in promoting expansion in the tradeable goods sector. If the initial imbalance is modest, the economy is highly diversified with a large potential export capability and world demand conditions are favourable, it may be possible to implement a stabilization programme with a minimum recessionary impact. Under more unfavourable circumstances, however, the recessionary impact will be larger.

The key issue is not whether there is a temporary recessionary phase as a consequence of stabilization, but whether there is any alternative adjustment programme. Critics usually have in mind two types of alternatives. The first is to design alternative stabilization programmes to handle the crisis without demand reducing policies. This is exemplified by various types of heterodox stabilization programmes of the type that were tried unsuccessfully in Latin America in the early 1980s, and also the efforts to manage balance-of-payments deficits through the imposition of controls as commonly practiced in South Asia. Experience gained so far with these approaches is not encouraging, and there is little doubt that an element of demand restraint is inescapable as part of stabilization.

Another alternative approach is to accept the logic of adjustment programmes with demand restraint, but to argue that the adjustment should take place at a slower pace. This is a relevant issue which needs to be carefully considered. A rapid adjustment based on demand restraint can perhaps be justified in a situation where the economy is overheated. However, when the source of the imbalance is external, the pace at which the economy can adjust without precipitating recessionary conditions depends upon the pace at which resources can be redirected into the tradeable sectors. Pushing the pace of adjustment beyond this point may introduce significant short-term costs of over-deflation and unemployment. The ideal pace of adjustment is one which takes account of these considerations, but this implies an ability to finance the resulting larger current account deficit over a longer period. Unfortunately, many developing countries faced with the need to make such adjustment in the 1980s were also placed in circumstances in which finance was simply not available. The high external debt already incurred by many of these countries obviously added to this problem. In many cases, the pace of adjustment was effectively forced by the lack of availability of finance on suitable terms, rather than the financing requirements determined on the basis of the ideal pace of adjustment. When this happens, it is important to be realistic about the outcome of such adjustments and the short-term costs involved. International agencies also need to recognize this problem and avoid underestimation of the cost of adjustment. The costs may be unavoidable if finance is not available, but they should not be understated for this reason.

Structuralist critics of stabilization programmes often paint extreme case scenarios where the economy may be pushed into a destabilizing spiral as reductions in aggregate demand lead to a fall in output while exchange rate depreciation fuels inflation, producing a stagflationary outcome with low levels of output compared to capacity and a sharp decline in real wages. In such scenarios the adjustment process operates by reducing aggregate output levels along with aggregate demand, and achieves equilibrium at low levels of capacity

utilization, with the distribution of income shifting against labour through falling real wages. The experience of many Latin American countries which experienced accelerating inflation and a decline in real wages during the 1980s underlies some of these fears.

It is important to draw the right conclusions from these criticisms of stabilization programmes. To begin with, it must be recognized that some of the problems described above reflect an "extreme pathology" based on some of the worst experiences of countries in Latin America and Africa, which faced an exceptionally large adjustment after the debt crisis. These are cases where it can be argued that a more extended adjustment might have been less disruptive, had adequate finance been available to permit a longer adjustment. But these outcomes should certainly not be viewed as inevitable in all cases, especially when corrective action is taken before the imbalance becomes too large. Nor should these problems be used to argue against undertaking adjustment when adjustment is necessary. Failure to adjust poses its own problems and, as the Latin America experiments with heterodoxy in the first half of the 1980s amply demonstrate, there is no effective alternative method of adjustment yielding better results. In fact, postponement of adjustment in the 1980s, followed by heterodox adjustment in Latin America, generated even more disastrous outcomes.

Perhaps the most important lesson to be learned from accumulated experience is to act at an early stage to correct macroeconomic imbalances before they become too large. Large corrections are more difficult to implement since the room for manoeuvre is limited. If the correction requires more than the available policy instrument, the corrective action is inadequate and destabilization is more likely.

2. *Stabilization and investment*

Stabilization programmes are often criticized on the grounds that the reduction in aggregate demand is typically achieved at the expense of investment, thus jeopardizing medium-term growth. The experience with stabilization in the past ten years in Latin America and Africa suggests that this is indeed a serious problem. A recent World Bank (1993) study of 57 countries having undertaken structural adjustment programmes, reports that both public and private investment rates declined during adjustment. What is more, the process of recovery of private investment took much longer than previously anticipated; time lags of four to five years where not unusual. It is important to consider why this occured and how it can be avoided.

Public investment has suffered in many stabilization programmes because of the need to reduce the fiscal deficit and the manner of its reduction. The case for reducing the fiscal deficit as part of an effort to reduce aggregate demand needs little elaboration. Most developing countries have suffered from excessively expansionary fiscal policies which have produced unsustainable fiscal deficits. A reduction in these deficits is desirable in many cases even without the compulsion of stabilization. It is all the more essential as part of stabilization. It is important to emphasize, however, that a reduction in the fiscal deficit does not necessarily imply a reduction in public investment. The objective of reducing the deficit can be equally achieved by increasing government savings while maintaining investment levels. In fact, a fiscal deficit reduction achieved by increased government savings is clearly much better than the same deficit reduction achieved by reducing public investment. Unfortunately, few countries have found it easy to follow the former route.

The scope for increasing public savings depends upon the ability to increase tax revenues (and also public sector surpluses where a consolidated view is taken of the public sector) on the one hand and reduce government consumption on the other. Since higher tax revenues reduce aggregate demand, essentially by reducing private disposable income and therefore private consumption, a combined effort at raising tax revenues and reducing government consumption ensures that the brunt of the aggregate expenditure reduction is borne by government and private consumption expenditure. If we can be sure that the reduction in government expenditure does not lead to a withdrawal of benefits to the poor, and if the incidence of additional tax revenues is not regressive, we can say that the burden of adjustment is fairly distributed. But such targeting is not always easy to achieve in practice. In practice there are severe limitations on the extent to which government consumption can be lowered or tax revenues increased in the short run.

There is no doubt that many developing countries suffer from problems of a bloated bureaucracy, and most budgets contain schemes and projects of doubtful social benefit which could be drastically pruned, if not entirely eliminated. In many cases government budgets are burdened by subsidies which are not effectively targeted to the poor, and also by the direct and indirect support provided to loss-making public sector units. The constraints upon how fast governments can move

in these areas are essentially political, but they are no less real for that. While a period of austerity may be generally accepted at a time of crisis, and governments may be able to take some hard decisions in such situations, some of the gains are often temporary. This is particularly so if expenditure reduction occurs in the form of "expenditure restraint", in response to the compulsions of short-term economic management, without any system changes which would eliminate certain types of demands entirely, such as abolition of certain subsidies or elimination of certain governmental functions, or privatization/closure of loss-making public sector units, which otherwise exert claims on the budget. Mere expenditure restraint leads to "expenditure suppression" rather than genuine "expenditure reduction", in the sense that the same expenditure demands resurface when the immediate crisis is over. The difficulty in reducing government consumption expenditure is further increased by the emergence of new pressures to increase expenditures, which may build up in the course of economic reforms. In a developing country there are many legitimate demands upon the Government to provide basic services to the poor. These demands are likely to intensify during a period of adjustment, because of the need to create social safety nets to limit the burden placed on the poor.

There are equally serious difficulties in increasing public savings through improved tax revenue mobilization in the short term. A major problem here arises from systemic weaknesses in the tax systems of most developing countries. It is always possible to raise additional revenues simply by raising rates in existing tax systems, but this may be counter-productive if the tax system is characterized by highly distortionary taxes. It is, therefore, necessary to first reform the tax structure and put in place a less distortionary tax system, and then mobilize revenue through effective enforcement of the new system.

The need for basic reform of the tax system as an essential component of structural adjustment is one of the initial elements in any strategy of stabilization and structural adjustment. All countries implementing structural reforms have taken important steps in this direction. Perhaps the most important initiative in this context is the introduction of a value-added tax (or some variant thereof) in a large number of developing countries, all of whom have reported very encouraging results. However, some elements of tax reforms, such as reductions in customs duties as part of trade reforms, may hurt government revenues. It may be possible in some situations to recoup losses in customs revenues by tariffication of existing quantitative restrictions, where these are important, so that the switch from quantitative restrictions to tariffs leads to higher revenues, but this may not provide large revenues in all cases. Besides, a comprehensive reform of the tax system cannot be implemented overnight. It needs to be tailored to the particular legal and institutional circumstances of each country and involves not only the redesign of the tax structure, but even more importantly, a thorough overhaul and modernization of tax administration. All this takes time to implement and in the process the growth in tax revenues in the first few years may not be as dramatic as expected.

The limitations on reducing government consumption expenditures and raising tax revenues in the short run define the narrow limits of the possible in reducing fiscal deficits without hurting public investment. Where the required macroeconomic adjustment is relatively small, it should be possible to restore macroeconomic balance without much damage to public investment. However, where the required level of adjustment is large, as was the case with many developing countries in the 1980s because of the size of the external shock, the reduction in the fiscal deficit required for macroeconomic stability forces substantial reductions in public investment. Some reduction in public investment may be acceptable in certain circumstances, for example, when public investment levels are high and the reduction reflects lower levels of low productivity public investment in non-critical sectors. However, sharp reductions in public investment in critical infrastructure sectors can be very damaging to medium-term growth, and there is evidence of such damage in Africa and Latin America. Real spending on new infrastructure fell in 11 of 13 countries, with real expenditures on infrastructure in countries such as Argentina, Brazil, Guatemala, Mexico, Panama and Venezuela being less than 50 per cent of the levels observed in the early 1980s.

This is not to argue against the objective of reducing fiscal deficits. The lesson to be learned is that it is not enough to define the objective solely in terms of reducing fiscal deficits. The quality of the deficit reduction is equally important and this means that deficits should be reduced primarily by raising public savings while maintaining essential levels of public investment. This forces attention on the difficult choices which are crucial for a successful adjustment, i.e. control over government consumption expenditure including non-targeted subsidies and bold implementation of tax reforms.

The impact of stabilization programmes on private investment is equally important. Unlike the case of public investment, there is no immediate reason why a stabilization effort should lead to a fall in private investment. In fact, a reduction in the fiscal deficit can be expected to help private investment if it leads to lower interest rates and less crowding out of private investment. Yet, as the World Bank (1993) study notes, private investment too has suffered in the course of stabilization efforts. One explanation of this phenomenon is that public investment, especially investment in infrastructure, is complementary to private investment rather than competing. Some empirical evidence for this view is given in Taylor (1993). There are also other reasons why private investment may be temporarily depressed in the course of a stabilization programme. Where the programme quickly succeeds in restoring macroeconomic stability and reducing uncertainty about the future course of action, and where there is a substantial inflow of foreign direct investment in the early stages, domestic private investment can be expected to respond favourably to the new situation, if not immediately, then at least in a relatively short time. However, if the stabilization programme is inadequate to the task at hand, and seen to be faltering, it can generate destabilizing expectations about the medium term which may hurt investment intentions. When this coincides with trade liberalization, which reduces protection and therefore the incentive to invest in many domestic industries, it may lead to an overall wait-and-see attitude on the part of investors, both domestic and foreign, which would depress private investment for a time.

The following lessons can, with a certain degree of confidence, be drawn for the design of stabilization programmes:

- Macroeconomic stability is a precondition for successful restructuring and countries which face instability, whether induced by internal or external factors, would be well advised to take corrective steps earlier rather than later. Such adjustment will entail costs, but failure to adjust could force even higher costs on the economy.

- The fiscal deficit is an important instrument in the adjustment process, but much more attention needs to be given to the quality of the deficit reduction and, in particular, its impact on investment, if the medium-term growth prospects are not to be jeopardized. A reduction in the fiscal deficit achieved through higher tax revenues generated from broad-based non-distortionary taxes, is the best way of reducing the deficit, as it represents a permanent strengthening of the fiscal position. A pruning of non-productive government expenditure is perhaps equally good in the short run, though these gains are more likely to be in the nature of once for all gains. Neither route to deficit reduction is easy, but the alternative is worse and the key to a well-designed adjustment programme is whether it can enforce some hard decisions early to avoid worse outcomes later.

- Depending upon the size of the macroeconomic adjustment needed, countries may be forced to carry deficit reduction to the point where cuts in public investment may be unavoidable in the short run. Some reduction in public investment may not be damaging if it is limited to low efficiency investment in manufacturing, and most government budgets have many such cases. It can present serious problems, however, if it leads to deep and prolonged cuts in public investment in key infrastructure areas where shortages will affect the productivity of capital generally in the economy. This is especially so in countries where reductions in public investment in infrastructure will not be offset by private investment for some time.

- The targeting of fiscal deficit reduction has to take account of the likely level of private investment in the economy, which may also be temporarily depressed for various reasons. Structural adjustment programmes should not assume that private investment will automatically crowd in to replace public investment. There is a possibility that private investment may take time to recover. In such a situation the pace of reduction in the fiscal deficit should be more gradual than would be otherwise justified, in order to maintain public investment in infrastructure sector at reasonable levels.

- Not surprisingly, these problems will be less severe the smaller the extent of macroeconomic correction that is required. The larger the correction the more likely that ex-ante corrective steps will fall short of what is needed, leading to various types of disequilibrium behaviour.

D. *Trade policy reform*

Trade policy reform typically involves some combination of the following package of measures:

- elimination of export restrictions and taxes;
- substantial depreciation of the exchange rate to increase export profitability and offset reduced protection;
- elimination of quantitative import restrictions, and a shift to tariff protection;
- reduction in average tariff levels;
- reduction in tariff variation with the ultimate objective of a uniform tariff on most if not all items.

Although trade policy is perhaps the most intensively researched area in development economics, it is only recently that trade reforms have been widely implemented. Trade policies were generally restrictive in most developing countries until the early 1980s, and in many cases the initial reaction to the debt crisis was to tighten trade restrictions in many cases. There was a turn around by the mid-1980s, however, when several countries in Latin America moved sharply in the opposite direction.

The pace of trade liberalization since the mid-1980s has been remarkable by any standards. Between 1985 and 1991 the average tariff rate (unweighted) was reduced from 80 per cent to 21 per cent for Brazil, from 83 per cent to 7 per cent for Colombia, from 92 per cent to 16 per cent for Costa Rica, from 34 per cent to 4 per cent for Mexico and from 64 per cent to 15 per cent for Peru. In many cases the reduction was brought about in one year. The coverage of non-tariff barriers has also been dramatically reduced. A similar process of trade liberalization has been initiated more recently in South Asia, though at a much more gradual pace. East Asian countries, whose tariff levels were low even earlier, have lowered tariff rates further in this period.

The shift to more outward oriented and liberal trade policies has certainly proved successful if we look at the export performance of reforming countries. Chile and Turkey both became highly successful exporters in the 1980s. The experience of other countries implementing structural reforms, surveyed in World Bank (1992 and 1993), also shows that export growth rates for most countries were markedly higher in the period 1987-1991 compared with the period 1982-1987. These results clearly indicate that the pessimism about export possibilities, the general attitude of the earlier structuralists, is not warranted by experience, and this has produced a general consensus on the importance of providing a supportive environment for exports. This includes at a minimum a realistic exchange rate, which ensures export profitability, and also an import policy providing exporters with an effective "free trade regime" for their inputs, so that they can be easily obtained at world prices.

While there is general consensus on the important of export orientation, there is less agreement on whether the full package of import liberalization, with elimination of quantitative import restrictions, reduction in the average tariff level and a narrowing of tariff rates, is an equally compelling necessity. Rodrik (1992) points out that the high export growth achieved by many developing countries owes more to their aggressive exchange rate policy than to any package of full fledged import liberalization, as recommended by trade reformers. Helleiner (1994) also expresses reservations on the pace at which full import liberalization needs to be introduced in Africa. The experience of East Asian countries is also often cited to question the importance of import liberalization. These countries, it is argued, certainly gave top priority to export performance and tailored their policies, especially exchange rates, to support exports, but except for Hong Kong they did not follow liberal import policies in the conventional sense.[2]

Because of these doubts, it is important to define the area of consensus on the role of import liberalization in trade policy reform. The theoretical case for reducing protection and liberalizing imports on efficiency grounds is well known, as is the usual qualification in terms of the infant industry argument, which is undoubtedly relevant in developing countries. The case for some protection for domestic industry can be readily conceded, but this should not be used to jusify very high levels of protection such as prevailed until recently in many developing countries, especially the larger countries such as Brazil and India. To some extent the smaller economies avoided excessively high import substitution cost, simply because the size of their domestic markets limited the extent to which import substitution could be pursued. In the larger economies the range of import substitution possibilities was wider and this led to a more pervasive structure of

2 As documented by Amsden (1989) in the case of the Republic of Korea, and Wade (1990) for Taiwan Province of China, both economies became successful exporters by (a) ensuring that exporters had easy availability of importable inputs at world prices; (b) ensuring a highly supportive exchange rate; (c) offering their firms a protected home market; and (d) combining all these with a complex system of government administered rewards and penalties, especially through directed credit arrangements which targeted individual firms and pushed them to compete internationally.

protection. It was not adequately recognized that such protection ultimately benefited protected sectors at the cost of others, especially, export-oriented sectors. High rates of protection over a wide range of industries created a situation where the effective exchange rate facing these industries was much more favourable than the exchange rate facing exporters. This created a powerful bias against exports which could only be offset by policies of special export incentives and subsidies. These are no substitute for a more favourable exchange rate, however, since they are not only inadequate to offset the anti-export bias in general, but also complex to administer and a burden on the budget.

While few would disagree that high levels of protection are undesirable, opinions vary much more on what is the appropriate level of protection, and in particular on the extent of variation in tariffs that can be tolerated. Committed advocates of trade policy reforms typically recommend duty rates around 10 per cent to 15 per cent, with near uniformity of the tariff if possible. While some countries in Latin America have moved quickly to this situation, others are making the transition more gradually. India, for example, until very recently had tariff levels which were high on average and also highly variable, and customs duties also contributed as much as 40 per cent of government revenue. In these circumstances it is difficult to move quickly to low and uniform tariff rates without imparting too large a shock to many highly protected industries and also creating serious budgetary problems. India's approach towards tariff reductions, therefore, has been more gradual, with steady but substantial annual reductions in tariff levels, combined with a more rapid reduction of peak rates to reduce tariff dispersion. It is expected that this process will achieve a phased transition to a more reasonable structure of protection over a five-year period. One of the problems with such a phased transition is the uncertainty about future levels of tariffs, which can delay investment decisions. It is obviously important to give clear signals to investors on the tariff regime they should expect in future. Some countries have followed the practice of pre-announced tariff reductions, which helps to reduce uncertainty and encourage early restructuring of industry in line with future levels of protection.

One issue on which there should be no misgivings is that quantitative restrictions on imports should be substituted by tariffs as soon as possible. Experience in many developing countries has established that quantitative restrictions, operated through discretionary import licensing, invariably creates delays and inefficiency at best and corruption at worst. There is also no justification for the rents which quantity restrictions imply, least of all in a period of structural reform. Actual experience also suggests that this switch can be effected with little difficulty. In three years India, which had one of the most complex systems of import licensing, has successfully dismantled licensing of imports for raw materials, components and other inputs into production and capital goods. Finished consumer goods are still subject to quantitative restrictions, but these too are being liberalized. This switch has been achieved with progressive reductions in tariff rates offset by exchange rate depreciation, and has presented no problems for the balance of payments.

Finally, it is important to consider the relevance of the East Asian example of combining export promotion with protection of domestic markets. There are several reasons why an uncritical acceptance of this approach may be inappropriate today. A general point which should be noted is that effective protection rates in East Asian countries, even during their earlier protectionist phase, were on the whole much lower than in Latin America or South Asia, because exchange rates were never allowed to become overvalued. Besides, replication of the East Asian approach, with its reliance upon interventionist regimes, depends critically upon the ability to design and operate such regimes in a manner which ensures that targeted firms are under pressure to perform in world markets, and actually do achieve international competitiveness at the end of the process. The line between targeted strategic support for good performers and unabashed favouritism is thin at best. It is particularly difficult to draw in situations where transparency in government dealings with individual companies can become an issue of public accountability. Changes in the global economy since the earlier years of the East Asian miracle also make strict replication of the East Asian strategy more difficult today. The phenomenon of globalization of production and the role of multinational firms in determining the ability of countries to access global production and marketing networks, make it much more difficult for countries to achieve outward orientation behind high protective barriers. Finally, the compulsions of the post-Uruguay Round world for moving towards greater openness and reduced reliance upon subsidies cannot be ignored by developing countries.

For all these reasons, trade policy reforms should aim not only at promoting exports, but also at liberalizing imports, though the latter process could be accomplished in a phased

manner. Some of the preconditions for the success of such policies are the following:

(1) Since trade liberalization is designed to reallocate resources among sectors on the basis of undistorted relative profitability, it is important that domestic impediments to such reallocation be removed. This implies elimination of domestic regulatory restrictions on production and investment, and also of price control, as a prior condition. Trade liberalization cannot play a useful signalling role if domestic prices are not free to adjust, or domestic resources to move.

(2) The issue of sequencing of trade liberalization in relation to macroeconomic stabilization can also present problems. Opinions vary between the view advocated by McKinnon (1982) and Edwards (1992) that macroeconomic stabilization should precede trade liberalization, and the view of Corden (1987) and Schweikert (1993) that it should be implemented simultaneously. The two views can be reconciled by distinguishing situations of severe macroeconomic imbalance from those of relatively mild imbalance. In the former case it may be necessary to restore a substantial measure of macroeconomic stability before undertaking significant liberalization on the external front, so as to avoid destabilizing movements of the current account deficit and/or the exchange rate. However, in situations of milder imbalance, where corrective macropolicies are being put in place, there may be no harm in proceeding with trade liberalization simultaneously. This is especially so if there is a substantial upfront exchange rate adjustment which removes the initial overvaluation and perhaps even overshoots a little to provide a cushion of credibility.

(3) On the related issue of capital account liberalization there is virtual unanimity that it should be attempted last. This is the main lesson drawn from the Southern Cone failures of the 1970s. It also follows from the proposition advanced by Frenkel (1982) that since goods markets and financial assets markets clear at different speeds, the goods market, which takes much longer, should be liberalized first. Too early a liberalization of the capital account can also lead to large inflows of capital which have the immediate effect of appreciating the exchange rate, thus moving in the opposite direction from the depreciation necessary to sustain trade liberalization. While long-term inflows of private capital are highly desirable and need to be encouraged, volatile capital flows of the portfolio type can present a problem, and the size of these flows needs to be carefully watched and, if necessary, regulated. The last thing developing countries need in the midst of trade liberalization is a dose of "Dutch disease", with sharp exchange rate appreciation induced by capital inflows which may be equally quickly reversed.

(4) In the longer term the success of trade liberalization depends upon its effectiveness in promoting new investment in sectors which are internationally competitive, and this depends upon the interaction between trade policy reform and other factors affecting investment. Investors will only respond if the future direction of trade policies is clear and the policies are also seen to be non-reversible. Where the bulk of the trade reform is undertaken upfront, as in many Latin American countries, there is less uncertainty about the future. Where the pace of trade reform is more gradual, as in South Asia, it is important that the pace of implementation over the future is clearly spelt out and the transition is seen to occur in a reasonably short time, so that investors can plan with confidence. Uncertainty about the future will only promote a wait and see attitude which will delay the expected benefits from trade reform.

E. Financial sector reform

Most countries undertaking structural adjustment have emphasized financial sector reforms as an integral component of the adjustment programme. Major overhauls of the financial sector are underway all over Latin America, South Asia and East Asia. The reforms focus mainly on the banking system, but also cover stock markets where these are important.

The impulse behind these reforms comes from three different sources. First, there is the literature on financial repression developed by McKinnon (1973) and Shaw (1973) which holds that excessive interest rate regulation and high reserve requirements combined with directed lending, have burdened the banking system in developing countries, reducing the efficiency of banks both in mobilizing domestic savings and in allocating them to different uses. Liberalization to reduce or remove these restrictions is, therefore, recommended. A second impulse, which may appear to run counter to liberalization, but is in fact an essential

accompaniment, comes from the recognition that banking systems in most developing countries have suffered from inadequate prudential regulation and weak external supervision, which have reduced the allocative efficiency of banks and also weakened them financially. Finally, there is a perceived need for financial sector reforms to enable the financial sector to support the restructuring of the real economy, which is the basic objective of structural reforms. Each of these considerations provides compelling reasons for reform in the financial sector.

The need for financial liberalization as a corrective for financial repression is self-evident. The complex regulations imposed on banking systems in developing countries, including multiple regulated interest rates on both deposits and lending, high levels of reserve requirements and government direction of credit to particular sectors, constitute a substantial tax on financial intermediation. The burden of this tax is borne by depositors who would otherwise have received higher interest rates on their deposits, and by the non-preferred borrowers who are charged high interest rates to cover the cost of subsidization elsewhere. The beneficiaries are the preferred borrowers who are charged lower rates or whose defaults are tolerated, and the Government which benefits from pre-emption of resources at below market rates because of high reserve requirements. Developing countries would be well advised to reduce, if not eliminate, the economic costs of these distortions, and this justifies a substantial measure of liberalization. A case can always be made for subsidization of certain classes of borrowers, but the multiplicity of controls and administered rates prevailing in many developing countries are difficult to justify. There should at most be a single subsidized rate applicable to a limited class of borrowers, leaving other rates to be determined essentially by market conditions. Reserve requirements imposed on banks should also be reduced, so that the implicit tax on financial intermediation is modest at best. Such changes would enable banks to pay somewhat higher interest rates on deposits, which would improve the banks ability to mobilize savings. On the lending side it would enable banks to charge a lower interest rate for non-subsidized borrowers more in keeping with the cost of capital. If banks are not able to reduce the burden of cross subsidy borne by non-subsidized borrowers, they run the risk of disintermediation as commercially attractive borrowers turn to non-bank sources of finance, a process which hurts the banks by depriving them of their best corporate clients. This problem becomes more acute as the financial sector becomes more developed.

These arguments for liberalization have been criticized on various grounds, which are well summarized in Akyüz (1992). The argument that freeing interest rates will promote domestic savings and thus support a higher level of investment has its limits. Promotion of domestic savings is undoubtedly important, but there is a view that domestic savings are not significantly affected by interest rates. Recent reviews of the Asian experience by Cho and Khatkhate (1989) and of African experience by Nissanke (1990), suggest that the level of savings appears to be determined more by institutional factors, including especially the scope for contractual savings, than by high real interest rates. Large negative real rates of interest on deposits, such as are witnessed in times of severe macroeconomic instability and hyper-inflation, are associated with declines in savings rates and a shift away from financial savings, but the dominant factors in such situations are the macroeconomic instability and high rates of inflation. Small variations in real rates of interest in conditions of relative macro-stability may not have much impact on domestic savings, or even on the ability of the banking system to mobilize savings.

Interest rate liberalization on the lending side may create serious problems in situations where macroeconomic stability has yet to be established. Where the government's domestic debt is high and its fiscal flexibility is limited, an increase in interest rates following financial liberalization can add to the interest burden on the budget at a time when the government is trying to reduce the fiscal deficit as part of structural adjustment. This could undermine the fiscal effort and lead either to excessive monetization of the deficit, with inflationary consequences, or to expanded government borrowing. The latter could put further pressure on interest rates especially in situations where the market for government debt is not well developed. Interest rate liberalization in a situation where the fiscal deficit is not in control could, therefore, lead to an "overshooting" of domestic interest rates, which could impose a severe strain on firms already under pressure as they restructure to face a more competitive environment. Financial distress in the corporate sector could, in turn, feed back on to the balance sheets of banks and force a contraction in bank credit. It can be argued that such a process, if it gets out of control, could have adverse effects upon investment. However, the key issue here is not financial liberalization as such, but the macroeconomic environment in which financial markets are liberalized. The policy conclusion to be drawn is not that financial liberalization and the efficiency gains which it promises are not important, but that

these gains can only be achieved if liberalization is undertaken in an environment of macroeconomic stability. Once again sequencing becomes critical.

The second impulse behind financial reforms is the need for effective regulation. It is important to recognize that financial markets are fundamentally different from commodity markets in the sense that prices (in this case interest rates) are not set to clear the market. Many borrowers may be willing to offer high interest rates, but they may be unacceptable credit risks, either because their projects are inherently risky or because they are individually unreliable. Bankers need to screen out such borrowers and this implies that interest rates are not set to clear the market, but are typically set in a zone in which there will be substantial excess demand for credit with bankers rationing credit by screening out risky borrowers. In principle, this process of screening can take place in a liberalized system through good banking practices in the form of prudential norms, effective internal management controls, and strong external supervision. Unfortunately, these features have been lacking in most developing countries. Financial liberalization, therefore, has to be implemented mindful of the danger that premature liberalization may lead to irresponsible competition, with banks chasing "high-return" but high-risk assets, resulting in the familiar problem of adverse selection and deterioration in portfolio quality. This is not to deny the need for financial liberalization to clean up over-regulated systems. It is clear that excessive regulation leads to gross inefficiencies and very poor banking, especially if the banks are also controlled by the government. It is only to argue that the pace of financial liberalization needs to be calibrated to be in phase with the introduction of appropriate regulation.

The time needed to introduce appropriate regulation should not be underestimated as this is not simply a matter of prescribing international norms for income recognition, asset classification, provisioning and capital adequacy. New prudential norms and capital adequacy requirements cannot be implemented suddenly in banking systems which have existed without them for many years without subjecting banks to large balance sheet shocks which would either seriously destabilize the system, or impose large burdens on the budget for recapitalization and restructuring of the banks. Banks will also take time to adjust to the requirements of the new situation, as their whole approach to lending has to change to give much greater importance to portfolio quality. Nor is this simply a matter of shifting from public sector banks to private sector banks. The introduction of new private sector banks in banking systems which have been dominated by public sector banks can be extremely important for increasing competition and setting a faster pace of change, but privatization by itself does not solve the problem. Experience with banking crises in many countries shows that private banks are also vulnerable if regulation is inadequate.

The learning process is a problem not only for the banks, but for supervisors also. Regulatory and supervisory authorities, hitherto used to lax supervision, face formidable challenges in upgrading their skills to the requirements of the new situation. For all these reasons financial sector reform takes time to implement.

The experience of East Asia in financial sector reforms is instructive. The Republic of Korea and Taiwan Province of China are exemplary in their long-run record of maintaining macroeconomic stability, achieving high rates of savings and investment, and ensuring allocation of resources in pursuit of economic efficiency. Yet in both countries the financial system during most of the period of rapid and highly efficient growth was far from being a liberalized system. In both countries the banks for many years were subjected to extensive interest rate controls, and programmes of directed credit were common, especially in support of export industries. In fact, the degree of direction went down to the micro-level, with targeting directed at individual firms. These countries have also undertaken financial sector reforms in recent years, but the pace of reform has been gradual rather than rapid. It has also been undertaken in a framework of macroeconomic stability.

An aspect of financial sector reform which has received less attention than it deserves is the appropriateness of the Anglo-Saxon model of the financial sector, in which banks provide short-term capital while maintaining an arms length distance from firms, and long-term capital is obtained from the capital market. The alternative is the German or Japanese model in which capital markets are less important and banks not only provide long-term capital, but are also closely involved with corporate borrowers through interlocking ownership. Singh (1992) has argued that the Anglo-Saxon model, which has influenced most financial sector reforms, is not necessarily the best model for developing countries to follow.

The reliance on capital markets as a source of long-term funds can be a disadvantage, because stock markets are imperfect instruments of resource allocation even in developed countries. They are overly influ-

enced by short-term factors and speculative movements rather than by longer-term fundamentals, and especially so where trading is dominated and driven by institutional funds under the control of fund managers who are judged increasingly on the basis of short-term performance. The decline of individual investors with longer-term commitments (rational or otherwise) to individual companies, and their replacement by institutional fund managers oriented towards more frequent shifting of the portfolio, can create conditions which are not conducive to allocating resources on the basis of long-term fundamentals. It has also been argued that this adds to volatility in the stock market, which in turn subjects corporate managements to unpredictable threats of takeover. Though such takeover threats have a role as a potential disciplining device, in practice they can also prove to be a distraction, preventing managements from taking a long-term view. These problems are even more serious in developing countries, where stock markets are immature, the number of players is limited, and stock prices can be easily manipulated.

Since structural adjustment typically involves short-term costs and uncertainty, a financial system which emphasizes short-term performance indicators may not be the most suitable for encouraging long-term restructuring. By contrast, financial systems in which long-term capital is provided by banks which have a much greater involvement in individual companies, are more likely to create an environment in which managements can count on sustained support of a long-term corporate strategy. The choice between these models is not easy to make and this is an area where issues are unresolved even in the developed countries. The limitations of capital markets elaborated by critics of the Anglo-Saxon model need to be kept in mind, and corrected as far as possible, on the basis of country specific circumstances. However, the weaknesses of capital markets should not blind us to their strengths. Active capital markets have certainly helped the corporate sector in many developing countries to mobilize substantial resources from the public and more recently also to attract funds from abroad. This calls for extensive reform of the capital markets as part of financial sector reform. These reforms should aim at establishing independent regulations with a view to developing transparent trading practices, appropriate disclosure norms and effective regulation of insider trading, takeover bids, etc.

The lessons to be learned from the experience with financial sector reform can be summarized as follows:

(1) Reform is definitely necessary in the kinds of situation which existed in many countries, where the banking system was burdened with excessive and multiple regulation and a deterioration in banking culture, leading to a large proportion of non-performing assets.

(2) Rapid financial liberalization may not be the best way of moving away from a highly regulated banking system. The pace of reform needs to be carefully calibrated, with financial liberalization being undertaken only after appropriate prudential norms and supervisory systems have been established. This can be a time-consuming process, as new institutions take time to develop strength.

(3) While the complex controls existing in most countries needed to be greatly reduced and simplified, a case can be made for retaining some key interventions in terms of concessional interest rates and some directed credit. The experience of East Asia indicates that such policies are not inconsistent with economic success.

(4) Financial sector reform is easiest to implement if macroeconomic stability is not in doubt and the Government's fiscal position is not too weak. Otherwise the shift to market related interest rates for government borrowing could worsen the fiscal situation.

(5) Privatization alone does not guarantee the achievement of good banking practices. However, the entry of private sector banks could add a welcome element of competition where the banking system is largely in the public sector. Entry of private capital can also help in recapitalizing banks, which is important in the course of financial sector reform.

(6) Since financial sector reform imposes new prudential and capital adequacy norms on the banks, it is essential to implement programmes for capital restructuring and cleaning up the banks' balance sheets as quickly as possible. Failure to do this quickly enough can introduce an unnecessary contractionary element in bank lending, which can hold back economic recovery.

F. Privatization and structural reforms

Privatization is a relatively recent addition to the agenda of policy reform in developing countries, but it has gained remarkable momentum in a very short while. Ignoring the early but ill-considered privatization experiment in Chile in the mid-1970s, it is only in 1984 that Mexico and Chile embarked on programmes of privatization as part of structural reform. This was followed by a bold push in Argentina a little later, and similar action by several other Latin American countries. More recently several countries in Asia, such as India, Malaysia, Pakistan, the Philippines and Thailand, have also embarked on privatization to varying degrees.

Most privatization programmes have been characterized by multiple objectives with the relative emphasis varying from country to country. Mobilizing non-inflationary financial resources was clearly a very important motivation behind the sale of public sector assets in many countries facing severe fiscal pressures, such as those in Latin America after the debt crisis, as well as Bangladesh, India and Pakistan. A second important objective behind privatization is the improvement of operational efficiency in the public sector. In fact, it is only if operational efficiency increases following privatization that there is any real efficiency gain to the economy from the process. A mere sale of public sector assets, with no expectation of improved performance after privatization, is of limited value. The revenue gain to the Government from the sale of assets has the same effect on the rest of the economy as additional government borrowing if the funds used to purchase public sector assets are withdrawn from other assets in the system. This is because the process generates the same "crowding out" problem that arises with additional government borrowing. The only advantage is that it does not burden the budget, thereby adding future debt service obligations.[3]

The view that privatization will improve performance in a way that cannot be achieved through public sector reform is a key element of the new consensus. The problems arising from inefficiency of public sector enterprises have been recognized for quite some time in developing countries, but the earlier perception was that public sector corporations could be made to behave exactly as private sector companies, provided the incentives and management structures were comparable. Reform of the public sector, therefore, focused on management reform, with particular emphasis on managerial autonomy. While there is undoubtedly scope for improving performance through such reforms, there is today much greater awareness of constraints on public sector companies arising from the fact that governments, however well intentioned, cannot insulate them from several pressures to which governments have to respond. The very need to ensure accountability in political fora can limit the managerial flexibility available to public sector organizations, making it difficult for such organizations to act in a purely commercial manner in the interest of the corporation alone. The result is a combination of problems such as a culture of excessive bureaucratic control, politicization of appointments, imposition of multiple non-economic objectives and toleration of pervasive overmanning, all of which lead to low efficiency. As noted earlier, there are many individual examples of good performance, but equally there are far too many poor performers.

Privatization, whether total or partial, is seen as a way of overcoming these problems. It is interesting to note that whereas some countries have opted for full privatization, others such as India, Malaysia and Thailand have pursued a path of partial privatization in the expectation that even partial privatization will help to achieve greater efficiency. Wider ownership with involvement of private sector shareholders is likely to generate greater pressure for efficient and commerically viable operations, even in situations where the government retains majority control. If combined with a credible indication of withdrawal of budgetary support, which is the logical corollary of even partial privatization, it can help to send signals which will push both management and labour in these organizations to higher levels of efficiency.

The results obtained in terms of both revenue mobilization and improvements in efficiency are encouraging. Argentina, Chile and Mexico were all able to mobilize substantial volumes of resources from the sale of assets, which helped to manage the fiscal situation. Other countries have been less bold in the scale of privatization, but even so have mobilized

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3 By the same token, however, it deprives the budget of future income streams from assets sold. Since these income streams are in any case too low, or even negative, the fiscal position can be said to improve compared with a situation where the same resources were obtained through borrowing. But if these low or even negative income streams are simply transferred to other agents in the economy there is no gain for the economy as a whole. It is only when privatization is seen as a means of improving the income stream from public assets that there is a real gain for the economy.

significant volumes of resources. India's programme of divestment of government equity in public sector enterprises, pursued since 1991, although constrained by the requirement that the Government should retain a majority shareholding, is expected to contribute about 0.4 percentage points of GDP in terms of additional revenues in 1994-1995. As far as the impact of privatization on efficiency is concerned, it is perhaps too early to pronounce definitively. However, a number of studies have examined impacts of privatization on labour productivity, total factor productivity and aggregate welfare, including benefits to consumers. The consensus view is that privatization has led to significant improvements on all these counts.

Privatization poses special problems in sectors that are not characterized by competitive markets in the normal sense, such as generation of electric power, telecommunications services, ports and even toll roads. Induction of the private sector into these areas, both by encouraging new utility companies to come in and also by allowing private companies to take over the whole or part of existing utilities, provides an attractive means of inducting new capacity and improving efficiency in these critical areas. However, privatization can only be implemented in these sectors if private investors can be assured that tariffs will be fixed on principles which ensure a fair return to investors. Since these are long-term investments, the assurance must hold not only for initial tariffs, but for future tariff levels through mechanisms for adjusting tariffs automatically in line with rising costs. If the sectors have previously been run as public sector monopolies, there is typically no independent regulatory body which fixes tariffs and adjusts them regularly in a manner which is transparent and fair to both producer and consumer. In such circumstances governments may not get the best value for the assets being privatized. In Argentina the telephone company was privatized before a modern transparent regulatory system had been established. The result was that bids were disappointingly low and the foreign companies which won the bids subsequently reaped capital gains when a modern regulatory framework was put in place. By contrast, the World Bank (1993) reports that in Venezuela, the telephone company was privatized after a modern regulatory system was established, and the privatization was more successful.

A problem that has plagued privatization in all countries is the difficulty in establishing the best modality for sale. Experience varies enormously, ranging from (a) sale of a controlling shareholding in the public sector enterprise to a single company or a consortium either by inviting bids or negotiation; (b) sale to the public at a fixed price; (c) sale by "Dutch auction" subject to a reserve price; (d) sale in the stock exchange; and (e) sale to workers. Each of these methods has associated problems and wherever privatization has occurred, there has been criticism that the method of sale could have been better. In general, sale to the public, resulting in wider dispersion of holdings, may generate less opposition than sale of large controlling blocks to individuals or a few groups.

An issue which is sometimes raised in the context of privatization is whether it would not be better to restructure enterprises and render them first profitable and then sell them, so as to obtain the best price, instead of selling them as they stand and letting the new owners undertake the restructuring. This issue cannot be resolved without taking into account the feasibility and cost of restructuring if it is undertaken within the public sector. To some extent, the poor performance of public sector enterprises, which provides the rationale for sale in the first place, suggests that it would not be easy to restructure the enterprises within the public sector, except at high cost, and this cost must be compared with the expected additional realization at the end of the process. Where, however, the controlling interest and management is expected to remain with government, it is better to undertake whatever improvements are feasible before selling shares to the public, so as to get the best possible price for a public sector managed unit.

The important lessons learned from the privatization experience thus far can be summarized as follows:

(1) Privatization offers a useful opportunity to restructure government budgets temporarily, by taking advantage of the sale of public sector assets to avoid large increases in taxation or public borrowing in the early stages of an adjustment programme. The success achieved by those who have followed a bold strategy of privatization, and the continuing resource constraints being faced by most governments, justify a much bolder approach.

(2) Privatization as a mere sale of assets may help the budget, but it does not represent any real gain to the economy as a whole. A real gain to the economy arises only if privatization is accompanied by an improvement in economic performance at the enterprise level. There are good reasons to believe that such improvements will take place even in cases of partial privatization. In the case of partial privatization, it is important that a clear signal should be

given of the removal of budgetary support in the future.

(3) Privatization of utilities, covering both induction of new investment and sale of existing utilities to the private sector, provides a valuable means of bring in new resources and encouraging efficiency in areas where rapid expansion is needed. However well realized an outright sale of a controlling block of shares to a single party may be, this should be accompanied wherever possible by sale to the public and the workers. Wider diffusion of ownership will allay some of the suspicion which sometimes attaches to public sector sales.

(4) Where utilities are concerned, it is essential to establish a modern regulatory mechanism under which they will function before undertaking privatization.

G. *Conclusion*

The review of structural reform experience presented in this paper indicates that the range of reforms currently underway in developing countries is impressive and is underpinned by a very substantial convergence of thinking on policy issues. It also indicates that there are problem areas in the design of structural reform programmes, especially regarding the pace and sequencing of different elements. However, this should not cloud the fact that the area of agreement is very substantial. In any case consensus on broad policy direction does not imply an identity of programme design. Countries vary in initial conditions, including not only institutional and structural characteristics, but also in the extent of imbalance from which they may suffer, and these differences can be expected to produce differences in the design of reform programmes. Some of the differences observed across countries are due to these considerations, rather than any basic differences on policy.

An important theme running through the review is the need for macroeconomic stability as an essential requirement for the resumption of growth, and also for the success of other reforms in trade policy and in the financial sector. Both types of reforms need a stable macroeconomic environment for the efficiency gains of the reforms to be realized. The reforms also impose additional strains on the fiscal situation, which need to be managed. Tariff reductions and exchange rate depreciation in the case of trade policy reforms, and interest rate liberalization in the case of financial sector reforms, can have negative feedback effects on the fiscal situation. Even if this happens, as long as the overall macroeconomic situation is relatively stable, and the extent of the distortions in the trade and financial sectors are modest, then the negative feedback can be managed relatively easily. But if it occurs when the macroeconomic situation is itself unstable, then the negative feedback may make the situation unmanageable. This implies that the pace at which trade policy reforms and financial sector reforms can be implemented, depends critically upon the pre-existing macroeconomic situation and the extent to which credible fiscal correctives can be put in place.

A cautionary note emerging from the review is that the time required for reforms to achieve the transition to high and sustainable growth rates should not be under-estimated. This is primarily because high growth rates require high levels of investment, and there is a lag between the implementation of structural reforms and the generation of an adequate investment response to the new signals. Many countries have experienced a slow-down in investment in the early stages of an adjustment programme, because fiscal problems constrain the levels of public investment, and private investment takes time to reorient to new signals. The slow-down in investment can in turn lead to low levels of output. These short-term output losses may be avoided where the initial adjustment required is not too large, and a strong export growth can be engineered to take up slack demand. Similarly, where foreign investment can be stimulated in a short time, an early revival of domestic investment as a whole may be more likely. These considerations underscore the importance of export policies, as also measures to attract foreign investment, in the early stages of adjustment. In the longer run, revival in investment and business confidence is crucial and this should be the central focus in designing reform programmes.

There are some important issues that have not been addressed in this paper, but which deserve explicit recognition. An obvious omission is the lack of attention to the problems of deregulation of individual sectors. Very often developing countries suffer from excessive regulation of individual sectors which are of special importance for economic performance, such as primary export sectors in some countries, and infrastructure sectors such as telecommunications, roads, ports and power generation in most countries. It is important to implement sector specific deregulation of such sectors, to maximize efficiency gains and attract private investment, in order to ensure rapid expansion in the future. These sectoral issues are not examined in this paper, since it

is difficult to generalize for all countries as the situation varies among them. Another important issue that has not been addressed in this paper is the need to create social safety nets in the course of structural reforms. Distributional changes are extremely difficult to absorb in any society, and where these changes affect the poor they naturally lead to a legitimate demand for compensation of one form or another. Governments may respond by intensifying certain types of development programmes which support income levels of particular groups, or by providing targeted subsidies specifically aimed at those adversely affected by reforms. A major challenge in this context is how to design safety nets which do not impose an unsustainable burden on the budget at a time when the fiscal situation is also under strain. It is essential to design safety nets which are effectively targeted, so that benefits are limited to lower income groups actually affected by the reforms, and not to a much larger category.

In the final analysis, the assessment of structural reforms in developing countries must depend upon the actual experience of countries undertaking reforms. Successful performance will strengthen conviction about reforms, just as failures will lead to the reexamination of future cases. However, these assessments are not a simple matter, as is evident from different lessons drawn by different authors from the unambiguously successful performance of East Asian economies. The lessons of East Asia obviously differ, depending on who is teaching them. It is important to subject the performance of different countries to close investigation, in order to draw the right lesson from each experience. The research sponsored by the Bank and the Fund has made a major contribution to our understanding of reforms in developing countries, but as participants in the process their research is sometimes viewed as conditioned by their policy stances. It needs to be supplemented by independent research on the same subject and a continuous evaluation of actual experience.

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9

TRANSITION AND INTERNATIONAL FINANCIAL INSTITUTIONS

Dragoslav Avramovic

A. *Introduction*

This paper assesses the course of economic events in Eastern Europe, including the former Soviet Union, since the upheaval of 1989. It reviews the reasons for their economic crisis and their social effects, and discusses the views on "transition economics" held by some influential economists and international institutions. It singles out the key problems facing these countries - unemployment, inflation and systemic uncertainty - and suggests that on present trends and policies most of these countries do not have a chance of satisfying the demands of their population for decent living standards, social security, economic stability and full employment in the near future.

B. *Disasters in production, investment, real wages and population trends*

Set out in table 1 are the rates of economic decline which have affected the region since the counter-revolution of 1989 set in. The enormous spread and depth of the decline in Eastern Europe and the former Soviet Union during 1990-1993 are probably only comparable with the catastrophe which engulfed the capitalist economies in the Great Depression of the 1930s.

Investment in Eastern Europe as a whole fell at an average rate of 13-14 per cent per year in each of the three years 1990-1992 for which data are available (table 2). In the former Soviet Union as a whole, investment seems to have held up well in 1990, but then fell by 12 per cent in 1991, to be followed by a catastrophic decline of 42 per cent in 1992 and an additional 7 per cent decline in the first half of 1993. With some exceptions, it appears that investment activity in the region has been reduced to that of a wasteland.

The fall in real incomes has followed that of output. Furthermore, as one of the core policies has been to dismantle the vast social expenditure systems characteristic of the former socialist States and to liberalize prices of essential goods without raising the money incomes of the lowest social strata proportionately, the incidence of the fall in real incomes has fallen on real wages and particularly on the pensioners' pay, as well as on incomes of welfare recipients and unemployed persons living on social insurance. In contrast, a new class of instant millionaires has been born, some on the basis of ability and speed in combining factors of production in new circumstances, and some, perhaps many, due to hoarding of goods under inflation, loopholes in newly enacted legislation on privatization, and connections with the governments now in power and powerful supporters abroad. Social tensions have increased greatly in the former socialist States as the discrepancy in living standards between the newly rich and the growing poor has widened, and as the newly rich have enjoyed the display of wealth and power.

A researcher at the American Enterprise Institute in Washington, D.C. has drawn attention recently to the "strange and alarming population trends that have gripped the former Soviet Union since the fall of communism in 1989 - many fewer babies being born, many more people dying - [moreover] this demographic calamity covers a much broader region ... From Leipzig to Vladivostok, birth and marriage rates are plummeting and death rates are soaring ... There is nothing intrinsically worrisome about declining population growth, or even declining population; West Germany,

Table 1

GROWTH IN GDP IN EASTERN EUROPE AND THE FORMER SOVIET UNION

(Per cent per annum)

	1990	*1991*	*1992*	*1993 estimate*	*1994 forecast*
Albania	-10.0	-29.9	-11.0	n.a.	n.a.
Bulgaria	-9.1	-11.8	-7.7	-5.7	-2.0
Czech Republic	-1.2	-14.2	-7.1	-0.5	2.0
Slovak Republic	-2.5	-15.8	-6.0	-6.7	-2.0
Hungary	-3.3	-10.2	-5.0	-2.0	0.0
Poland	-11.6	-7.7	1.0	4.0	4.0
Romania	-7.3	-13.7	-15.4	-2.8	-2.0
Croatia	-8.5	n.a.	n.a.	-9.0	-0.5
Slovenia	-4.7	-9.3	-6.8	-1.0	1.0
FYR of Macedonia	-9.5	-13.0	-15.0	-15.0	n.a.
Armenia	-8.2	-11.4	-46.0	-41.2 [a]	n.a.
Azerbaijan	-11.3	-0.4	-28.1	n.a.	n.a.
Belarus	-3.2	-1.9	-10.6	-14.0 [a]	n.a.
Kazakhstan	-0.9	-10.3	-14.2	-13.8 [a]	n.a.
Kyrgyzstan	4.8	-5.2	-19.0	-21.9 [a]	n.a.
Moldova	-1.5	-18.0	-21.3	-20.2 [a]	n.a.
Russia	-4.0	-14.3	-22.0	-15.0	n.a.
Tajikstan	0.2	-8.4	-31.0	n.a.	n.a.
Turkmenistan	1.8	-4.7	n.a.	n.a.	n.a.
Ukraine	-3.6	-11.2	-16.0	-12.0	n.a.
Uzbekistan	4.3	-2.4	-12.9	-3.6 [a]	n.a.
Georgia	-4.3	n.a.	n.a.	n.a.	n.a.
Estonia	-8.1	-10.0	-30.0	n.a.	n.a.
Latvia	2.7	-8.3	-44.3	-17.0	n.a.
Lithuania	-6.9	-13.1	-35.9	-17.0	n.a.

Source: Plan Econ Europe Ltd. (1993); ECE (1994); World Bank (1994).
a January-June.

after all, did rather well in the 1970s and 1980s. But sudden, precipitous changes in the birth and death rates are compelling indicators of societies in extreme distress - societies unable to cope with health problems that were once routine.

"From 1989 to the first half of 1993, according to official data, the birth rate fell more than 20 per cent in Poland, around 25 per cent in Bulgaria, 30 per cent in Estonia and Romania, 35 per cent in Russia and more than 60 per cent in Eastern Germany - which, if present rates continue, can expect an average of less than one birth per woman *per lifetime.* In the past, such abrupt shocks were observed in industrial societies only in wartime. Perhaps even more alarming is the pervasive surge in mortality in the former Soviet bloc ... From 1989 to 1991, the death rate rose nearly 20 per cent for Eastern German women in their late 30s, and nearly 30 per cent for men of the same age. Infant mortality is reported rising not only in Russia but also in Bulgaria, Latvia, Moldova, Romania and Ukraine. In 1992 and 1993, Eastern Germany buried two people for every baby born" (Eberstadt, 1994).

C. Reasons for the economic crisis and its effects

1. Simultaneous shocks

The fundamental reason for the collapse of the Eastern European and Soviet economies

Table 2

GROSS FIXED INVESTMENT IN EASTERN EUROPE AND THE FORMER USSR

(Percentage change over same period of preceding year)

	1990	1991	1992	1993 estimate
Albania	-14.8	n.a.	n.a.	n.a.
Bulgaria	-18.5	-19.9	-7.2	n.a.
Czech Republic	6.5	-17.7	3.8	1.5 [a]
Slovak Republic	3.3	-20.0	-6.0	n.a.
Hungary	-7.1	-11.6	-8.0	-30.5 [a]
Poland	-10.1	-4.1	-11.2	-8.5 [b]
Romania	-38.3	-28.8	-18.9	n.a.
Slovenia	-9.8	-14.8	-20.0	-4.0 [a]
Armenia	-4.6	-35.2	n.a.	n.a.
Azerbaijan	-3.6	-14.3	n.a.	n.a.
Belarus	n.a.	4.0	-15.0	n.a.
Kazakhstan	-2.9	0.5	-43.0	n.a.
Kyrgyzstan	11.3	-12.8	-35.0	n.a.
Moldova	-0.5	-0.9	-38.0	-41.0
Russia	0.1	-15.5	-45.0	-12.0 [c]
Tajikstan	0.7	-14.6	-6.9	n.a.
Turkmenistan	7.5	11.2	2.0	n.a.
Ukraine	1.9	-7.8	-36.9	-14.0 [c]
Uzbekistan	13.0	4.6	-35.0	n.a.
Georgia	-14.4	n.a.	n.a.	n.a.
Estonia	2.7	-12.0	-11.1	n.a.
Latvia	-8.2	-36.3	-53.0	-45.0
Lithuania	-10.3	-46.0	-34.3	-32.4

Source: ECE (1994).
a January-June.
b January-June; forecast for the whole of 1993 is -10.0.
c January-September.

in 1990-1994 was that they were exposed to enormous pressures resulting from a number of simultaneous shocks:

(a) The majority of countries, having suffered from inflation and balance-of-payments disequilibria in the 1980s, applied sharp stabilization and adjustment programmes in the early 1990s, aimed at ending inflation in as short a period as possible, balancing budgets and closing balance-of-payments gaps, while at the same time liberalizing prices in order to correct major distortions. This adjustment-*cum*-stabilization, involving deflationary policies, led to output declines in most cases and represented a major shock to the economies concerned (Laski, 1994).

(b) The sudden dismantling of the central planning machinery was another shock. Its functions included allocation of materials for current production and allocation of funds and materials for investment. It proved impossible, in the majority of countries, to provide and organize overnight commodity and financial markets of sufficient depth and flexibility as substitutes for the planning machinery.

(c) Drastic import liberalization was the third shock. The unleashing of imports on an economy in deflation further tended to curtail domestic competing production, particularly if imports were bought at dumping prices. This has been frequent in recent years, both in agricultural products sold with a subsidy, particularly by rich

countries, and in consumer goods sold at marginal cost by many producers.[1]

(d) Privatization has been the fourth shock. It has not advanced much in so far as denationalization of large publicly-owned plants is concerned (see below). But it has involved much uncertainty as to the future ownership structure and therefore arrested the investment process and even slowed up current production, while cases of plunder of valuable pieces of the capital stock and inventory holdings have been frequent.

(e) Large mutual trade among the Eastern European countries, organized through the CMEA system, broke down as the socialist structure was dismantled and as the Soviet political influence on the Eastern European countries diminished. The dependence of individual countries on intra-bloc trade was very large, and the loss of markets and sources of supply for some vital imports affected some countries badly. Attempts to revive intra-bloc trade have not been successful so far, and attempts to develop a large East-West trade have had only limited results.

Not all countries experienced all five shocks, and those which were spared some shocks fared better in sustaining output and real incomes. Czechoslovakia had not suffered from inflation and was largely free of external debt. Hungary had decentralized its economy and introduced significant market elements in production and investment before 1989, and therefore the shocks of the sudden demise of planning and drastic import liberalization did not appear. The economies and societies of the Czech Republic and Hungary appear to have adjusted better to the new regime (i.e. to the *ancien regime* of the pre-1948 vintage) than the broad expanse of Eastern Europe and the former Soviet Union.

2. *Main protagonists of simultaneous shocks*

Janos Kornai of Hungary and later Harvard, and Jeffrey Sachs of Harvard, were in the forefront of the school advocating a simultaneous administration of stabilization, privatization, dismantling of planning and import liberalization ("opening of the economy"). Kornai, somewhat disappointed by what he considered to have been too slow movements of the Hungarian reforms in the direction of a capitalist market economy, thought that the only way of curing the weaknesses of "administrative socialism" (identified with the management of the Soviet economy between 1930 and 1990) was to abolish all elements of socialism and jump straight into the market system in all its aspects and with all speed. Otherwise vestiges of the old system would stifle the needed marketization of the economy (Kornai, 1990).[2]

Sachs' views, expressed in numerous articles on the Polish and Soviet "transitions" and economic reform programmes (he was a top-level adviser to influential people in these as well as in some other countries), were summarized by himself: the need for a simultaneous advance on all fronts of stabilization, privatization and liberalization of the economy was similar to a jump across an abyss in one go: half a jump would inevitably end in a disaster mid-way. How Sachs came to this simplification is not clear. In a recently published volume on transition, he expresses considerable understanding of the Yugoslav model of market socialism of the 1970s and 1980s, which was one of a mixed economy and certainly not of a straight road to capitalism at a maximum speed which Sachs advises the "transition" governments to undertake:

> Yugoslavia, it is well known, chose a distinctive path of socialist development after Tito's break with Stalin in 1948. Industry was socialized, as in the rest of Eastern Europe and the Soviet Union, but was not subjected to central planning after 1965. Market forces were given more scope, and enterprises were left with significantly more autonomy than in the Stalinist states ... Yugoslavia also maintained a trade pattern that was distinctive among the socialist economies, in that the direction of trade remained heavily toward Western Europe rather than toward other socialist states ... More important than the ownership and control structure itself was the fact that Yugoslav industrial enterprises were more market oriented than their counterparts in Eastern Europe. These enterprises ... had considerable flexibility as to choice of inputs and outputs, and had some flexibility related to prices. In general, there was not a chronic

[1] The danger of a "double shock" (stabilization and import liberalization at the same time) was stressed by Marcelo Selowsky from the World Bank in his discussions with some of his colleagues several years ago. Selowsky was then Economic Adviser of the Bank's Regional Office for Latin America and the Caribbean. He is now Economic Adviser of the Bank's Regional Office for Europe and Asia, which handles Bank activities in Eastern Europe and the former Soviet Union.

[2] The title of Kornai's book, *The Road to a Free Economy*, is suggestive: it reminds one of Hayek's book *The Road to Serfdom*, a virulent attack on socialism of any kind.

shortage economy in the industrial sector or in the consumer markets, so that inputs were available on a fairly reliable basis (Pleskovic and Sachs, 1994, pp. 192-193).

3. *Attitude of international financial institutions*

A special research project would be needed to document the attitude of international financial institutions towards "transition economies" expressed in their numerous studies, speeches, pronouncements, communiqués and, most important, actions. These attitudes have been shifting at the margin as management needed to accommodate the evolving views of the governments of the institutions' main member countries, while at the same time attempting to assure a certain minimum of professional requirements for thoroughness, objectivity and respect for facts. But cutting through all the complexities of actual situations, it is fair to say that the leading institutions were in the front line of a simultaneous shock approach aimed at a rapid transformation of Eastern European socialist states into capitalist economies.

The IMF was allotted a rôle by the leading western powers as the main supervisor or even an architect and builder of new structures in the former socialist States. "The reform plans which were part of the IMF programs, recognized that a simultaneous assault on macroeconomic stabilization, prices and property rights was necessary from the inception stage of these programs" (Bruno, 1994, pp. 20-21). Concerning the World Bank, a former high official in charge of its activities in Eastern Europe is reported to have stated that "the pace of certain reforms was over-ambitious ... Reformers have tended to be overly purist in advocating total free-market liberal capitalism ... Long development experience makes him uneasy with the glibness of the youthful reformers: we should confess to doubts and ignorance ... nobody understands these transitions" (Lari, 1992).

A new mood may be creeping through the IMF doors as reflected in its recent lending to Russia agreed with the Government of Viktor Chernomyrdin , who, while "reformer", has displayed a great deal of independence in the assessment of the Russian economic situation and possible gradualistic remedies. Concerning the World Bank, there is a critical article by Michael Bruno, its new Chief Economic Adviser, who questions some of the tenets of simultaneous shock strategy, such as rapid import liberalization, and raises the question as to the ability of "reform" governments to cope with the need to maintain social consensus over the period of reform programmes and their political sustainability even in the near future (Bruno, 1994, pp. 37 and 47). Kemal Dervis, Head of the Bank's Central European Department, and Timothy Condon, from the same Department, discuss the case of Hungary in a recent article as perhaps an "emerging gradualist" success story in Eastern Europe (Dervis and Condon, 1994, pp. 123-154). But judging by experience, one should be cautious in projecting policy changes in country relations of these formidable and controversial institutions. In one case, they are today in flagrant violation of the basic tenet of their original charters: not to be influenced in their actions by political considerations.

4. *Shifts in attitudes of Eastern European countries*

Among the Eastern European governments, it was the former Deputy Prime Minister and Finance Minister of Poland, Leszek Balcerowicz, who was perhaps the most consistent and non-compromising adherent of the "big bang" simultaneous shocks approach (Balcerowicz, 1993). Balcerowicz fell from power when the social and political burden of this approach turned out to be unbearable for the voting public. Vaclav Claus, the present Prime Minister of the Czech Republic, has similarly expressed uncompromising views in favour of a big-bang approach; but in practice, it seems, he has followed a considerably softer line.

There is no doubt that the attitudes of socialists and even governments in Eastern Europe and the former Soviet Union have now shifted in favour of a non-big-bang approach. In Russia, the key country in terms of size, influence and world-wide importance, it is clear that economic reform has become a much more pragmatic rather than ideological exercise, following the elections in the autumn of 1993 in which the voters' dissatisfaction with the current state of affairs had become abundantly clear. In Hungary, "the shock therapy is rejected in order to enter better into the market economy", according to the head of the National Privatization Agency (Pongracz, 1993).

From an international survey of public attitudes in late 1993, the following has emerged:

(a) in Albania 72 per cent of those surveyed were satisfied with developments since the

fall of socialism, whereas in the Czech Republic 51 per cent were satisfied;

(b) in Estonia, Latvia and Slovenia half of the sample was satisfied, while the other half was dissatisfied;

(c) in Romania, Poland and the Slovak Republic 59 per cent of those surveyed were dissatisfied. This figure reached 68 per cent in Bulgaria, Lithuania and Hungary (Tanjug, 1994).

Thus, against two "satisfied countries", accounting for only a small part of the total population in the sample, there are six, most of them large, "not satisfied". If Russia had been included, it is likely that the "not satisfied" would win. This is suggested by much anecdotal evidence.

D. Three key issues: inflation, unemployment and transition to what?

1. Inflation

In 1993, consumer prices rose by more than 100 per cent over the preceding year in 15 countries, out of 23 countries for which data are available. In 12 of the 15 countries, the price increase amounted to more than 300 per cent over the preceding year. Almost all these countries are former members of the Soviet Union (ECE, 1994, p. 51). For them, stabilization of the monetary system remains the primary objective, as without it production can hardly recover. The 12 countries are: Armenia, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikstan, Turkmenistan, Ukraine, Uzbekistan, Lithuania and the Former Yugoslav Republic of Macedonia.

2. Unemployment

The spectre of unemployment, which haunts Western Europe, has now descended on Eastern Europe, and with a vengeance. Unemployment rates have risen sharply, and there is no end in sight (table 3).

No comparable data are available for the former Soviet Union. A recent report suggested that in Russia, if the Government sticks to the recently concluded agreement with the IMF, cutting back further on subsidies to factories and farms, it risks an explosion of unemployment which could soar to nearly 15 million (*Washington Post*, 1994), or 18 per cent of the labour force. This is an unheard of figure for the Soviet Union since the October 1917 Revolution, and unlikely to be affordable for any regime which might be in power.

At a 1992 conference on Eastern Europe, held at the World Bank, it was stated by the organizers that "the prospect for a rapid upturn of production does not seem favourable across the region" (World Bank, 1993, p. 4). Hence the prospect for improved employment is also gloomy, on present trends and policies. John S. Flemming, Economic Adviser of the European Bank for Reconstruction and Development, suggests that only 10 per cent annual growth could help Eastern European countries achieve their welfare objectives (EBRD, 1993, p. 5). The median growth rate expected for 1994 is still minus 1 per cent.

3. Transition to what?

The simplest, but in a sense the most difficult, question to consider is what form the transition economies will have taken when the transition period is over. This has never been spelled out clearly, to my knowledge. Dervis and Condon (1994, p. 148), have suggested that the objective for the Central European countries, and specifically Hungary, would be to have an economic system close in essence to that of neighbouring Austria, Italy or France. More generally, it would seem that the objective of the West is a conversion of Eastern European countries into capitalist States. But which variety? Swedish, Japanese, American or Hong Kong's?

How far have the Eastern European countries moved along this road? How much of their capital stock or of their output is now held or produced by the private capitalist sector, as opposed to the public and cooperative sectors? The unanimous view of most observers is not much. The United Nations Economic Commission for Europe says that "the restructuring of industry in the transition economies is still at a very early stage, as is suggested by the relative importance of private ownership in the various sectors. In the middle of 1993, the share of the private sector in East European GDP ranged from 16 per cent in Bulgaria to 50 per cent in Poland; in Russia, it was roughly 15 per cent" (ECE, 1994, p. 10). Two experts from American universities, writing in an IMF-World Bank periodical, concluded last year that "three years after the systemic changes sweeping the political and economic landscape of Eastern Europe, privatization is still widely talked about and seemingly pursued. Yet, despite ardent support for the concept, not

Table 3

UNEMPLOYMENT RATES IN EASTERN EUROPE

(Unemployed as per cent of labour force)

	December 1991	*December 1992*	*December 1993*	*December 1994 forecast*
Bulgaria	11.5	15.6	17.0	18.0
Czech Republic	4.4	2.6	4.0	7.0
Slovak Republic	12.7	10.4	15.0	18.0
Hungary	7.4	12.3	12.0	12.0
Poland	11.8	13.6	15.5	18.0
Romania	3.1	8.2	9.5	12.0
Croatia	14.1	17.8	18.0	20.0
Slovenia	10.1	13.3	15.0	18.0
FYR of Macedonia	24.5	26.8	28.6 [a]	n.a.
Former Eastern Germany	11.8	13.9	15.9 [b]	n.a.

Source: ECE (1994); World Bank (1994).
a July 1993.
b September 1993.

much privatization is actually taking place, and what does occur is often much more ambiguous than originally expected ... For reasons that are by now too well known to recount in detail, the attempts to emulate western privatizations were, by and large, a failure" (Frydman and Rapaczynski, 1993).

The AMEX Bank Review judges that "privatization is probably the area [of reform] which has seen the least progress. There are numerous reasons for this slowness, not least the concern over the social implications of restructuring large state companies. However, the lack of progress in selling off the state sector has not stopped the private sector from growing. The small private enterprises that are springing up are likely to lead the recovery, building a cushion for the expected disruption and rising unemployment once state enterprises are restructured" (AMEX, 1993, p. 2). And a Hungarian scholar concludes: "However strong the expectations attached to a fast privatization are, it is a time-consuming process. What is more, it has by now become clear that it is a concomitant of privatization and the transformation of the pattern of the economy that unemployment becomes widespread and a marked polarization in income and wealth takes place. The polarization in incomes and wealth has in turn inevitably generated social tensions as production has declined and the living standards have either stagnated or somewhat decreased" (Tardos, 1993, p. 3).

E. Implications for international financial institutions

The policies on transition in Eastern Europe and the former Soviet Union pursued by international financial agencies need to be changed, radically and quickly. First, it should not be their objective to remake these countries in this or that image: the enormous economic disasters of the last five years have shown that such attempts carry enormous risks of failure. What economic, social and political systems will emerge in Eastern Europe and the former Soviet Union after the present era of upheaval had better be left to their peoples to decide. Also, international financial institutions should keep away from prescribing trade policies: no monopoly on wisdom in this field exists, as both enviable successes and great failures have been reaped from identical policies in different countries, whether free trade or support and protection. Trade issues should be left to the countries and to international trade organizations to sort out. Finally, international financial institutions should stick to the area of finance which they know best and where their assistance is needed and demanded, for the benefit of both borrowers and ultimate lenders.

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V. RELATIONS BETWEEN THE IMF, THE WORLD BANK AND THE DEVELOPING COUNTRIES

10

THE ROLES OF INTERNATIONAL FINANCIAL INSTITUTIONS: A LATIN AMERICAN REASSESSMENT

*Patricio Meller**

A. *A short review of the conditionality practised by international financial institutions*

There have been deep political and economic changes over the past 50 years. Should organizations like the international financial institutions (IFIs) created in 1944 be restructured? Are the objectives specified for the IMF and the World Bank during the 1940s still valid in the 1990s? There have been changes through time in the roles and objectives of the IFIs; moreover, we now live in a different world where "new" ways of thought prevail. Do the IFI changes correspond to world changes?

External trade liberalization of many developing countries, especially most Latin American economies, and the increase in world economic integration and interdependence, have reduced the degree of autonomy of national governments in implementing domestic policies; some IFI policies with respect to conditionality tend to be redundant. The considerable enlargement of private capital markets and the increase of global financial intermediation have reduced the need to borrow from IFIs. This is clearly the case of the developed countries, which have not requested IMF finance since 1977. The IFIs have thus become a type of club with two different categories of members, borrowers and non-borrowers (Kafka, 1991); the non-borrower members establish the conditionality rules that should be complied with by the borrowers.[1] The IMF seal of approval role on a developing country's macroeconomic situation and its evolution is being replaced by private investing firms providing risk country gradings and rankings; a similar role is beginning to be played by specific regional trade agreements like NAFTA. The end of the East-West ideological confrontation is affecting capital movements in Latin America; capital flight has diminished and, moreover, there is a significant trend towards capital repatriation.

At Bretton Woods (1944) it was stipulated that the key concern of the IMF would be the short-run adjustment problem faced by a country experiencing an external imbalance; i.e. the IMF provides credit to facilitate the elimination of the balance-of-payments disequilibrium of a given country. The World Bank should be concerned with growth and development; hence, it provides loans for specific investment projects and/or development programmes. In other words, the IMF's main orientation is *macro* and its concerns are the balance of payments and inflation; therefore its tools will be fiscal and monetary policies and the exchange rate. On the other hand, the World Bank focus should be mainly *micro*, and its objective is to stimulate savings and investment in order to promote growth; its tools are relative prices and trade policies.[2] A

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1 A softer way of stating the borrower and non-borrower relationship is that borrowers would like easier access to IMF credit while non-borrowers prefer making access more limited (Kafka, 1991). A stronger way would state that the developed countries will regard the IMF as the institution "suggesting" to deficit developing countries the policies considered to be the most appropriate for them and for the functioning of the international monetary system (Akyüz and Dell, 1987).

2 IMF methodology is oriented towards the control of aggregate demand; a financial flow analysis applying nominal

strange division of roles of the IFIs with respect to the exchange rate could be observed; while the IMF is concerned with the nominal value of the exchange rate, the World Bank is concerned with its real value.

The IFIs provide loans, not grants; therefore, it seems logical that they would have as an elementary condition the clause of credit repayment by the borrowers. However, IFI conditionality went further; IFI loans should be used for the specific purpose for which they had been requested. Later on, IFI credit became conditional on the adoption of an adjustment programme (stabilization in the case of the IMF and structural adjustment in the case of the World Bank). During the 1980s, the rationale of IFI conditionality went further, stating implicitly that "domestic adjustment and development policies in the recipient countries" were at fault and their governments require external advice and/or pressure to "set their own house in order" (Helleiner, 1988, p. 1). One of the outcomes has been that "the historic distinction between conditional and unconditional (or low conditional) Fund credit ... has for all practical purposes ceased to exist" (Polak, 1991, p. 15).

The IMF has played different roles. First, it is an institution created to provide short-run financial resources to countries experiencing an external liquidity problem. In this respect it is a "credit club" applying specific rules to protect the welfare of all its members; these rules include currency convertibility, free access to the foreign exchange market, and avoiding import restriction measures. Second, and especially for developing countries, an IMF programme has been considered as a prerequisite and/or seal of approval required by official and private international sources for providing credits to a country having balance-of-payments difficulties. In this way, the Fund has become the "lender of last resort" for developing countries; in this situation, the bargaining power of their governments is quite low.

After the Latin American external debt problem (1982), the IMF played a crucial role in helping to avert a world financial crisis. For this purpose, the Fund organized and coordinated complex packages of financial resources from very diverse sources, which helped to confront the insufficiencies of external liquidity of many Latin American countries during 1982-1985. In assuming this role of intermediary, the IMF imposed conditions on both debtors and creditors. Debtors have had to adopt adjustment programmes that include the total payment of debt servicing. Similarly, creditor banks (which, obviously, were not members of the Fund) have had to supply, "not very voluntarily", additional loans in order to bolster the packages put together by the Fund, in which its contributions were merely one of the components. As Bacha notes (1987), when the IMF assumed the role of intermediary in the Latin American debt problem, it was dealing with a long-term stock problem. In fact, the Latin American foreign debt and its prompt servicing was not due to a temporary lack of liquidity, but to a critical problem of stock imbalance. In this respect, the Fund has been criticized for acting as if the debt crisis could have been solved without major reliefs and/or write-offs; in this way, the Fund may have postponed drastic and needed actions. Related to this fact, Edwards (1989, p. 8) points out that some conservative critics have accused the Fund of becoming a "development-aid granting agency".

In the case of the World Bank the changes have been more related to changes in its growth and development vision. In the 1950s and 1960s development was mainly related to growth; for this purpose, World Bank credits were oriented towards large public investment infrastructure projects which would stimulate private investment projects by increasing their rate of return; it was also believed that "trickle-down" would solve poverty problems. In the 1970s, it was found out that the benefits of greater growth were not reaching the poor; hence, the World Bank introduced the "growth with redistribution" approach. The alleviation and/or elimination of poverty became the conceptual focus of the Bank, and actually became a moral goal. This new approach took the form of credits for investment projects that directly benefited specific poor groups.

During the 1980s, there was a major change in the World Bank's vision. Since the level of investment depends, among other factors, on the global economic context, the conclusion was drawn that in many countries the prevailing policies and institutions introduced an enormous amount of distortions. Consequently, it was very difficult for the Bank to find viable investment projects to which it could grant financing. Within this framework, it has created new lines of credit (for example, SAL, Structural Adjustment Loan) aimed at supporting countries that must undertake structural adjustment in order to resolve external imbalances, rather than financing specific

variables is used. The World Bank is oriented towards affecting aggregate supply; project evaluation and consistency models applying real variables are used.

Table 1

ANNUAL INFLATION IN LATIN AMERICA IN THE 1980s AND 1990s [a]

(Percentages)

	1980-1981	*1982-1989*	*1990-1993*	*1993*
Argentina	108.3	504.8	140.8	7.7
Bolivia	24.5	323.9	13.0	9.2
Brazil	93.3	359.9	1,197.9	2,244.0
Chile	19.9	22.2	17.6	12.2
Colombia	26.6	26.2	26.3	21.2
Costa Rica	39.5	29.7	19.5	9.2
Ecuador	16.2	42.3	47.4	32.2
El Salvador	15.0	21.7	15.6	13.5
Guatemala	8.9	14.8	22.7	12.8
Honduras	10.3	7.0	19.4	13.4
Mexico	29.2	81.3	17.1	8.7
Nicaragua	24.0	866.6	531.1	28.3
Panama	9.5	1.6	1.7	1.6
Paraguay	11.9	23.4	22.0	19.5
Peru	66.6	301.3	350.1	41.3
Uruguay	35.9	67.4	78.1	52.3
Venezuela	15.2	25.6	35.8	44.1

Source: ECLAC.
a Average values of annual (December-December) figures.

projects. The content of such programmes constitutes the basis of the new World Bank conditionality. Its purpose is to boost the general efficiency of the economy by establishing suitable incentives, a goal which assumes changes in trade and price policies, the size and structure of the State and the role that the government plays in the economy. In short, the World Bank became the main promoter of the free market, external liberalization, deregulation, and the privatization development model.

This new development vision of the World Bank has shown marked hostility toward government interventions in developing countries, since they were indiscriminately considered to be obstacles to growth (Feinberg *et al.*, 1986). Moreover, public bureaucrats were always viewed as inept and corrupt, and private businessmen as efficient and honest; hence, privatization, no government interference, and leaving the private sector of developing countries alone would generate an increase in efficiency and welfare. In the 1990s, a reappraisal of the "East Asian miracle" has challenged this World Bank view; in spite of the stabilization and restructuring efforts of some developing countries, private investment has been limited. Therefore, it has been argued that active public policies and selective government interventions that complement the private-public sector relationship can help to promote development. Therefore, it has been suggested that the World Bank should help developing countries to enhance their institutional and technological capabilities so as to be able to intervene more effectively in guiding and "governing" the market (Wade, 1990).

After the external debt shock and the drastic cut of foreign financial flows, most Latin American countries have had to adjust; there were no alternatives. The severity of the adjustment and its long duration led to the replacement of the prevailing import-substitution development strategy; more of the same was not useful, new ideas were welcome. Moreover, the IFIs were making the availability of the needed new credits conditional on the implementation of policy reforms. At the beginning of the 1990s it could be observed that Latin American countries had already implemented profound economic policy reforms during the 1980s, which provided a greater role for the market mechanism and the private sector; moreover, the old import-substitution strategy (i.e. "inward looking development") had been replaced by an export-oriented strategy (i.e. "outward looking development"). There are differences among countries with respect to the degree and procedures concerning the imple-

Table 2

PUBLIC SECTOR DEFICIT IN LATIN AMERICA IN THE 1980s AND 1990s

(Percentage of GDP)

	1980-1981	*1982-1989*	*1990-1993*	*1993*
Argentina	5.0	4.6	1.8 [a]	0.1 [b]
Bolivia	n.a.	11.7	5.9	6.0
Brazil	-1.0	4.5	-0.3 [a]	2.3 [b]
Chile	-4.2	0.8	-2.0	-2.9
Colombia	-1.5	0.7	0.4	0.6
Costa Rica	n.a.	2.9 [c]	2.8	1.5
Ecuador	n.a.	5.4 [c]	0.7	0.2
El Salvador	n.a.	4.0 [c]	3.9	3.2
Guatemala	n.a.	2.9 [c]	1.0	1.0
Honduras	n.a.	6.9 [c]	5.8	6.9
Mexico	4.9	10.2	-1.6 [a]	-4.5 [b]
Nicaragua	8.8	20.2	9.7	5.8
Panama	7.1	6.2	-1.0 [a]	1.2 [b]
Paraguay	0.6	0.1	-0.6	-0.5
Peru	3.2	4.2	1.3	-0.6
Uruguay	0.7	3.5	-0.1	0.1
Venezuela	0.7	1.7	2.5	6.0

Source: ECLAC, IMF, Ministry of Finance of Chile, and Meller (1990, pp. 54-85).
a Average 1990-1992.
b 1992.
c Average 1987-1989.

mentation of these economic reforms, but there is considerable coincidence in the overall approach.

Williamson (1990) has characterized this recent economic reform scheme as the Washington Consensus. The so-called Washington Consensus stresses the following policy reforms, (1) State reforms which include: (a) Fiscal discipline, i.e. the fiscal deficit should not surpass 1-2 per cent of GDP. To achieve this goal in the short run, the reduction of government expenditures (in real and relative terms) is considered to be the most efficient way. On the other hand, a tax reform should be oriented towards increasing its efficiency in providing revenues to the government; for this purpose a broad tax base with low marginal tax rates is required. (b) Privatization of state enterprises: the private sector is considered to be much more efficient as a producer than the public sector. Moreover, the existence of fewer public firms will make it easier to achieve the objective of fiscal discipline. (2) Liberalization and deregulation reforms which would promote domestic competition. These include: (a) Domestic capital market liberalization which would imply freely floating interest rates; real interest rates should be positive but moderate. In this context supervision of financial institutions is recommended. (b) Trade liberalization where quantitative restrictions and discretionary measures should be replaced by tariffs; furthermore, tariffs should be reduced. (c) Positive treatment for foreign investment, which provides required capital, skills and know how. (3) A high and stable real exchange rate to increase international competitiveness for export promotion.

Several indicators show the changes observed lately in Latin America. Macroeconomic stability has achieved a high priority (tables 1 and 2): (a) Considering a set of 17 countries, the number of economies having an annual inflation rate of less than 20 per cent reached 10 in 1993 compared to (around) four in the 1980s; moreover, there were even four countries showing a one digit level of inflation in 1993. On the other hand, in the 1980s there were five Latin American countries having three digit annual inflation, while in 1993 there was only one (Brazil). (b) The large public sector deficits of the 1980s have been considerably reduced during the 1990s. During the 1980s many countries had public deficits higher than 4 per cent GDP, while during the 1990s, most of them have public deficits smaller than 2 per cent of GDP; there are even some Latin

Table 3

TARIFFS AND QUANTITATIVE RESTRICTIONS IN LATIN AMERICAN COUNTRIES IN THE 1990s

(Percentages)

Country	*Tariffs*	*Surcharges*	*Share of imports affected by quantitative restrictions*
Argentina	0 - 22	10	4 [a]
Bolivia	5 - 10	1 - 2	2
Brazil	0 - 40 [b]	-	1 [a]
Chile	11	-	0
Colombia	0 - 20	0 - 16	14 [a]
Costa Rica	1 - 40	0 - 18	1
Ecuador	5 - 35	-	15 [a]
Mexico	0 - 20	-	2
Peru	15 - 25	-	5
Uruguay	10 - 20	0 - 5	0
Venezuela	0 - 20	-	10

Source: GATT, IMF.
a This percentage corresponds to all tariff categories.
b Mean tariff will be 14 per cent in 1993.

American countries showing a public sector surplus.

In the external sector there have been important changes in trade and exchange rate policies. The Latin American trade regime which prevailed during the period of import substitution strategy had a highly complex and messy structure; there were different types of non-tariff barriers like import licensing, import prohibition and quotas, together with a high level and large dispersion of tariff schedules, surcharges, etc.; moreover, there were special regimes and special exemptions, some related to geographic areas and some related to type of firms (public firms). At the beginning of the 1990s there could be observed a clear trend towards a rationalization of the trade regime (see table 3); typical features included the simplification and reduction of bureaucratic procedures related to trade operations (exports and imports), the elimination of most non-tariff restrictions, and a diminution in the number of special regimes and special exemptions. With respect to tariffs, the following reforms have been undertaken: (a) in many countries there is a tendency towards the use of only a few tariff categories: Chile and Bolivia have a flat structure, Argentina and Peru have three tariff categories, Mexico and Brazil have six and seven respectively; (b) average and maximum tariff levels have been greatly reduced; nominal tariff rates larger than 20 per cent are nowadays considered to be too high in most Latin American countries; this is quite a change with respect to the 1960s and 1970s when tariff rates lower than 20 per cent were considered to be too small.

Multiple exchange rates had been used in many countries in Latin America during the period of import substitution strategy as a complement to the complex trade regime; a dual exchange rate regime, with a controlled official rate for the trade balance components and a free rate for the capital account, had been used by many countries. However, at the beginning of the 1990s, a unified exchange rate system prevailed in most countries of the region. Strict exchange controls, which were a normal feature in most of the Latin American countries prior to 1980, have been considerably relaxed in many economies; foreign exchange transactions and dollar deposits are now legal operations to which most agents have easy access in many countries.

The role of exports in Latin American economies has changed. There has been a sharp increase in the share of exports in GDP in the region from 14 per cent (1980) to 21.3 per cent (1993) (table 5). However, the level of exports measured in per capita terms is still too low.

It is difficult to provide compact and actual figures on privatization; however, it is well known that there has been a major

Table 4

TARIFFS AND QUANTITATIVE RESTRICTIONS IN LATIN AMERICAN COUNTRIES IN THE 1980s

(Percentages)

Country	*Year*	*Tariffs*	*Surcharges*	*Share of imports affected by quantitative restrictions* [a]
Argentina	1986	0 - 100	0 - 14	60
Bolivia	1984	0 - 60	0 - 2	90
Brazil	1985	81 [b]	-	34 [c]
Chile	1984	0 - 35	5 - 15	0
Colombia	1984	61 [b]	0 - 18	93 [d]
Costa Rica	1985	0 - 220	13 - 100	1
Ecuador	1984	0 - 290	1 - 30	38 [c]
Mexico	1984	0 - 100	3 - 19	38
Peru	1989	0 - 117	3 - 147	100 [d]
Uruguay	1982	0 - 75	0 - 74	0
Venezuela	1988	0 - 80	2 - 5	65 [e]

Source: IMF (1992).
a Quantitative restrictions (QRs) include import restrictions through exchange control. In general, QRs correspond to non-automatic requirements to import permits.
b Average value of all tariff categories.
c This percentage corresponds to all tariff categories.
d In this case QRs correspond to prohibitions.
e QRs through allocation of foreign exchange.

privatization programme implemented in many countries in Latin America.

In short, in spite of all the old criticisms, IFI policy reforms are finally prevailing; in general terms, Latin America has made deep changes towards becoming an IFI reformed area.[3]

B. Review of IFI criticism

Given the fact that most Latin American countries are following IFI policy packages, is there anything left of criticism of IFI conditionality? Let us look at the following issues (most of them are related to IMF conditionality): the use of the same adjustment model everywhere, the overkill of adjustment policies, and the asymmetry problem.

The traditional macro-stabilization adjustment view relates the external disequilibrium to the internal one; the excess of domestic expenditure (absorption) over national income generates a deficit in the current account. Standard policy prescription suggests the combination of expenditure-reducing policies (adjusting expenditure to income restriction) and output-expenditure-switching policies through relative price changes (for example, a devaluation would provide an incentive for the production of tradeables, while it would discourage the consumption of tradeables, thus helping to reduce any external disequilibrium). Moreover, if the private sector budget is in equilibrium (or its expenditure-income deficit is relatively small), the fiscal deficit becomes the main factor generating the external disequilibrium. In this case, a tight fiscal policy, complemented by devaluation, has been the policy package recommended for solving the external and internal disequilibria; besides, these policies are of a complementary nature. In order to transform a nominal devaluation into a real one, it is necessary to have a contractionary fiscal policy to avoid an inflationary outcome which would erode the real effect of the devaluation.

[3] There are distinct reasons which could explain these reform changes: (a) The IFI have "convinced the Latin Americans". (b) "We are all neoliberals now". (c) The 1980s were really a "lost decade in Latin America". The recovery of growth acquired the first priority, and more of the same old policies would not work; hence deep IFI reforms were implemented.

The experience of the 1980s in Latin America shows that there are three distinct problems with this standard view. The first includes the possibility that a non-sustainable external disequilibrium can coexist with a public sector showing an important surplus; in this case, it is the private sector expenditure-income deficit that generates the disequilibrium. In Chile the public sector had an annual surplus of the order of 2 per cent of GDP during 1978-1981, while at the same time the current-account deficit was increasing, reaching almost 15 per cent of GDP in 1981. In short, the Chilean experience indicates that it is not desirable to distinguish between good and bad trade gaps on the basis of whether they are generated by the private or the public sector. A large, unsustainable, and non-financeable current account deficit, no matter which sector produced it, will lead eventually to an unavoidable adjustment (Meller, 1990).

The second problem is related to the difficulties associated with a reduction of the fiscal deficit. In the short run, the reduction of the fiscal deficit would crucially depend on the contraction of government expenditures; however, this situation is aggravated when increased external debt services have to be accommodated. In other words, when the IFIs assign first priority to full and punctual external debt servicing and there are rising international interest rates, this factor increases the magnitude of the existing fiscal deficit, i.e. an external element increases the fiscal deficit and the causality is reversed: an external factor causes the internal imbalance to deteriorate.

The third problem relates to the fiscal difficulties (or benefits) generated by a devaluation when an external debt service exists. Given the international capital market situation, during the 1980s Latin American governments had to make an external transfer in order to meet external debt-service requirements; for this purpose, these governments required foreign exchange. When the public sector is not an exporter (i.e. there are no state export enterprises), an internal transfer of foreign exchange from private agents to the government is required. When a devaluation is implemented, there is a corresponding increase (in domestic currency) in the magnitude of this internal transfer and, in this way, there is an augmentation of government expenditures; thus a devaluation aggravates the fiscal deficit. Moreover, economic authorities face the additional problem of sterilizing the acquisition of foreign exchange; this is one of the factors related to the increase of domestic public debt. The opposite situation is generated when there exist public export corporations (such as for petroleum in Mexico and Venezuela, and copper in Chile). In this case, one tool, (real) devaluation, helps simultaneously to reduce the fiscal deficit and the external disequilibrium. In other words, the existence of public export corporations alleviates the internal transfer problem; moreover, devaluation acts like a tax instrument, increasing government revenues (see table 6). Furthermore, it is relatively easier to sterilize the monetary impact generated by the foreign exchange of public export corporations without increasing public debt; a special stabilization fund can be used.

The initial conditions related to the magnitude of the fiscal deficit at the beginning of the 1980s (prior to the external debt shock), in addition to the two problems mentioned above, as well as the external transfer (accommodation of increased debt services) and internal transfer (the negative relationship between devaluation and fiscal expenditures), are behind the difficult stabilization experiences and inflationary price explosions observed in several Latin American countries.

The overkill adjustment criticism issue was behind the discussion related to the alternative definitions of the fiscal deficit (primary, operational and real, including internal and external debt interest) and (nominal) public sector borrowing requirements.

In order to realize the magnitude of the effort behind the recently implemented fiscal adjustment in Latin America, let us use a simple decomposition analysis of the fiscal deficit. Using $f = (T\text{-}G)/Y$ as the percentage of the fiscal deficit with respect to GDP (Y), where G and T are government expenditures and tax revenues respectively, then, by differentiation, df will be the change observed in f:

$$df = f\hat{Y} - \alpha_T \xi_{TY} \hat{Y} + \alpha_G \hat{G},$$

where $\hat{Y}$ and $\hat{G}$ are the GDP and government expenditure growth rates, α_G and α_T are the GDP government and tax revenue shares, and ξ_{TY} is the income-tax elasticity. In the reduction of f, there is a contribution of three distinct factors: government expenditure contraction, the positive contribution of taxes (mixture of the tax system and economic growth), and a third element which combines the initial conditions (the initial level of the deficit) and economic growth.

Let us assume that the initial fiscal deficit is 6 per cent of GDP, i.e. f = -6 per cent. Standard IMF adjustment programmes have used a simple rule for fiscal deficit reduction: "cut (in one year) the fiscal deficit to half", i.e. in this case, df = 3 per cent. Using α_G = 26 per cent, α_T = 20 per cent, ξ_{TY} = 1 and as-

Table 5

LATIN AMERICAN EXPORTS

	Export growth [a] *(Annual average, per cent)*			*Exports/GDP* [a] *(Per cent)*		*Exports* [b] *($ million)*	*Exports per capita* [b] *($/per capita)*
	1970-1980	*1980-1990*	*1990-1993*	*1980*	*1993*	*1993*	*1993*
Argentina	3.8	5.3	7.6	8.3	14.6	13,000	386
Bolivia	1.1	0.4	8.7	23.5	27.7	630	82
Brazil	9.9	6.9	6.1	8.9	17.4	38,900	248
Chile	8.0	5.8	8.8	23.1	32.9	9,215	666
Colombia	4.7	5.8	14.0	16.4	26.9	7,695	226
Costa Rica	4.8	4.9	13.2	33.8	65.4	1,915	590
Ecuador	8.1	5.2	6.2	25.1	40.6	2,925	260
El Salvador	4.7	-0.5	20.6	34.8	44.4	720	131
Guatemala	6.3	1.7	5.6	22.2	23.4	1,325	134
Honduras	4.3	0.8	1.7	37.4	30.9	965	174
Mexico	6.8	8.4	7.7	11.8	27.1	29,375	328
Nicaragua	0.0	-8.0	-2.2	23.9	16.1	260	65
Panama	15.5	9.5	15.8	46.6	59.1	5,265	2,058
Paraguay	7.3	10.8	3.4	13.9	27.0	1,330	289
Peru	1.7	-2.4	2.5	22.5	22.8	3,385	148
Uruguay	5.6	3.2	1.8	22.9	28.2	1,600	502
Venezuela	-3.9	1.3	7.6	32.4	41.0	13,945	679

Source: ECLAC.

a Exports (goods and services) measured in 1980 dollars.

b Exports (FOB).

suming that the economic growth rate is 4 per cent, employing the df expression, the required government expenditure contraction becomes -7.5 per cent. More than 60 per cent of the reduction of the fiscal deficit is related to government expenditure contraction.

The previous calculation underestimates the effective reduction of government expenditures that had to be implemented by Latin American economies. If the required increased external debt services are added, which introduce pressures for expenditure enlargement, the effective primary government expenditure contraction becomes: $\hat{G}_P = (\hat{G} - \alpha_S \hat{S})/\alpha_{GP}$, where $\hat{S}$ is the growth rate of external debt services, and α_S and α_{GP} are GDP shares of external debt services and primary government expenditures. Assuming that α_S increases from 2 per cent to 3 per cent, then $\hat{G}_P$ becomes -9.5 per cent; i.e. the required real contraction of (primary) government expenditures is close to -10 per cent.

Latin American governments have imposed the fiscal discipline principle; at the end of the 1980s, most of their economies showed primary fiscal surpluses. In spite of this fact, many governments faced a critical fiscal disequilibrium; when public-sector debt interests are considered, some countries, like Argentina, Bolivia, Brazil, Mexico and Peru, still had operational deficits of around 5 per cent of GDP at the end of the 1980s. Government expenditures (excluding social security transfers and interest payments) were reduced throughout the 1980s by 9 per cent of GDP in Bolivia, 6 per cent of GDP in Peru, 3 per cent of GDP in Chile, and around 1 per cent of GDP in Colombia and Venezuela. If the GDP share of these government expenditures is considered to be around 15 per cent of GDP, a reduction of 1 per cent of GDP corresponds to a 6.7 per cent contraction of expenditures.

It is interesting to compare the public sector deficit of some Latin American countries with those of some developed countries during the 1990s (see table 7). It is observed that, in general, the public sector deficits of Latin American countries are smaller than those of the industrial countries.

Now, let us look at the asymmetry issue. There is an asymmetrical situation with regard to the problem of external imbalance, depending on whether the country is industrialized or developing. The IMF has been unable to convince the industrial countries to apply a consistent, uniform economic programme that promotes international financial stability and world growth; in short, "IMF surveillance over the exchange rates and other macroeconomic policies of industrial countries is not effective" (Mohammed, 1993).

Moreover, although the external imbalance and the fiscal deficit of the United States economy have been at the core of the world economy's unsatisfactory functioning in recent years, the IMF can do nothing to surmount them. How would the United States Government and people react if the Fund suggested that they reduce the size of their fiscal deficit from 4 per cent to 2 per cent of GDP within one year?

The maintenance of a stable world economic and financial system today depends essentially on the policies applied by the industrial nations. At the present time, not only is there an asymmetry in the conditionality - the latter applying only to developing countries - but as a result the IMF cannot even fulfil its main function. It has become a mere spectator and commentator with regard to world economic trends, unable to influence or alter their course (Miller, 1988). In this respect, Polak (1993), has (almost) begged developed countries' governments to listen to IMF statements": "the design of national policies with due attention to their international repercussions must allow for an input from ... more than seven countries". Given this inability to convince the industrial nations to modify their policies, the IMF and the World Bank should at least be concerned with their probable effects on the functioning of the world economy and on the developing countries (Please, 1987).

Indeed, if the developed countries apply policies that adversely affect the world economy, the developing countries are going to suffer the consequences;[4] hence they had best be warned, so that they can use the appropriate tools to try to neutralize the impact. The IFIs must be aware, then, that however restrictive the conditionality imposed on the developing countries, either to eliminate the external imbalances or to ensure continued flows of debt servicing, this will not lead to an orderly growth of the world economy, which primarily depends on the policies of the industrial nations.

During the 1980-1990 period there was gradual or no "adjustment" in the United States fiscal and trade deficits, whereas deep adjustments were observed in Argentina, Brazil and

[4] The impact of the hike in the real international interest rate in the 1980s has represented quantitatively around 50 per cent of the total amount of interest payments paid by Latin American countries during the 1982-1986 period (Bianchi, Devlin and Ramos, 1987; Meller, 1988).

Table 6

FISCAL REVENUES PROVIDED BY PUBLIC EXPORT CORPORATIONS

(Percentage of GDP)

	1980-1981	*1982-1984*	*1985-1990*
Chile (copper)	2.5	2.1	4.4
Mexico (petroleum)	7.8	14.1	11.1 [a]
Venezuela [b] (petroleum)	18.5	17.4	12.8 [c]

Source: Romaguera (1991); Ortiz (1990); and Velázquez (1991).
a 1985-1989.
b From 1983-1987 it includes exchange rate profits which were (annual averages): 5.6 per cent of GDP for 1983-1984 and 4.6 per cent of GDP for 1985-1987.
c 1985-1987.

Mexico. This quite different adjustment behaviour pattern lies at the root of the asymmetry issue; Latin American economics have to implement drastic adjustment programmes generating heavy social costs, while developed countries are able to smooth and face out adjustment over a long period of time, in this way minimizing social costs. Basic elements explaining this difference are related to the fact that developed countries have many financial alternatives which allow them to ignore the IMF; moreover, they have stronger bargaining power, which is used to "convince" their commercial partners to share part of the external disequilibrium adjustment process.

Related to the last issue, the international asymmetry entails another basic problem. The fact that there are countries with a trade deficit necessarily implies that others are accumulating a surplus. Then why, in view of the existing imbalance, should only those with a deficit bear the brunt of adjustment? The obvious answer would be that only the countries with a trade deficit face problems of financial liquidity; and this is what leads Latin America to turn to the IMF. However, this need not be so. Already in the 1940s, when the creation of the IMF and the World Bank was being discussed, Keynes advocated symmetry in the distribution of the costs of adjustment.

The countries with trade surpluses have to permit access to the exports of deficit countries, so that they are able to generate the foreign exchange necessary for financing the deficit. This is exactly what the United States is trying to do by "convincing" Japan of what it should do to reduce its trade surplus. In order to alleviate the burden of adjustment linked to the United States external imbalance, Japan should be willing to increase its imports from the United States and "voluntarily" reduce its exports to that market. As can be observed, this is a partial bilateral approach to a more general problem, which can be used only by big and powerful countries.

In sum, the IMF and the World Bank are facing a number of dilemmas in fulfilling their function of supervising the orderly and stable growth of the world economy. How can the IMF influence the economic policies of the industrial nations? How can it have an influence on countries that do not need loans from it? How can it suggest changes in the policies of countries with a trade surplus? (Kenen, 1987). The overall problem seems to be associated with the disposability of the appropriate mechanisms so that the IMF can have a symmetrical influence on both the industrial and the developing countries, or on the surplus and deficit countries, so as to promote a more equitable distribution of the costs of adjustment where external imbalances exist. For example, the IMF could rely upon various mechanisms to induce trade surplus countries to facilitate access for the exports of deficit countries.

C. Present economic problems and roles of international financial institutions

The present economic world is one where the rules of the international monetary system are not clear at all; i.e. there are no defined nor

Table 7

PUBLIC SECTOR DEFICIT IN LATIN AMERICAN AND INDUSTRIAL COUNTRIES, 1992

(Percentage of GDP)

Latin America		*Industrial countries*	
Argentina	0.1	Belgium	6.1
Bolivia	6.8	Canada	5.8
Brazil	2.3	Denmark	2.6
Chile	-2.8	France	2.8
Colombia	0.6	Germany	3.2
Costa Rica	1.9	Greece	13.2
Ecuador	1.5	Ireland	2.5
El Salvador	4.5	Italy	11.1
Guatemala	0.5	Japan	-1.3
Honduras	5.0	Luxembourg	-2.6
Mexico	-4.5	Netherlands	3.8
Nicaragua	7.9	Portugal	5.4
Panama	1.2	Spain	4.7
Paraguay	1.0	United Kingdom	6.6
Peru	1.7	United States	4.7
Uruguay	-0.3		
Venezuela	5.7		

Source: ECLAC and UNCTAD.

agreed rules of international monetary behaviour which establish a pattern of constraints to national behaviour. The Bretton Woods system established in 1944 was based on a fixed exchange rate regime; currencies were pegged to the dollar which was pegged to gold; the dollar constituted the main international reserve asset, and Bretton Woods rules specified national monetary authorities' interventions to avoid divergences between market and official pegged exchange rates. This system collapsed in 1971 when the United States Government "closed the gold window".

The Bretton Woods system was replaced by a floating exchange rate regime, where national monetary authorities would let market forces establish the respective equilibrium exchange rate values; interventions by monetary authorities were considered useless against market forces. "The Bretton Woods rules were changed, not because it was thought that the new rules were superior, but because the old rules no longer corresponded to monetary reality" (Dam, 1982, p. 6). Later on, the floating regime was replaced by the G-7 managed intervention regime during the second half of the 1980s.

There has been a long and inconclusive discussion at the academic level with respect to the superiority of a fixed or floating exchange rate regime. The pragmatic "pegged but adjustable" exchange rate regime (including target zones) implemented by the G-7 is a sort of mix of the free market and interventions by the monetary authorities in order "to avoid the excessive instability of flexible rates and the excessive rigidity of fixed rates" (Bergsten, 1990). However, this type of pragmatic regime is considered to be unsustainable in the long run.[5]

The IMF is the international institution which should be concerned with the orderly evolution and the smooth functioning of the international monetary and payments system. But, there are no generally established rules which should guide the behaviour of the IMF; moreover, international monetary stability and its evolution depends fundamentally on the economic situation of the developed countries and the policy measures adopted by the G-7. So what role can the IMF play? Has the IMF become an irrelevant institution?

The present world is one where there has been an increase in economic global interdependence; hence, what is required is a coherent

[5] The main argument here is that the markets can bring to bear considerable resources that will make it increasingly difficult to face a speculative attack. Moreover, "systems of pegged but adjustable rates and narrow target zones offer investors costless one-way bets" (Eichengreen, 1993, p. 67).

overall economic framework to examine the consequences for the rest of the world of G-7 actions. Given the present situation, the first best would be active participation by the IMF in G-7 meetings, specifying and discussing the effects of different G-7 policy alternatives upon the global economy and upon the developing countries; the IMF would be a sort of representative of the rest of the world in the G-7 meetings. The second best role of the IMF would be related to analysing the global effect of G-7 measures upon the world economy, with specific reference to the developing countries. Given the global interdependent relationship and the crucial impact of G-7 policies upon all economies, developing countries have the right to know and to anticipate the consequences of G-7 actions; the IMF has the resources to perform the role of analysing and disseminating the relevant information.

Moreover, the developing countries require the IMF to perform its more traditional and specific role related to the provision of financial liquidity to meet short-run external disequilibrium problems. Since it is clear that their economic behaviour does not affect orderly world monetary evolution, the IMF conditionality package should start considering some of the suggestions already made by economists from developing countries; a list of these recommendations will be provided below.

The traditional main development objectives are (long-run) growth and equity. Increasing long-run growth is related to the augmentation of savings and investment, and to the increase of productivity; this involves issues like investment in human capital (education and training), entrepreneurial performance and labour motivation, improving domestic capital and labour market institutions, investment in infrastructure; research and development, etc. The equity objective includes poverty alleviation and the reduction of income inequality; the focusing of objectives, decentralization, and local government accountability have become key concepts in the achievement of this objective.

Growth and equity objectives have been affected negatively in the short run by stabilization and structural adjustment reforms; however, the non-implementation of policy reforms does not achieve better (medium- and long-run) results for the growth and equity goals. Moreover, adjustment reforms can have IFI financing to help achieve the long-run growth objectives; but developing countries have observed that "adjustment without a human face" can be politically destabilizing in the short run.

Policy reforms have distributive effects; this is especially valid for adjustment policies. It is important to quantify the distributive impact of alternative reform policies upon different income groups. There is now a wide consensus that the poor should not bear most of the burden of adjustment and policy reforms; safety nets for the poor should be a required component of IFI conditionality packages.

In general, policy reforms generate short-run losers and long-run winners; hence, the losers will actively oppose the reforms, while the prospective winners will maintain a passive attitude. In some developing countries the losers can prevent or stop reforms, while in others, reforms are sustained until they achieve economic success. Some stabilization and structural programmes applied in different Latin American economies have worked and some have failed; therefore, it is important to study the specific contexts and the forces behind the political process of decision-making which lead to positive economic results. Furthermore, the implementation of reforms takes time; it takes even more time until society becomes aware of clear improvement in its welfare; in this case the time is measured in years ... many years. So how can consensus and a political coalition be established in order to maintain and sustain policy reforms over a long period? In some Latin American countries a political coalition including government and opposition political parties is required in order that all political parties share the concrete short-run costs and eventual long-run benefits. The political economy analysis of policy reforms in developing countries is an important ingredient for the understanding of successful reform programmes (Rodrik, 1993).

Macroeconomic stability, elimination of distortions and extensive use of the market mechanism, external opening and export promotion, private investment and entrepreneurship, are now considered the key necessary components for rapid growth in developing countries; however, they seem to be only necessary but not sufficient conditions. A recent World Bank study of East Asian economies has stated that the previously mentioned "fundamental policies do not tell the entire story. In most of the East Asian economies, in one form or another, the government intervened - systematically and through multiple channels - to foster development, and in some cases the development of specific industries ... At least some of these interventions violate the dictum of establishing for the private sector a level playing field, a neutral incentives regime ... Our judgment is that in a few economies, mainly in North-East Asia, in some instances, government interventions resulted in higher and

more equal growth than otherwise would have occurred. However, the prerequisites for success were so rigorous that policymakers seeking to follow similar paths in other developing economies have often met with failure" (World Bank, 1993, pp. 5-6).[6] In other words, "contrary to the currently fashionable views worldwide, one of the key ingredients in East Asia's success was active government. But it was not *more* government which had a positive effect - it was *better* government" (Leipziger and Thomas, 1993, p. 6).

Another interesting result of the East Asia study by the World Bank is that each successful country seems to be a special case; i.e. there has not been only one model or formula which generated the final success. One surprising outcome is related to the alternative and sometimes opposed interpretations about the common features surrounding the successful growth performance of East Asian economies.[7] In short, it has been argued that "no simple generalizations can capture either the diversity or complexity of East Asian success ... East Asian development strategy must be sought not in policies, but in deeper, functional aspects of the development process. Rapid development does not call for any specific policy package, but it does require policies that achieve certain fundamental goals" (Petri, 1993).

As stated previously, Latin America has in general implemented the fundamental economic reforms (macro-stabilization, the market mechanism, external opening, the private sector playing a key role); however, something else is required to achieve growth and equity: (a) Political elements are important: evaluation of the political feasibility and appropriate timing of a policy package, and building political consensus and a political coalition. (b) Knowledge of specific domestic key features: institutional aspects, behaviour of the public bureaucracy, national leadership. (c) Measures improving the public sector and oriented towards having a "better" government. (d) Focusing of objectives, decentralization, local government accountability, higher efficiency and a degree of control of specific policy measures.

In brief, there are no general rules for the promotion of development in Latin America; ad hoc specific and detailed action at different levels has to be taken in each specific country to generate political consensus, deepen democracy and build the appropriate institutional framework. So what role can or should the World Bank play in this respect? What overall role is left for the World Bank? Sectoral and regional programmes require large amounts of specific domestic inputs; specificity instead of generality has become the key ingredient for a successful policy measure (for example reforms related to education, labour training, health, social security, improving public sector human capital skills, etc.). It is not obvious what advantage an institution located in Washington D.C. has to suggest or propose a given specific reform for each Latin American country; furthermore, what comparative advantage or additional information do World Bank professionals have with respect to Latin American profesionals, especially considering the large number of the latter that have had graduate training in United States or European universities? In short, what do they know about Latin American economies that we do not know?

The IFIs have been used as scapegoats for the required adjustments and policy reforms. Moreover, they have been criticized for "doing too little" or "doing too much"; "doing too little", because distributive and social dimensions are not considered or included in conditionality packages; "doing too much", because conditionality packages include economic objectives which go beyond IFI mandates, and in this way interfere too much with national priorities.

The IFIs have been sensitive to this type of criticism. However, IFI reaction has been misguided in the direction of spending resources in the *marketing* of IFI conditionality packages and IFI research activities in developing countries. The World Bank (1989) defined this approach in a very neat way: "Experience has shown that the government needs to "own" the programme. Although the government may have received help in designing the programme, the authorities must understand it fully and be satisfied that it is the appropriate course of action for their country" (World Bank, 1989, p. 23). It is quite obvious that each Latin American government will feel it "owns" a programme, when this programme has been "home-made" by its own professionals; in that case, it will fully understand it and will be fully satisfied with its proposed course of action. IFI advice is welcome, but should be complementary to a "blueprint" prepared by local staff.

To finish, we will provide a short synthesis of IFI conditionalities which have already

6 For a discussion of these prerequisites for successful government interventious see Hibino and Amsden (1992), Amsden (1993), World Bank (1993) and Leipziger and Thomas (1993).

7 See references provided in the previous footnote.

been suggested by different economists.[8] The main guidelines suggested for IMF conditionality have been the following (Group of Twenty-Four, 1987; Bacha, 1985 and 1987; SELA, 1986):

Reverse conditionality. The adjustment programme must be designed by the borrowing country, taking into account the existing external constraint. Thus, the homogeneous and uniform programmes of the IMF would be replaced by "home-made", "fitted" adjustment programmes. This proposal is probably more significant for the small countries than for the larger ones, since the latter have greater bargaining power.

Now let us look at this conditionality from an operational standpoint. A country presents the IMF with its adjustment programme and a request for credit. IMF experts review the consistency and viability of the programme. If serious disagreements arise over its feasibility, the Executive Director is called in to settle them. The final result probably consists of a compromise solution between the adjustment programme submitted by the country and the observations suggested by the IMF experts. But what is crucial about this process is the point of departure of the negotiations (in this case, the home-made programme), since the final result commonly depends on the initial terms of the discussion.

Conditionality that takes into account variables of the real sector of the economy. In order to put a ceiling on the domestic cost of adjustment, it could be stipulated that when given levels are exceeded in the decline in output or the increase in the unemployment rate, the country will be provided with further increases in external credit. The programme signed by Mexico in 1985 contained a clause of this type.

Thus, Bacha (1987) suggests that the financial-budgetary exercises traditionally carried out by the Fund be complemented by national feasible economic growth rate exercises, from which will evolve, as a residual, the volume of financial resources necessary for supporting a given rate of expansion of output.

The identification of that minimum rate (consistent with adjustment), which can be used as a point of reference for all countries, can cause some difficulties. The zero figure always holds great attraction, in as much as it could be asserted that zero growth in per capita income means that the current levels at least do not deteriorate. But this would mean applying a stricter criterion to those countries that have a higher rate, which would make no sense.[9]

Conditionality at two levels. In this case, it is suggested that a distinction be made between the external variables (those linked to the balance of payments and international reserves) measured in foreign currency, and the internal variables (fiscal deficit, domestic credit, inflation) measured in local currency. The priority conditionality for the IMF would be that corresponding to the variables expressed in foreign currency, the domestic goals would then be relaxed when the external goals had been met (Bacha, 1985).

Spraos (1986) suggests a more extreme option. IMF conditionality must be centred on a single goal, the balance of payments, and later, using only indicators (targets, in this case), linked directly to external accounts. A similar point has been made by Cooper (1993). Bacha (1987) feels, from a pragmatic standpoint, that it is more feasible to achieve a modification in IMF conditionality toward conditionality at two levels, as previously indicated, which attempts to eliminate a considerable part of the existing conditionality. From the perspective of the borrowing countries, conditionality at two levels would substantially fulfil a very similar function to the one centred exclusively on the balance-of-payments objective.[10]

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8 This part uses elements from Meller (1989).

9 The application of the "rule of two", i.e. dividing by two the average value of the country's economic growth rate for the last five years, is probably a less discriminatory criterion. This "rule of two" would have a precedent in the financial exercises of the Fund, which would use it in order to determine the level of fiscal deficit that must be reached by the concerned developing countries in order to implement the adjustment programme (Bacha, 1987).

10 Spraos (1986) raises an additional problem with respect to the indicators (targets) included in the conditionality, which are the frames of reference for determining the performance (or non-performance) of the agreed adjustment programme. Should they be linked to the policy *goals* or *instruments*? The IMF uses as a criterion the level of the instruments. Thus it is supposedly possible to discern when the non-performance of an adjustment programme is caused by endogenous or exogenous factors; a country would be responsible only when it does not meet the goals of a programme that is under its control (Kenen, 1987). But how can those cases in which the governments do not retain total control over the instruments be distinguished? Spraos also points out some of the difficulties involved in the use of instruments as *targets:* (a) there must be a stable and very well-defined relationship between the policy instrument and the objective for which it is being used; (b) there is not always an operationalization of the instrument which indicates that it is the best; this is illustrated by the various types of M_i used to tie in to the concept of money; (c) the instrument selected has to be the only one that can alter the value of the objective variable in the direction desired. Obviously, it is difficult for all of these requirements to be met in the real world.

Consistency between the level of external variables and the minimum goal of economic growth stipulated. This level has to take into account: (a) an adequate expansion of domestic credit (probably with one quota that is lower and another that is higher), so as to maintain enough liquidity to sustain the desired level of growth; (b) a fiscal deficit that ensures the essential levels of public investment and social spending for achieving the objectives of economic growth, alleviation of poverty and redistribution of prosperity.

Expansion of the compensatory financing facility (CFF) in order to cover a major proportion of the drop in exports, consideration of possible variations in international interest rates, and facing policy shocks from G-7 macro-management. It would probably be more logical that the access to the CFF programme be related, not to the quota that each country contributes to the Fund, but to the magnitude of the domestic disequilibrium generated by the external maladjustment (associated with the fall in exports, the increase in the interest rate or the G-7 policy shock).[11]

The present World Bank role is less clear. Development, i.e. growth and equity goals, require highly specific and numerous "home made" ad hoc actions; the World Bank should focus its role as a financial intermediary for developing countries, i.e. International Finance Corporation (IFC), Multilateral Investment Guarantee Agency (MIGA) and International Development Association (IDA) should play the major roles. Sectoral loans and specific investment projects should constitute the core of total lending. However, if this is the task of regional development banks (for example the Inter-American Development Bank (IDB)), why should there be a separate entity like the World Bank?

Furthermore, in order to improve the quality of policy reform advice and development research in developing countries, several distinct specific local features (political, social, institutional, country idiosyncrasies, etc.) have to be considered; this requires researchers and policy advisors "to be there, where the action is".

The World Bank and the IMF should apply to themselves a major structural reform. These IFIs are highly protected research institutions; they should be exposed to external competition in research matters related to developing countries. As usually happens with protected sectors, IFI professionals cost much more than professionals living in their native developing countries and having similar qualifications; moreover, these professionals in developing countries also have the comparative advantage of knowledge with respect to domestic institutions and idiosyncracies. In short, there exists a distortion that open competition for IFI research funds would help to remove, leading in this way to the decentralization of developing country research; this would upgrade policy advice and development research for developing countries. For example if the equivalent of 50 per cent of the resources used in Washington to finance 1000 World Bank economists were used in 100 developing countries to finance 1000 graduate domestic economists (on average 10 per country), the policy reform advice and development research would be greatly improved; there would also be spillovers and domestic externalities increasing local research and development.[12] At the same time, there would be an important saving of resources in Washington D.C. World Bank expenditures, since at least 1000 of its economists located in Washington would be axed from the staff. The result would be better policy advice, more relevant development research and reduction of staff expenditures. This is clearly a Pareto improvement proposal; what prevents its achievement?

In synthesis, the main IFI *raison d'être* is related to the developing countries. At the beginning of the 1990s, Latin America became an IFI reformed area. In the near future, the IFIs should become a developing countries' forum for global macroeconomic discussions, and should convey developing countries' concerns to the G-7 about the implications of their policy actions; if this is to be the case, it is already time to start thinking that the IMF Managing Director should come from a developing country. The World Bank, together with (or incorporated into) the IDB and other regional banks, should become financial intermediaries for the economies of the developing countries.

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[11] Other proposals by the Group of 24 (1987) are that: (a) the IMF should not set precise quantitative goals, but ranges of goals for crucial variables; and (b) CFF programmes must definitively replace standby loans.

[12] One thousand World Bank professionals located in Washington, D.C. require (including staff support) $200 million per year. One thousand developing country Ph.D. economists working in 100 research centres located in their own countries would require (including staff support and fixed costs) less than $100 million per year.

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11

IMF-WORLD BANK POLICY ADVICE: THE COORDINATION/CROSS-CONDITIONALITY QUESTION

Roberto Junguito

A. *Mandates of the IMF-World Bank: original coordination issues*

The purpose of this paper is to analyse, from a historical perspective, the process of policy advice given by the IMF and the World Bank to developing countries, focusing on the coordination and cross-conditionality questions, as well as on the challenges for the 1990s.

It is clear that from their creation the two institutions were given different, though complementary mandates. In a memo from the United States Treasury Department, dated April 1942, it becomes evident that the American idea was to have two institutions dealing respectively with the issues of currency stabilization and economic growth. It also stresses that the two tasks were diverse and that, therefore, the institutions should have different responsibilities, resources and criteria for action. In the terms of reference for the United States negotiators at Bretton Woods, the House of Representatives recommended that the future IMF should only extend short-term balance-of-payments support. On the other hand, it is also known that the representative of India in the negotiations insisted on including the idea of promoting "development" in the mandates of both institutions (World Bank, 1989).

The final draft of the mandates reflects the compromise reached among the negotiating parties. While the position of the developing countries, led then by India, conveyed the idea of promoting development by including a common article referring to the objective of seeking the development of productive resources as well as income and employment (see chart 1, Article III of the Bank and Article II of the IMF), the specialization of functions between the institutions was also clear cut. The Bank was given a direct role in promoting growth, through its functions (Article II) of stimulating domestic savings and promoting foreign investment and lending by the private sector, as well as by directly extending long-term loans (Article IV). On the other hand, the IMF's emphasis was on stability of exchange rates (Article III), cooperation in monetary problems (Article I), and temporary support to overcome balance-of-payments disequilibria.

There are a couple of references from the late 1940s which suggest that, at a very early stage, both institutions recognized their fields of common interest and the need to collaborate, while preserving their independence. A Bernstein memorandum established that: "The Fund working with exchange problems and the Bank with loan and development problems have a broad field of common interest" (World Bank, 1989, p. 9). However, it was recommended that the Fund concentrate on its own field of action: "The Fund should never offer advice on development programs or encourage dependence on foreign loans as substitutes for monetary policy".

At the same time, the President of the Bank, while recognizing the need to collaborate, insisted on protecting the Bank's autonomy in an even stronger fashion, by adding that: "We must, however, preserve at all times our own freedom of judgement of action" (McClain, 1989, p. 9). In this regard, it is interesting to point out the Bank's "revealed preference" in terms of policy advice, as is evidenced in the report of its first mission to a developing country, which was led by Currie in 1950. The mission was organized by the Bank with "the task of formulating the basis for a coherent and global program of development for Colombia" (World Bank, 1951). Looking through the report, there was a chapter on

public finance and another on money, credit and inflation, both based on papers by Musgrave, while another two chapters, based on papers by Anderson, dealt with the balance of payments and multiple rates of exchange. In an introductory letter to a second edition published nearly 30 years later, Currie added that the report had dealt with "not only the identification of projects appropriate for the Bank's allocation of resources, but also with the discussion of a broad range of policy topics including macroeconomic policy". He further added that "Later on, this last field became the focal interest of the Fund, although more recently (i.e. the mid-1980s) the Bank has taken renewed interest in it" (Currie, 1988).

This first section of the paper may be closed by saying that despite the purpose of creating two very distinct institutions to deal, respectively, with stabilization and growth issues, and establishing the corresponding mandates, the functioning of the IMF and the Bank showed from a very early period that their roles in developing countries had common areas and that there was need for collaboration. Moreover, even though each institution attempted to safeguard its autonomy and concentrate on its own field of action, everyday practice, as exemplified by the first World Bank mission, signalled the difficulties in separating policy advice on stabilization and growth issues. Notwithstanding such concerns, it seems reasonable to conclude and agree with Polak that during this period, on the whole, "the two institutions could perform their tasks side by side without coordination arising as a major issue" (Polak, 1993).

B. Policy advice in the 1960s and 1970s: the period of formal coordination

The early 1960s continued to show the institutional patterns of the previous decade. According to Mason and Asher (1973) existing collaboration was developed more between individuals, on a personal rather than on an institutional basis. It was not until 1966 that the first formal collaboration procedures and policies were announced. At that point, a memorandum on Fund-Bank collaboration was drafted (IMF-World Bank, 1966).

Its objective was to assure "a consistent view by both organizations on economic policy matters in connection with individual member countries". In terms of structure, the principal characteristics of the understanding were the definition of the primary responsibilities of each institution, and the explicit specification of the broad range of matters of interest to both the Bank and the Fund.

The Bank's primary responsibilities involved development programmes and priorities, while the Fund's priorities were exchange rates and restrictive systems for balance-of-payments adjustments. In other words, the role of the Bank had to do with supply oriented tools to reach longer-term growth objectives and with external resource requirements, while the IMF had to concentrate on the design of demand policies to tackle short-term stabilization, balance-of-payments and exchange rate issues.

Perhaps more important than the definition of primary responsibilities, which, after all, was a reaffirmation of the principles established in the mandates, was the attempt made in the 1966 memorandum to spell out the matters of common interest to both institutions, given that some of them became in the following decades the key issues of the developing economies and the source of joint concerns to the institutions. In fact, the sixth point of the memorandum defined as the broad range of matters of common interest the following items: the structure and functioning of the financial systems, the adequacy of capital markets, the promotion of domestic savings, foreign debt problems, and the financial implications of economic development programmes for the internal and external positions of countries.

How significant then was the 1966 statement of competence and procedures for collaboration? From the point of view of formalizing the rules for collaboration between the institutions it was very important, given that it set the basis for future collaboration. From a theoretical viewpoint it suggested, but did not develop, the idea that stabilization programmes were a sound basis for economic growth. From a practical standpoint, however, the agreement does not seem to have led to significant collaboration, except with respect to the institutional aspects of country missions. In fact, in an address to the staff following the understanding, the President of the Bank at the time referred only to issues such as exchange of information, parallel missions, and participation of staff in missions of the other institution (Wood, 1985).

At this stage, the hypothesis that could be advanced to explain the lack of a more practical development of the collaboration understanding was that up to that time there were no major common economic disruptions in developing countries, and no pressure to

collaborate in areas of common interest. In this respect, it is interesting to note that according to historical references "no discussion of the Memorandum took place in either of the two Boards" (World Bank, 1989, p. 12). In fact the only major topic of interest to developing countries that seems to have been examined jointly by the IMF and the Bank by 1967 was the way to deal with the instability of commodity prices (de Vries, 1986, p. 36).

By 1970, and apparently in response to the Pearson Commission which suggested that in countries where both institutions operated they should adopt procedures for preparing unified country assessments and assuring consistent policy advice, the President of the Bank and the Fund's Managing Director proceeded to issue a statement reaffirming the 1966 understanding. In the vein of prevailing practices, the joint memorandum was entirely procedural and referred to the methods of collaboration before and after missions, circulation of documents, technical assistance, exchange of final documents, and collaboration in the field.

The crucial issue, however, that provoked the need to realize the first step towards effective institutional collaboration, and which established lending as the primary activity of the Fund in the second half of the 1970s, was the impact of the oil shock, mainly on non-oil producing developing countries. It is well known that in 1974 the Extended Fund Facility was prolonged to eight years and then to 10 in 1979. On the other hand, it is also worth recalling that in 1974 the Group of Twenty endorsed the proposal for a temporary facility in the Fund to assist members in meeting oil-related payment deficits and for creating an oil facility with a subsidy account for developing countries (de Vries, 1986). Such a decision was very probably also adopted as a result of pressures by the G-24, which was by then highly critical of the Fund.

By way of summary regarding the evolution of IMF-Bank coordination in the 1960s and 1970s, one could reasonably argue that while the 1966 agreement set the rules for formal collaboration and specified in a clear way the significant number of areas of common interest to both institutions, it was not until the late 1970s, as a result of the oil crisis, that there was an evident need for collaboration. It was made effective by extending medium- and long-term loans to non-oil producing developing countries, with the aim of preventing balance-of-payments crises and rapidly falling growth rates.

C. *Policy advice in the 1980s: implications of the debt crisis*

The 1980s may be characterized as the decade when collaboration between the IMF and the Bank passed from its formal to its effective stage, and the years when the debt crisis made coordination a necessity. It was also the period when the question of cross-conditionality surfaced. The decade started with a review of the collaboration understandings originated both by the deterioration of the economic environment and by the need to develop new tools to support adjustment policies in developing countries. On the one hand, as was indicated above, the IMF had reinforced its Extended Fund Facility and had begun to pay attention not only to aggregate demand, but also to the increase of productive resources. On the other, the Bank introduced in 1980 and reviewed in 1981 the system of Structural Adjustment Lending, whereby it started to realize that the macroeconomic policies to correct external disequilibria required short-term stabilization efforts associated closely with Fund programmes (World Bank, 1989, p. 15). From the perspective of both institutions, it was becoming evident that adjustment policies had to be focused both on the short-term stabilization and the long-term growth issues.

The communication from the Vice-President of the Bank to its staff, which resulted from the review on collaboration, illustrates the point. He argued that although the performance criteria of the Fund were normally limited to macroeconomic variables and those of the Bank to development priorities, it was also true that some of these areas impinged on each other: "Supply considerations and long-run development programs in such areas as energy are crucial determinants of eventual balance-of-payments adjustments. Conversely, budgetary management and taxation policy are important determinants of the availability of resources for recurrent investment expenditure". What is most interesting to point out is that despite the clear conceptualization of the economic issues linking stabilization and growth, the Vice-President of the Bank insisted on the independent role of the institutions when he immediately added that: "Despite such interrelationships, we believe there is ample scope for each institution to pursue its primary objective of assisting its member countries with the tools available to it" (Stern, 1980).

From 1984 to the end of the decade there were periodic reviews of the status of Fund-Bank collaboration. It has been referenced that as a result of the 1984 review, the scope of activities of the IMF, given its involvement in the Latin American debt crisis, was broadened. In the literature reviewed, it was also found that the Managing Director of the Fund affirmed clearly, perhaps for the first time, that "it was a misconception the view that the Fund was an institution focused on short-term stabilization" (World Bank, 1989). On the part of the Bank, it is also found that by 1985 it considered its role mixed with that of solving balance-of-payments problems. In a memorandum to the Executive Directors, the Bank's President, while discussing the situation of the highly indebted countries of Latin America and sub-Saharan Africa, indicated that "the sustainable resolution of their balance-of-payments problems is inextricably linked with the issue of resumption of growth"; adding that "this requires a coherent analysis of issues, complementation in the adjustment programs supported by Bank and Fund resources, and coordinated efforts to mobilize external financial support for the country's program of policy and institutional reform" (Dubey, 1985).

All these considerations signalled the need for coordination to become permanent and effective and for policy advice to be "Comprehensive and well integrated, going from minimalist collaboration - to avoid inconsistent policy advice - to a positive one of providing more effective and better support to growth and stability" (Dubey, 1985). As far as cooperation is concerned, this meant that besides the institutional and informational aspects, it was desirable to extend it in order to cover matters such as the mobilization of external resources to support programmes and the management of rescheduling exercises in indebted middle-income countries. As to advice, it became absolutely essential that it should be consistent, not only in terms of the adjustment policies suggested to individual developing countries, but also in the positions adopted by both institutions vis-à-vis the private banking committees that were set up to deal with the rescheduling exercises.

In 1986 the institutions issued a new and much publicized Memorandum on Fund-Bank Collaboration (IMF-World Bank, 1986). From reading its contents one is, however, struck by the fact that despite the significant turnaround in the underlying economic and external factors that had compelled the institutions to develop effective coordination in the first half of the 1980s, and despite a common view with regard to policies towards stabilization and structural reforms in debt-burdened countries, known as "The Washington Consensus", its presentation was again strictly formal and in the spirit of the original 1966 understanding. A possible interpretation is that the administrations of these two institutions, while they saw the need to collaborate (because of the areas of common interest) and had developed the means to do so and to inform the general public of the steps taken, were somehow at the same time afraid that their institutions could begin to lose their identities and influence. They were eager to stress the need to maintain separate institutions and to prevent the submission of one to the other by reaffirming each other's priority fields of action. A hypothesis of such a nature could find support when one considers that the adoption of adjustment policies had started to show the complementary aspects between short-term stabilization and growth in a period when, besides, the institutions were being criticised by developing countries on account of the cross-conditionality of their policies.

To finish the account of IMF-Bank collaboration at the end of the 1980s, it should be pointed out that a major step forward in coordination with regard to low-income countries was instituted in 1988 as a result of the adoption by the Fund of its ESAF (Enhanced Structural Adjustment Facility) and its almost indistinguishable nature from the Bank's Structural Adjustment Lending (SAL), and their obvious interrelationships in terms of policy advice and conditionality. To coordinate their actions, it was necessary to design a mechanism to agree on common policy advice. This was reached, according to the paper on Current Procedures and Practices (IMF, 1988), through the adoption of joint action in the design of Policy Framework Papers (PFP) approved by both institutions for adjustment in low-income developing countries, and by the establishment of either systematic parallel missions or joint participation of staffs in country missions.

The closer collaboration was, moreover, extended to all types of assistance to developing countries. In the 1989 account of the Status of Fund-Bank Collaboration in Assisting Member Countries (IMF, 1989), the idea that comes forth was the initiative to progress with a scheme of "enhanced collaboration", based on joint staff work, exchange of information, joint handling and discussion of the PFP of low-income countries, collaboration in adjustment programmes, the design of PFP-like documents for middle-income countries, agreement on the common interest in viable medium-term debt service profiles, and the quest for solidarity in respect of overdue obligations.

Such enhanced collaboration was undoubtedly motivated by the Argentinean con-

flict. As Polak (1993) reports, in 1988 the Bank extended a loan to Argentina "in conditions where it was known that the Fund considered the country's current and prospective policies inadequate to support a new stand-by agreement with the Fund", with the consequence that, in a few months, the Fund's view was confirmed when Argentina failed to adopt the fiscal policies promised. This situation moved the Group of Ten Ministers to demand the new and stricter Enhanced Collaboration Agreement referred to above.

The 1990 Progress Report on Bank-Fund Collaboration (IMF, 1990) basically shows that it had advanced well in all fields of action, except the establishment of PFPs for middle-income countries. Such an objective was established by the IMF and the Bank probably as a result of the Argentinean debacle and as an attempt to prevent future cases. The middle-income countries, according to Polak (1993), "successfully resisted suggestions that the Bank and Fund lending to them should also be coordinated through PFPs", a case in point being that of Colombia, which is discussed below.

D. *Political economy of collaboration and the cross-conditionality question*

To close the analysis for the 1980s, there are three major topics that remain to be discussed. In the first place, there is a political economy question regarding the positions taken with respect to IMF-Bank collaboration by the developing and developed countries, and their underlying "interests". Related to that is the issue of cross-conditionality. Finally, from a more substantive economic perspective is the topic of the interrelationships between short-term stabilization and growth objectives.

As to the political economy question, one may infer that the push towards more effective collaboration was, in fact, stimulated by the more developed countries, over and above the initiatives taken by the administration of the two institutions and against the prevailing views of the developing countries. Although the summary mentioned above indicated that the IMF and the Bank were interested in promoting collaboration, due both to economic judgement (the interrelationship between stabilization and growth), as well as self-interest (their exposure in debt-burdened countries would be at risk if economic adjustment was not successful), it is also true that many of the initiatives taken were due to external demands.

There were repeated requests by the Group of Ten to the administrations of the institutions urging stronger collaboration. In the Report of the Deputies of the Group of Ten on the Functioning of the International Monetary System, published in the mid-1980s (IMF, 1987a), it was explicitly established that they considered the IMF should play an essential role in the multilateral efforts to respond to external debt problems, but that coordination with the Bank was essential given the complementary nature of their functions: "In the case of developing countries these functions are complementary, since macroeconomic balance is a precondition for growth and development and over the longer run, project and sectoral efficiency and realistic investment priorities can be crucial to sustained balance-of-payments adjustment". Within such a framework they envisaged, however, that the strengthening of cooperation should not be in the direction of transforming the IMF into a channel of long-term finance or of shifting the Bank away from its focus on development finance. As mentioned above, the enhanced collaboration established in 1989 as a result of the Argentinean debacle was also a response to the requests of the G-10 at the Berlin conference. It is well known that the German Chair in the IMF has, since then, repeatedly argued that the Fund has been transformed into a channel of long-term finance, and stressed that it contravenes the Articles of its mandate.

The United States, specifically the Chairman of the Federal Reserve, Paul Volcker, was another major individual force in favour of stronger coordination. Among the many anecdotes that can be brought to mind of the key role played by the Fed Chairman in those days is that of the coordination forced upon the IMF and the Bank in order to address the case of Colombia's debt situation. The point at the time was that Colombia was not facing, and has never faced to the same degree, the typical balance-of-payments crisis and excess burden of external debt of other Latin American countries, but was lacking voluntary access to international capital markets. The IMF's intended approach was to force Colombia to a stand-by agreement that was not required. The Chairman's proposal and the eventual solution was that the Bank should provide longer-term resources. The Fund would play a catalytic role in monitoring the Colombian performance in order to allow the country to regain access to external private finance, so as to fund its coal and oil projects. In this connection, it is interesting to note that the IMF Board was then quite opposed to the idea of monitoring.

Upon the departure of the Fed Chairman the leading role was taken up by the United States Treasury, which proposed and developed longer-term solutions to the debt problem better known as the Baker and Brady Initiatives: the Baker Plan aimed at providing additional resources, not only from the IMF and the Bank, but from the commercial banking community. In the case of the Brady Initiative, both the Bank and the Fund were involved in lending to support debt reduction, a procedure which, despite its merits in solving the debt problem, was criticized from the institutional point of view, for the reason that it prolonged the involvement of the Fund with the developing countries, in contrast to its original mandate of temporary balance-of-payments support; and, furthermore, it placed both the Fund and the Bank in conflicting positions with the commercial banks (Feinberg and Gwin, 1992).

In contrast to the position taken by the G-10, the developing countries, led by the highly indebted Latin American countries, but with notable exceptions such as Colombia, were far less enthusiastic about IMF-Bank collaboration. Their overall view, as reflected in the G-24 communiqués and in their reports on the Functioning and Improvement of the International Monetary System (IMF, 1987b), was highly critical of the role played by the IMF and sceptical in respect of IMF-Bank coordination. They considered that the Compensatory Financing Facility had become very limited; that the conditionality criteria should change from demand deflation to growth-oriented structural adjustment; that the levels of financial support should be increased, as well as programme lengths; and that, to solve the diverse debt problems, it was indispensable to move to a more positive type of adjustment, consistent with sustained growth of output.

In terms of IMF-Bank collaboration, the G-24 visualized that it should be geared only to providing more resources for developing countries, but that it should not lead to cross-conditionality. From that perspective, they did not find it advisable even to seek uniformity in advice for fear of cross-conditionality, arguing that it would dilute responsibilities and become a means of exerting concerted pressure on borrowing countries. It was thus the G-24 that placed the issue of cross-conditionality at the forefront of the IMF-World Bank coordination debate.

In its strictest formal definition, cross-conditionality is said to exist when the conditionality imposed by one institution (IMF or Bank) on a specific borrowing country becomes a precondition for the disbursement of resources by the other institution. Additional examples of direct formal cross-conditionality include situations when either institution exercised a veto over a loan under consideration by the other, if there were formal understandings that neither would make a loan, or when ineligibility for Fund's resources interrupted access to the Bank (Feinberg, 1988).

Such a type of "formal" conditionality did not become a major threat to developing countries, among other reasons, because of the concerns expressed by the G-24. As explained above, as a result of the G-24 request, all the IMF-Bank collaboration agreements adopted since the mid-1980s specifically ruled out the adoption of cross-conditionality clauses. Perhaps the only aspect where formal cross-conditionality stood was in regard to arrears, given that both the Bank and the Fund agreed not to disburse loans if there were arrears pending with the other. This type of cross-conditionality is understandable, to the extent that pending arrears would hurt their balance-sheets and, besides, their joint action was their only way out to prevent the rescheduling of their own obligations.

Concerns for cross-conditionality by the G-24, however, were not limited to its straight formal definition. Indirect ways of exercising potential cross-conditionality were also subject to criticism. Particularly, as explained above, the G-24 objected to the principle of seeking uniformity of advice: its caution was based on the fact that, as a result of the IMF's monitoring agreements, cross-conditionality could be extended to third parties. It also criticized the Fund's programmes, not only on account of their being too restrictive, but also because they had begun to be introduced, almost invariably, as a first step to structural adjustment programmes and lending.

Other forms of indirect cross-conditionality also include what has been termed "consultative cross-conditionality", which represents the non-purely random parallel discussions of the Bank's structural and sectoral loans with IMF stand-bys; "interdependent cross-conditionality", which refers to the case when the Bank and the Fund each consider the same policy variable (i.e. a realistic exchange rate) as critical for their programmes; and "indirect financial linkage" when, for example, the withholding of Fund resources injures the outlook of the economy to a degree that prevents access to the resources of the other institution or from the commercial banks (Feinberg, 1988, pp. 554-556).

Another case is what could be called "substitute conditionality", which would occur

through the imposition of macroeconomic conditionality by the Bank upon a borrowing country when it did not have any financial linkages with the Fund. This occurred in the case of Colombia as a result of a Bank loan to reform the public sector, whereby a PFP-like document was proposed as a condition for disbursement by the Bank, and the Government rejected it with the argument that the short-term stabilization measures proposed were the realm of the IMF (Republica de Colombia, 1990). Similar cases could also be documented in Latin America for the various types of cross-conditionality discussed above.

As to the arguments of the G-24 against seeking uniformity in policy advice, the IMF and the Bank attempted to solve the problem, not always successfully, by maintaining in all the collaboration agreements discussed the distinction of priority areas, and by establishing that each institution would furnish advice only in the realm of its mandate. In like fashion, the question of policy advice would become, in theory, one of consistency rather than uniformity. However, the involvement of both institutions in structural adjustment, as well as in areas classified as of common interest, such as debt management, implied the need to pass from consistency to uniformity, when the conditionality implied the adoption of similar policy packages, as stated in the already mentioned "Washington Consensus". Even though the criticisms of uniform policy advice were also stressed at the academic level, by affirming that independent policy advice would allow more freedom for policy decisions in the countries involved, and by arguing that there were no clear best policy options (Commonwealth Secretariat, 1986), the costs of conflicting advice in terms of issues involved and reputation, although not explicitly quantified, were presumably considered by the IMF and the Bank as too high to take the risk.

In regard to mechanisms adopted by the IMF, such as monitoring and enhanced surveillance schemes, the G-24 argued that these could represent an undesirable indirect cross-conditionality to the extent that the disbursements of third parties (i.e. commercial banks) would depend on performance criteria established by the Fund. In such circumstances, the G-24 recommendation was to make "enhanced surveillance" an exception, to be undertaken only at the request of a member country, with the main objective of reaching early normalization of market relations with the international financial system (IMF, 1987b, p. 61). That was exactly what happened in the case of countries such as Colombia, and can be said to have been a means to overcome the reluctance of the commercial banks in the midst of the debt crisis to extend voluntary lending to developing countries with adequate economic performance, but located in regions with external debt crisis. The "enhanced surveillance" scheme represented a temporary solution for countries to regain access to the international capital markets.

The final and more substantial issue regarding IMF-Bank collaboration, and one which was also deemed a form of cross-conditionality by the G-24, was the practice developed in adjustment programmes, supported by the G-10, whereby there was a stabilization programme with the conditionality established by the Fund and with access to its resources, as a basis for the structural adjustments supported with Bank resources. As explained in this paper, such a practice evolved more as a result of adjustment lending to individual cases and the analysis of the interrelationships between short-term adjustment and growth, than as a cross-conditionality issue or an issue of political economy. Somehow, the evolving view then was that long-lasting successful stabilization required the "right" type of economic policies, which included not only the "appropriate" and traditional demand management policies, but also changing the economic model through structural and institutional reforms.

The argument in favour of such sequencing of reforms on the part of the Bank was, at the time, that the presence in any country of prolonged and significant imbalances, in the sense that the aggregate demand for resources available internally or obtainable from abroad on appropriate terms could not be satisfied, was inimical to long-term growth (Michalopoulos, 1987). It was recognized, though, that stabilization alone would not guarantee growth and that structural adjustment measures were needed. Further, these would be easier to adopt if they took place in a stable macroeconomic environment, especially one in which inflation was under control. From that point of view the Bank concluded that there were strong links between Bank programmes and Fund stabilization efforts. Such points of view were also shared by the Fund, which at the time was strongly arguing that there was a complementarity between stabilization and growth, and that the argument of short-term trade-offs was misconceived, given that the choice policy makers faced was between adjustment now versus harder adjustment later (Guitian, 1987). These views, as well as a vast literature published at the end of the 1980s, gave support to the opinion that there was, in fact, a positive interrelationship between short-term stabilization efforts and longer-term growth, a basic issue in the 1990s

for defining the future roles of the of the IMF and the Bank.

One may conclude from the analysis of IMF-Bank collaboration in the 1980s, that the decade marked a definite turning point in the requirements and practices of collaboration, something that has originated principally from the need to support the adjustment efforts of debt-burdened countries. Such collaboration was developed at the request of the G-10 and the direct participation of the United States Government. This was out of self-interest on the part of the management of the IMF and the Bank, as a means to safeguard the financial integrity of their institutions and based, above all, on the experience and the conviction that short-term stabilization and longer-term growth objectives were to a large extent complementary. The debt crisis and the type of collaboration developed to face it were by no means costless from the institutional viewpoint. One of the consequences of the strengthening of collaboration was the surge of cross-conditionality, both direct and indirect, so fiercely opposed by developing countries through the G-24. Of greater concern was the blurring of the distinctive characteristics of the Fund and the Bank, as both institutions engaged in medium-term structural adjustment lending.

E. Future outlook

From what we have discussed thus far, it becomes evident that despite the collaboration agreements and the efforts made to safeguard the distinctive roles of the IMF and the Bank according to their priority areas and their original mandates, the decade of the 1980s ended with a certain degree of institutional chaos. According to Feinberg and Gwin (1989), it had become impossible to maintain the old sharp distinction between short-term financial distress support and long-term development disequilibrium, given that both the Bank and the Fund had elaborated similar lending instruments that focused on similar policy issues. This led them to conclude that "the result has been a confusion of roles and contradictory advice".

In a recent analysis of the World Bank, Ranis (1993) arrived at a similar conclusion and blamed the Bank for intruding into IMF territory: "It has become increasingly difficult of late to tell the difference between the two institutions, with the Bank moving into macro issues and closely related macro-focused structural adjustment lending". A similar criticism could be raised with regard to the IMF, an institution designed primarily to ensure stable monetary relations among industrial countries, which has ended up lending exclusively to the developing world and, in any case, in commitments with maturities that go far beyond the temporary relief of balance-of-payments problems that was originally envisaged.

In such a context, it is not surprising to find a great deal of academic discussion regarding the reforms that ought to be introduced into the IMF and the Bank, with implications for the future of collaboration. There appear to be three major visions regarding the future of the IMF. There is in the first place, what could be called the "power" view of the IMF expressed by Kafka (1987), who considers that the Fund has lost influence over major countries, and that one should search for means to regain it. He suggests that the G-7 should give a greater role to the IMF in its discussions on world monetary matters; that major countries ought to be encouraged to borrow from the Fund, if necessary by replacing conditionality with collateral, or even by restricting free floating, and by preserving the monetary objectives of the institution. Given that such a view seeks to strengthen the IMF as an institution, he does not consider that the Fund "could be usefully merged to any other international financial institution". The IMF's role in the developing world is considered significant, not only due to its macroeconomic expertise, and its capacity to channel resources, even with longer-term maturities, but also due to its importance as a catalyst for other institutional lending. From that perspective coordination is seen as necessary, but with a clear IMF leading role.

A second approach to reform is that held by the developed nations and led by the G-10, which could be termed the "monetary" view of the IMF (Duisenberg and Szász, 1987). It refers to strengthening the monetary character of the Fund. It implies that the Fund should go back to its role of a monetary institution for bridging temporary balance-of-payments deficits by providing short-term credit, and not structure itself as a development institution. Such temporary balance-of-payments support is seen as quite limited and implies that conditionality has to focus on adjustment. Surveillance rather than finance would become a basic function of the Fund. In terms of relationship with the Bank, its coordination requirements would be reduced, given the elimination of overlap in longer-term lending and the IMF's limitation of policy advice to short-term stabilization policies.

The third view on reform is the one held by the developing countries and expressed in various G-24 reports and communiqués. It could be named as the "symmetry" viewpoint on the IMF, whereby the Fund should act in a similar fashion (i.e. Article IV reviews, advice, and conditionality) when dealing with similar problems either with the developed or the developing countries. It also stresses that conditionality criteria should be more oriented towards growth and that its policy advice should be independent of that of the World Bank.

What is most interesting to underline about the alternative views towards reforming the Fund discussed above, is that in all of them the issue of coordination with the Bank would be weakened or eliminated, though for very different reasons. It is only those proposals which maintain relatively unchanged the present activities of the IMF and the Bank in structural adjustment lending where the coordination issue remains. Two cases in point could be cited. Feinberg and Gwin (1989) in their proposal to reform the Fund establish a set of conditions to make it more effective (i.e. defining its role in global monetary management, lifting the debt overhang, improving economic performance, and helping to integrate the Eastern bloc into the global economy), most of which would require the enhancement of cooperation with the Bank. On the other hand, Polak (1993) does not consider either that overlapping credit activities should be eliminated, or that more determined efforts should be made to avoid duplicating staff activities. Neither does he find it appropriate that the two institutions merge, considering that the Bank is already too large and that there is merit in maintaining the IMF, given its role in the international monetary system. His solution is simply coexistence.

As to the proposals for reforming the Bank and their implications for IMF-Bank collaboration, there are two major papers which agree with Polak in identifying as a major stumbling block the multiplicity of roles assigned to it and the size that it has acquired. Ranis (1993) considers that the Bank has given too much emphasis to the quantity rather than the quality of its loans, and proposes to scale down the lending activity by suggesting that its efforts should be directed to playing a leading role in helping regional banks to channel resources, as well as facilitating the full integration of borrowing countries in the international economy and commercial bank lending. On the other hand, despite his agreement to retain SAL-type lending to facilitate reform for the remaining borrowing countries, he suggests that the Bank should leave short-term conditionality to the IMF and concentrate on longer-term policies and conditions. In the same vein, Naim (1994) argues that the Bank's mandate is too broad; that there is goal congestion and a need for a more focused role.

The proposals reviewed, however, do not solve conceptually in a satisfactory manner the major common challenge actually facing the IMF and the Bank, namely the way to deal, simultaneously, with short-term stabilization and longer-term adjustment without either running the risk of inconsistent policy advice, or some form of cross-conditionality. All the proposals for reform maintain explicitly or implicitly the institutional priority areas. Those advancing the more radical changes tend simply to suggest that the IMF and the Bank should gradually return to their original roles.

An alternative solution, which has not been suggested and analysed in the literature, would be that of transferring completely to the Bank the responsibility for policy advice; and also for short-term balance-of-payments support and macroeconomic policy conditionality in those countries that also require significant longer-term development finance from the Bank (i.e. small and medium developing countries with severe balance-of-payments disequilibria that depend highly on longer-term bank resources for development purposes, and which have little or no access to the international capital market). Such a scheme would have, it must be recognized, prospective costs, such as adding responsibilities to an overburdened institution and diluting those of the IMF (i.e. its surveillance function), but they seem small against the benefits of eliminating the need to exercise very complex institutional coordination and preventing cross-conditionality, which, according to the survey presented in this paper, are very significant.

The major backing for such a scheme would lie, moreover, in the complementary character of stabilization and longer-term growth policies. As has been explained in this paper, such a supportive character was suggested almost from the creation of the Bretton Woods institutions, and argued by both the IMF and the Bank as one of the basic considerations for the need to enforce coordination agreements, but it can be equally argued as a favourable factor for the delegation of both functions to only one of the institutions. Furthermore, the experience with adjustment policies in developing countries in the 1980s has indicated a large degree of correlation between IMF balance-of-payments support and the Bank's structural adjustment lending.

Despite the establishment of a "Washington Consensus" and the various papers written on such a complementary character, it has not been until very recently that economists have begun to debate the matter on empirical and theoretical grounds. The recent paper of Fischer (1993) on the role of macroeconomic factors in growth is a prime example. He presents the results of cross-section and panel regressions which show that growth is negatively associated with inflation, large budget deficits and distorted foreign exchange markets, as well as supplementary evidence suggesting that there is a causal link between macroeconomic stabilization policies and growth. He concludes that macroeconomic stability is conducive to sustained growth. By delegating to the Bank both policy advice and financial support in stabilization and development policies, the original mandate of the Bank with regard to stimulating longer-term growth in developing countries would be left intact, given that short-term stabilization policies would be an essential step in the longer-term growth strategy.

An institutional arrangement such as the one suggested above, which implies delegating completely to the Bank the policy advice and support of stabilization and longer-term structural lending exclusively for those developing countries that require simultaneously resources for short-term balance-of-payments support as well as longer-term development finance, would have the additional benefit of allowing the IMF to concentrate on its monetary character, to abandon its ESAF-type lending, and instead, to extend loans for balance-of-payments purposes for the remaining (i.e. not covered by the Bank) developing and developed countries. The mechanism would also be consistent with G-24 views regarding less demand-oriented balance-of-payments adjustment policies, given that the Bank would have to look simultaneously to the stabilization and growth objectives. From the operational point of view, the IMF would delegate its responsibility for policy advice and financial support to the Bank once Article IV reviews confirmed the existence of severe balance-of-payments disequilibria in developing countries that receive and require significant long-term development resources from the Bank.

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VI. GOVERNANCE ISSUES WITHIN THE IMF AND THE WORLD BANK

12

FROM SUPPLICANTS TO SHAREHOLDERS: DEVELOPING COUNTRIES AND THE WORLD BANK

*Moises Naim**

A. Introduction

Complaints about the lack of influence that developing countries have on the World Bank are as old as the Bank itself. Over the years, the substance of the complaints varied and their stridency waxed and waned according to the ideological and geo-political fluctuations of the times. However, the central, disappointed message, did not vary. From the insufficiency of funds available to support development to the excessively harsh conditions attached to the loans or to the inattention given by the Bank's staff to local specificities, ministers representing developing countries have consistently denounced these problems and stressed their frustration at not having a stronger, more influential voice in the Bank.

The explanation for their limited influence has frequently been couched in terms of the control that the richer shareholders of the Bank - the industrialized countries and especially the members of the so-called Group of Seven or G-7 - have over the Bank.[1] Indeed, the largest shareholders, which are also the countries that provide much of the financial backing for the Bank, do have a substantial amount of influence over the Bank's behaviour. None the less, explaining the role that the non-industrialized - or borrowing - shareholders play in the Bank, mostly as the result of the exclusionary and narrowly self-interested tactics of the G-7, ignores a richer and more complex reality. In fact, there are many examples in which the actions of the industrialized shareholders had little to do with the limited impact that borrowing countries have had on the Bank.

In the following pages we examine some of the factors that shape the adoption and execution of the policies of the World Bank. In particular, we discuss the goal-setting mechanisms of the Bank, its governance system and the organizational culture - the unwritten values, rules and habits - that guide much of its internal functioning. Throughout the discussion, special attention is given to the influence of developing countries. As a case study we use the Development Committee, a ministerial group of 24 Governors of the Bank that, since 1974, meets twice a year to discuss matters relating to the Bank; the study illustrates some of the policies and attitudes that over the years have guided developing countries in their role as shareholders of the Bank. We conclude by highlighting some of the implications of the analysis in terms of actions aimed

* This chapter is based on the essay "The World Bank: Its Role, Governance and Organizational Culture" which I prepared for the Committee on the Future of the Bretton Woods Institutions, April 1994. It draws on my experience as a minister in Venezuela at a time in which major structural adjustment loans were negotiated with the World Bank and, later, as an Executive Director at the Bank. It is also based on extensive interviews conducted with a number of individuals, both outside and inside the Bank, who contributed generously with their time and ideas. Previous drafts of the essay provoked numerous reactions that helped to correct facts and clarify arguments. My thanks to all of them, especially Mort Abramowitz, Tom Carothers, Domingo Cavallo, Armeane Choksi, Uri Dadush, Sebastian Edwards, Judith Evans, Mary Jo Griesgraber, Ricardo Hausmann, Jerry Helleiner, Eveline Herfkens, Shahid Husein, Enrique Iglesias, Devesh Kapur, Robert Klitgaard, Peter Mountfield, Joan Nelson, Lew Preston, Jeffrey Sachs, Alex Shakow, Ibrahim Shihata, Ernie Stern, Strobe Talbott, Joseph Tulchin and the several members of the staff of the Bank and different government agencies whose ideas I used, but who preferred to remain anonymous. Obviously, all remaining errors of fact or interpretation are solely mine.

1 The seven countries that form the G-7 are Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

at strengthening the Bank and the role played by developing countries in its governance.

B. The role of the bank: four models

The purposes of the World Bank are constantly reiterated in official documents. None the less, the expectations and the behaviour of the different groups with influence over its policies frequently tend to reflect very different assumptions about these fundamental purposes. There are significant differences among the governments that "own" the Bank. Top managers and the staff of the institution have different views about the core purpose of the organization and, needless to say, public opinion is also divided.

The lack of consensus about the Bank's basic mission, limitations in its governance system and other conditions, have led to a proliferation of goals, which in turn has had important organizational repercussions. Furthermore, the size, complexity and relative independence of the Bank create a substantial margin for inconsistencies between its environment, its strategy and its organization.

Usually, competitive pressures do not leave decision makers much choice but to adapt goals and strategies to changes in the international environment and to make the internal adjustments needed to support the new strategy. But without intense competition, or other external challenges, organizations like the Bank - large, complex, relatively autonomous, and with a significant capacity to influence its environment - can postpone, or even avoid, the difficult decisions required to minimize incongruities between strategy and internal organization. They can often afford the added costs and inefficiencies that result from the ineffectiveness of an internal structure whose objectives and policies do not respond adequately to new external threats and opportunities. Furthermore, in large organizations, the structure, operating procedures and systems, internal culture, behavioural inertia and similar factors, end up shaping the strategy and not vice versa. Therefore, while the World Bank will certainly have to adjust its policies and operations to new challenges and changes in its external environment, its internal structure will significantly constrain the range of strategies it can seriously consider or effectively implement.

The lack of consensus about the specific role of the World Bank (and how it should be translated into an operational mission, measurable objectives and policies) has burdened the institution for years. Differences of opinion about the fundamental role of the Bank go beyond the fact that some shareholding countries borrow from the Bank while others provide the funds.

While there are many expectations and definitions of the fundamental role of the Bank, four different models or perspectives are the most common. The first is the view that the World Bank is a financial intermediary, the "Bank-as-a-bank" model. A second perspective - or model - views the Bank as an instrument for the countries that dominate its decisions and policies to exert their influence. This is the "Bank-as-a-rich-country-instrument" model. The third model is the view of the "Bank-as-an-evangelical-agent", bent on changing the behaviour of governments in developing countries. The fourth is the view that the World Bank is a mechanism to transfer financial resources from richer to poorer countries. This is the "Bank-as-a-transfer-agent" model.

From the "Bank-as-a-bank" perspective the role of the World Bank is, quite simply, to be a bank. It follows that maintaining the institution's long-term financial integrity is a crucial purpose on which all other goals depend. The second model views the Bank as an instrument for the countries with more influence on its decisions to advance their national interests. Such interests are expressed in their policies towards other countries, in procurement goals for their companies in projects financed by the Bank, or even in expanding employment opportunities at the Bank for their nationals.

There is a growing constituency favouring the evangelical model. In this view, the Bank's combination of money, access, knowledge and expertise is a powerful instrument to convert the souls of governments implementing misguided public policies. This is, in fact, a more concrete manifestation of the expectation that the Bank's main role is to support a liberal, or market-based, economic system as expressed in the promotion of liberal trade and investment regimes. Another version of this approach sees the Bank as an instrument for the promotion of values not readily accepted by the traditional power structures within developing countries. Increasing investment in, and attention to, women, environmental protection and better governance in terms of respect for human rights, as well as accountability and transparency in government decisions, are prime examples of the sort of objectives that flow from this perspective on the Bank's role.

Still others maintain that the advisory and *"imprimatur"* roles of the Bank will grow

even faster in the future, as economic and institutional constraints will increasingly limit its role to act as a financial intermediary. The argument is that the Bank's accumulated developmental expertise and its capacity to generate and disseminate policy-relevant knowledge have been gradually replacing its financial resources as its main assets. As donor countries face increasing fiscal constraints and aid budgets cannot cope with mounting demands, the Bank's capital will not grow as fast as the needs of the borrowers. This trend will presumably accelerate in the future, pushing the Bank towards its knowledge-intermediary, research-centre, consulting-company role.

Finally, the fourth widely held view is that the Bank exists to transfer resources to poor countries. It is impossible, according to this view, for an institution that has the promotion of development at the core of its *raison d'être* , not to have the supply of capital to developing countries as it's basic function. The assumptions and policy implications of this model underlie many of the attitudes and official positions of developing countries towards the Bank. This is also the model underlying the creation and the general orientation of the Development Committee. This is reflected in the official name of this Committee: the *Joint Ministerial Committee of the Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries.* This perspective stands in sharp contrast to the first model, which takes the view that the Bank is a financial intermediary.

The view that the Bank is, first and foremost, a bank, leads naturally to the assumption that it is an institution with fiduciary responsibility to its depositors and that it has to administer its loan portfolio accordingly. The Bank raises funds in the capital markets at premium interest rates, thanks to the guarantees provided by its shareholding governments and the government guarantees it secures for the loans it makes. It then lends these funds to developing countries at interest rates lower than those they would normally secure on their own.

But for those that assume that the main role of the Bank is to transfer badly needed resources to poor countries, having its essential purpose defined as that of a financial intermediary, is confusing means and ends. For the resource-transfer model, development is the objective and finance the instrument. Therefore, it assumes that the Bank is a developmental institution first and a financial intermediary second. The "Bank-as-a-bank" perspective responds that while this may be true, in practice, if the capacity of the Bank to raise cheaper funds from international financial markets is impaired, money for all the other developmental objectives will be less readily available.

The resource-transfer perspective counters by stressing the need for the industrialized countries to do more for developing countries. In its more extreme formulation, the resource-transfer model of the Bank leads to a view that expects the institution to resemble more a fund that has to be periodically replenished by its richer shareholder-donors, than a bank. This is in fact the role played by the Bank's concessionary credit arm, the International Development Association (IDA), which instead of loans gives "credits" to the poorest countries (defined as those with per capita incomes of less than approximately $1,200 per year), charging only a small "service fee" but no interest. But IDA's geographical and financial scope is, according to the resource-transfer perspective, too narrow. It argues that more money to more countries should be transferred to the developing world in order to overcome the immense obstacles it faces. In recent years this resource-transfer role has been declining. The Bank's net disbursements have tended to decrease substantially and, in some developing regions, the Bank often extracts more funds than it provides. The negative net transfers of the Bank to the developing world have thus become the focal point of most of the speeches of the Governors of the Bank representing borrowing countries at their annual meetings.

But for those assuming that the World Bank is a bank, negative transfers should not be a cause of alarm. As one Bank official puts it:

> I think it perfectly normal that, after a period of strong growth, the Bank has now reached a period of maturity. The Bank's exposure cannot be increased without significant dangers for the rating of the institution by financial markets. It would be dangerous to define any net transfer target, since it would mean that the bank would constantly increase its exposure and, in practice, refinance its own interest charges. I would insist on strengthening the balance sheet, both on the asset side, improving the quality of the portfolio, and on the liability side, building a stronger capital base through larger provisions for losses and more reserves.

Widely differing assumptions about the basic role of the World Bank not only engender very different visions about its goals and policies. The standards by which the organization's performance is to be judged and proposals for the changes needed to respond to new problems, also depend very much on the assump-

tions about the Bank's role. The quality of the Bank's loan portfolio, for example, should not have top priority if the main operational goal is to approve as many loans per year as possible, and get the funds out to client countries as quickly as possible. This is the "Bank-as-a-transfer-agent" model. If, instead, maintaining a top credit rating for the Bank by financial markets is seen as a condition without which its other developmental objectives cannot be achieved - the "Bank-as-a-bank" model - then the quality of the loans becomes a central objective. Under this perspective, transferring resources to clients should not take precedence over the quality of the loan portfolio. Some also argue that these two objectives need not be mutually exclusive and that the quality of the portfolio can be interpreted simply as an operational constraint on the goal of maximizing the resources transferred to borrowing countries. But part of the difficulty in the debate over the Bank's role is that what for some are objectives, for others are means to achieve other, higher order goals. For some, transferring resources is the goal. For others, alleviating poverty is the goal and transferring resources - including knowledge - is a means towards the objective of reducing poverty.

Lending to the countries of Eastern Europe and the former Soviet Union provides a very illustrative example of the practical repercussions of the lack of consensus over the Bank's role. The World Bank has been publicly criticized (together with the IMF) by some governments in the G-7 for not reacting quickly enough to the needs and the emergencies of these new clients. This accusation is valid for those that think the Bank's role is to transfer resources to its clients. It is not valid, however, for those that think the Bank is a bank, as some G-7 governments have often stated. This is also an example cited by those that hold the view that the Bank is simply an instrument to advance the interests of its more influential shareholders. From this perspective, even the adoption of the different perspectives about the fundamental role of the Bank by the more powerful shareholders responds to their circumstantial interests and, therefore, changes through time. Proponents of this perspective refer, as an example, to the fact that the same countries that were urging caution and restraint in the Bank's actions during the debt crisis, citing the need not to imperil the Bank's financial integrity, had no qualms in holding these sound financial principles in abeyance when pressing the Bank to take immediate and massive action to aid the former Soviet Union.

The consequences of the lack of consensus among its owners about the fundamental role of the World Bank have become more visible in recent years as a result of changing international circumstances, notably the end of the cold war. But different views about the basic function of the Bank have shaped its evolution since its inception and will probably continue to coexist in the foreseeable future. Development is a multifaceted process and the shareholders of the Bank are political actors subject to - often conflicting - pressures. This obviously limits the Bank's capacity to focus its efforts. As a senior Bank official put it:

> These different views are held by the same sets of shareholders; and indeed, often by the same shareholder. Which view predominates depends on the subject and time. An institution that gets such diverse and variable guidance as a steady diet will have problems in focusing on fewer objectives far greater than those created by internal constraints.

C. *The purpose of the World Bank: from mission ambiguity to goal congestion*

Growing needs and external expectations, rapid changes in its environment and a governance structure that inhibits a more sharply focused strategic agenda, have naturally led to mission ambiguity and goal congestion.

As constantly emphasized by the Bank's official statements, poverty reduction is the fundamental purpose of the institution. But the very different ways through which this goal was pursued over the years, the growing diversification of the Bank's operational priorities and the highly political nature of the agenda-setting process, have eroded the usefulness of poverty alleviation as the anchor providing a solid grounding against the strong pressures for diversification. As a result, while knowing that poverty alleviation is the official line, Bank staff hold as diverse views as those outside the institution on what in reality the Bank's mission is, and ought to be.

"Poverty reduction" replaced "development" as the overarching goal of the World Bank to refute the notion that the unequal growth often implied by development was acceptable. Economic growth was too reductionistic as a mission and "growth-with-equity" too cumbersome to use as a rallying cry. "Sustainable development" was soon replaced by "poverty alleviation" but both became politically incorrect as they seemed to suggest that the aim was only to buffer the impact of poverty. "Poverty elimination" was too

overwhelming a mission and not really credible. Thus, for the time being, "poverty reduction" is the official line, even though it does not capture the fact that the Bank's primary objective in many countries, e.g. the former Soviet Union, the Republic of Korea or Thailand, is not poverty reduction.

The Bank's charter, drafted in 1944 and called "Articles of Agreement", defines five purposes for the institution, but does little to clarify the goals. Three of the purposes mentioned in the Articles provide some general strategic direction and two give a more operational orientation. The three strategic purposes of the Bank are (a) to help member states to reconstruct and develop by facilitating capital investment; (b) to promote foreign private investment and (c) to promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments. This should be achieved by encouraging international investment aimed at mobilizing domestic resources and thus "raising productivity, the standard of living and conditions of labour". The other two, more operational, mandates in the Articles of Agreement emphasize the need to coordinate with other lending agencies and the need "to conduct its operations with due regard to the effect of international investments on business conditions".

These purposes have been interpreted in a variety of ways in the last half century. In his writings, even the Vice-President and General Counsel of the Bank wonders how, in this changing environment, the Bank managed to avoid having to modify its constituent charter in any significant way. His explanation is that, "... this is in large part due to the broad scope of the Articles of Agreement and the extensive power of the Board of Directors to interpret these articles" (Shihata, 1991, p. 14).

After its role in postwar reconstruction, the Bank concentrated on financing infrastructure in developing countries. It eventually became a major source of financial and technical assistance for the newly formed governments of the former colonies that gained independence in the 1950s and 1960s. In the early 1970s, poverty, rural development, support for agriculture and concerns about population issues gained a significant prominence in the Bank's agenda.[2] In the 1970s the financing of industrial development - often through state-owned enterprises -intensified. The debt crisis propelled the IMF and the Bank onto centre stage and gave rise to policy-based lending: loans disbursed in exchange for policy reforms aimed at correcting macroeconomic imbalances and boosting the productivity of the economy through structural reforms. The last decade of this century finds the Bank with a growing consensus about its developmental doctrine - the "market-friendly" approach - and with the challenge of figuring out how to deliver on the environmental front and how to minimize the costs of the transition of the former centrally-planned economies. In 1992, the Bank's region-oriented organizational structure was complemented by the creation of three new goal-oriented vice-presidencies, dealing with the environment, development of the private sector and poverty and human resources (health, education etc.).

Throughout this evolution, the Bank never shed its previous goals as it adopted new ones. This created a "sedimentary" approach to goal formulation that clearly contributes to its congestion. New goals were adopted not only as a result of the Bank's own propensity to grow and diversify. Pressing needs were certainly there and few other institutions have been available to respond to such needs. In other cases, existing institutions were perceived as inadequate. For example, widespread disappointment with the performance of other agencies of the United Nations system increased the pressures on the Bank to intervene, and more happily than grudgingly the Bank often obliged. As the institutional decay of UNESCO intensified and donor frustration about their lack of control over it increased, the Bank boosted its efforts at assisting countries in education and science. In the areas of health, child nutrition, population, industrial development, trade policy, agriculture, technical assistance and, more recently, the environment, the Bank's expansion was often justified by the need to "complement" the efforts of UNICEF, UNFPA, UNCTAD, UNIDO, FAO, UNDP or UNEP.[3]

Goal congestion at the Bank was also intensified by the growing influence of legislatures in donor countries which, in turn, have become much more sensitive to the pressures of non-governmental organizations (NGOs) than 10 or 20 years ago. The explicit incorporation of the environment or the role of women in development into the Bank's agenda and the growing concern in the Bank's operations for issues like human rights, military expenditures, the quality of governance in borrowing coun-

2 Rural development, for example, was officially adopted as a central priority for the Bank at the shareholders' annual meeting in Nairobi in 1973.

3 The performance problems of multilateral regional banks also played a similar role in justifying the Bank's expansion in a given region (Culpeper, 1993).

tries, democracy, corruption and the like, owes itself in no small measure to the active role of NGOs and their congresses (Nelson and Eglinton, 1993).

Practical realities are also shaping the Bank's agenda. As countries privatize most of their state-owned firms, some clients are inevitably lost. In the past, Bank loans were often used to establish or expand these companies. So, paradoxically, while the Bank could provide funds to a country to upgrade an electricity company, the Bank cannot lend directly to it once the company is privatized because it does not have a sovereign guarantee. The International Finance Corporation (IFC), the subsidiary of the Bank that invests and lends to the private sector in developing countries, does not have the capital base to cover the huge needs in private infrastructure investments that are being faced by these countries.

Another important reality that is bound to shape the Bank's agenda is the growing integration of capital markets and the increasing capacity of successfully reforming countries to access these markets directly. Countries that have been successful in stabilizing their economies and achieving a substantial degree of political and institutional stability can now secure through the international capital markets the funding for projects that in the past could only be financed through the World Bank. Developing countries perceived as good risks will increasingly be able to obtain funds from international capital markets under conditions that are competitive with those offered by the Bank. This, of course, means that the Bank's portfolio will be increasingly concentrated in the more unstable and, therefore, more risky countries or projects.

Again, some may regard this as a very positive evolution and as proof of the Bank's effectiveness, while others will worry that in the long or even the medium run this trend could impair the capacity of the Bank to operate.

D. *The Bank's governance system: from constructive gridlock to dysfunctional stalemate*

One of the reasons for the Bank's accumulation of goals is that its governance system is not very good at sorting out priorities, at least formally. Once an objective is incorporated in the Bank's agenda, it becomes almost impossible to delete it from the list. Political factors, organizational inertia and the way strategic decision-making is formally organized make it very difficult explicitly to exclude an item from the Bank's priorities. One of the more insidious effects of this goal-overload is that it impacts more negatively on the weaker countries. Countries with little bargaining power have to accept the conditions and objectives that, in a given period, acquire great visibility and priority within the Bank. Instead, stronger countries can - and often do - manage to persuade the Bank to be more lax on conditions that are not central to the loan being negotiated.

It is practically impossible to incorporate into all the operations the complete set of priorities that may form part of the Bank agenda at a given time. These priorities also vary through time, and it is politically difficult to announce formally that the Bank is dropping one of its priorities. Thus, the solution has been to reduce their importance tacitly. When this happens, budgets assigned to these objectives stagnate or shrink, the frequency with which they are expressed in actual operations declines, visibility and the internal status of the staff working on them decrease and, in general, the staff becomes rapidly aware that these are not the issues on which successful careers are built. While this mechanism lacks transparency, over the years it has served the purpose of containing what otherwise would be an even more confusing and wasteful accumulation of goals.

In many aspects the governance system of the Bank has worked well. Even its more scathing critics recognize that the Bank has been able to avoid some of the profound governance and management problems that plague other multilateral organizations. The Bank's reaction to the debt crisis, to the need for a more balanced use of markets and the State in development, to the need for more effective protection of the environment, or to the challenges posed by the transition of the former communist countries, are, for many objective observers, the most effective responses possible under the prevailing circumstances. To others these are misguided policies that actually harm borrowers, fleece donors, or even combine both effects. Still, most of these critics accept that the Bank's accumulation of technical capacity on issues relevant to developing countries is one of the best in the world, if not the best.

While political considerations often shape the Bank's decisions, technical considerations and objective criteria also play a major role in the decision-making process. In fact, it is not rare for political pressures to be deflected by technical arguments. The promotion of staff, especially at the higher levels, is certainly influenced by the political dynamics typical of all

large organizations. But the Bank has been able to avoid the blatant patronage and politically motivated recruitment that are often found in quasi-public bureaucracies. Careers advanced on the Bank's internal merit system continue to be the norm and those based on the influence of shareholders the exception.

Balancing the political nature of the institution with a strong technical orientation was, after all, one of the main objectives of the drafters of the Bank's charter. The design of its governance system reflects the attempt to isolate as much as possible the Bank's operations from the interference of shareholders. These are represented by the Board of Governors, composed of cabinet members or governors of central banks of the shareholding governments. While all the powers of the Bank are vested in the Board of Governors, most of them are delegated to the Board of Executive Directors. The only decisions that, according to the Articles of Agreement, are not delegated to the Board are: the admission of new members or the suspension of a current member, the increase or decrease in the Bank's capital, the establishment of permanent arrangements of a non-administrative nature with other international organizations, the allocation of the Bank's net income (profit), and the termination of the Bank. As already noted, any question of interpretation of the provisions of the Articles has to be submitted to the Executive Directors for their decision.

The Articles of the Bank also provide for an Advisory Council (Article V, section 6). The Advisory Council met twice and then fell into disuse despite the Article's admonition that it "meet annually". Another advisory body is the Development Committee. Originally, it was envisioned to be, if not a counterpart, at least a parallel body to the Interim Committee of the Governors of the IMF. While the IMF committee issues a communiqué that in its earlier stages has had some important repercussions on international financial markets, the statements of the Development Committee have rarely provided more than general expressions of concern about the conditions of poor countries and vague exhortations about the actions needed to improve such conditions. It would be very hard to argue that the Development Committee really provides any concrete guidance or has any significant influence in shaping the Bank's operations or that its meetings are much more than a wasteful ritual. Below, we return to the Development Committee in the context of the discussion of the attitudes of developing countries vis-à-vis the Bank.

In any case, the drafters did envision that ministers acting as Bank governors would have to rely on their envoys at the Board for overseeing the Bank's functioning. The drafters probably envisioned a board with more influence than it has had in practice over the years. In fact, the first President of the Bank, Eugene Meyer, resigned a few months after his appointment over what was, in his judgement, the excessive interference of the Board. One of the most polemic provisions in the Articles of Agreement is that,

> The Executive Directors shall function in continuous session at the principal office of the Bank and shall meet as often as the business of the Bank may require.

This can be interpreted merely as an organizational arrangement. But it really was an attempt to resolve a major political dilemma: how to make the organization accountable to its shareholders, while at the same time protecting its operations from their undue political interference. The answer was to internalize the political body in charge of overseeing the institution. A board with almost all the powers in the institution, but without operational responsibilities and composed of full-time political appointees of the shareholders, certainly appears to be a legitimate oversight mechanism. At the same time, however, the Executive Directors were made, for all practical purposes, employees of the Bank. They worked there full time and their salaries and other employment conditions were those of the Bank and not those of the governments they represented. It was hoped that under such an arrangement, the Executive Directors would become "part" of the institution and therefore would behave less like ambassadors representing the interests of their country and more like trustees with the long-term interest of the Bank as the value guiding their decisions.

While many other factors contributed to endow the Bank with a significant degree of relative autonomy, this arrangement clearly helped. The full-time Board provided a buffer from unwarranted external political influences and allowed internal merit criteria and objective technical standards to flourish and become well embedded in the culture of the organization. This orientation was also supported by the Articles:

> Only economic considerations shall be relevant [in the Bank's] decisions, and these considerations shall be weighed impartially in order to achieve the [Bank's] purposes.

The actual influence of the Board varied over time. From the personality of the President of the Bank (who is also the Chairman of the Board) to geo-political and international

economic conditions, many different elements defined the power that the Board wielded in practice. However, in the second half of the Bank's existence, the influence of the Board has been waning, while the power and independence of the President and the administration has increased. Many factors account for this decline in the actual power of the Board.

1. Size

From 1944 to 1994 the Board doubled in size (from 12 to 24 Executive Directors) as a result of the World Bank becoming a truly global institution (its member countries grew from 44 to 176 in 1993). This increase in size made directors a more heterogeneous group, thus making their integration and cohesion more difficult.

2. High turnover

Directors are appointed for a two-year renewable period. In practice, the average tenure has been around three years, but the majority (65 per cent) leave before three years. Obviously, some directors, especially those representing only one country tend to stay for much longer periods.[4] Even though the number of the members of the Board has increased, the number of directors representing a large number of countries has also increased as more countries joined the Bank (the Executive Director of one of the African chairs, for example, represents 25 countries). This has meant an increase in turnover, as countries are eagerly awaiting their turn in the rotation in their group to appoint one of their nationals to the Board. Thus, reappointments after the first two-year term is completed are decreasing in frequency. The acceleration of political change in both borrowing and non-borrowing countries has also contributed to a more frequent replacement of Executive Directors, even though, formally, once appointed they cannot be removed by their authorities until the two year period is completed.

3. Complexity

While the tenure of the directors is short and decreasing, the operations they have to oversee are increasingly complex. The volume and complexity of the Bank's work make it very difficult for the directors to be well-informed and participate effectively in all the discussions over Bank policies and decisions. Even though the support staff (alternate directors, advisors, assistants, secretaries, etc.) of the Executive Directors has expanded substantially, and some directors receive additional support from public agencies in their capitals, the volume and the intricacy of the work has expanded even more. In the two or three years that most directors stay at the Bank, it is impossible, even for the few that have a good prior understanding of the institution, to master the overwhelming array of complex issues on which they are supposed to develop an independent opinion. This problem is even more acute in the case of Executive Directors from developing countries. Not only do they lack the technical support in their capitals that some of their counterparts from developed countries have, but very often they only have a very superficial experience of the Bank and only cursory information about its functioning. Many spend their two years at the Board learning the fundamentals of the Bank and cannot, therefore, play any influential role.

4. The functioning of the Board

The procedures guiding the functioning of the Board are woefully outdated and, in fact, reduce its influence by making it inefficient and often irrelevant. The difficulty that the Board has traditionally exhibited in modernizing its ways and means and increasing its relevance is an excellent example of the decision-paralysis that plagues its operation. In essence, Executive Directors spend their time at Board meetings (twice a week the entire morning and often the entire day), being briefed by staff, in committee meetings, receiving delegations from their constituent countries or reading the materials for the next meeting. It took almost two years of prodding and debate before the Board reluctantly agreed - in 1992 - to reform some of its procedures, streamline its functioning and increase the policy-relevance of its discussions. While these changes implied significant progress in comparison to the previous situation, they still fell very short of the more drastic revamping needed to adjust the Board to the circumstances faced by the Bank.

From this perspective it is even easier to understand why, in an institution with a Board

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[4] From 1970 to 1994 the Bank has had 121 Executive Directors. Directors representing borrowing countries rotate on average every three years, while those from non-borrowing countries stay on average slightly less than four years. (Data compiled by the author.)

that has such difficulty deciding how to modernize the way it operates, decisions that focus more sharply the Bank's priorities would be close to miraculous.

5. *A divided Board*

It is not clear to what extent the directors were able, in the early stages of the Bank, to tilt the balance of their dual loyalty towards the Bank and avoid the interference of circumstantial interests of their countries with the Bank's long-term health. It is, instead, very clear that in the latter stages this balance shifted towards the more "ambassadorial" model of behaviour. Directors receive explicit instructions from their capitals, and actively lobby for the appointment of their fellow nationals to top management positions or for easing the conditionality on a loan to one of the borrowing countries in their constituency.

While the East-West divide somewhat influenced alignments in the Board, the most important cleavage was - and is - between directors representing borrowing and non-borrowing countries. Given that non-borrowing countries are the majority owners of the Bank, their policy preferences are determinant and tend to be communicated directly to the staff or interpreted in advance by it. For many fundamental policy issues, this shifts the arena for decision making - or at least for the building of sufficient agreement - out of the board room and into the offices of the largest shareholders, notably to those of the neighbouring United States Treasury. The G-7 summits or the series of meetings of representatives of donor countries (IDA's deputies) that centre around the replenishment of IDA's funds, often have much more impact over the Bank's policies and priorities than an entire year of Board meetings.

The debates that do take place in the Board often tend to be divided along a predictable line between what in the Bank's jargon are called part 1 (non-borrower) and part 2 (borrower) countries. This trend has created an internal culture in the Board where Executive Directors representing borrowing countries almost never criticize or, even less, oppose a loan, regardless of how poor the project may be. On the other hand, some part 1 directors, attempting to compensate, occasionally overstep their remit, creating time-consuming discussions that rarely result in major modifications of the project.

With the incorporation of the former communist countries into the Bank, the number of directors representing "mixed constituencies" with both borrowing and non-borrowing countries, has also increased. Together with the eventual consolidation of European integration and other such groupings elsewhere, it is likely that the traditional coalitions within the Board will be replaced by new ones. The likelihood of a less divided Board, however, is very small.

6. *The quality of the Board*

It is never easy to have an objective assessment of the overall quality of a human group, other than those related to its measurable performance. Given that the Board has no formal responsibility for concrete results, its performance is impossible to evaluate objectively. None the less, the generalized, and admittedly subjective, anecdotal and perhaps even uninformed perception among observers is that the calibre of the Board has tended to decline. While this may well be an unfounded and slanderous evaluation, the fact is that there are many factors negatively affecting the recruitment patterns of Executive Directors. First, the status of Executive Directors has declined, perhaps as a result of the increasing perception of the Board as a rubber-stamping, powerless and inefficient body. Second, the position of the Bank - or IMF - Executive Director has been increasingly "captured" by the bureaucracies of shareholding governments. In the developed countries, the post has tended to be incorporated - explicitly or implicitly - in the organizational charts, career plans and expectations of the bureaucracies in charge of the Bank. This has often lessened the political influence of the director in his or her home country as the latter's communications and instructions are usually managed by "handlers" in the bureaucracy that are normally not at the higher levels of government. In contrast, the Bank's top management usually has direct and frequent access to ministers and heads of State. Paradoxically, while developing countries tend to appoint Executive Directors with higher political profiles and more access to their governments' highest officials, the effectiveness of these individuals is often hampered by their lack of experience, insufficient technical background and, in some cases, commitment. In fact, not infrequently, Executive Directors from developing countries are more committed to their political career at home than to the kinds of issues with which they have to occupy themselves at the Bank. Often they see their tenure as a temporary - sometimes tactical - retreat from the political careers to which they have a long-term commitment. It is very hard to maintain simultaneous attention to the daily

affairs of the Bank and to politics at home, thousands of miles away.

7. *The growing autonomy of the President and the administration*

It is not surprising that, under these circumstances, the relative balance of power between Board and managers has been shifting away from the Board. A divided Board of overwhelmed directors, many of whom cannot afford to irritate the Bank's management, and usually leave by the time they begin to be more effective, is no match for a usually brilliant group of professionals with decades of experience at the Bank.

Some argue that maintaining an ineffectual Board can serve some valid objectives; maximizing the Bank's autonomy, for example. Some representatives of developing countries have occasionally maintained that, given the G-7 dominance of the Board, strengthening it runs counter to the interests of borrowing countries, a position that has also been discreetly echoed by some in the Bank's management. The argument is that the Bank's management does a much better job than developing countries' directors in protecting borrowing countries from the politically motivated interference that industrialized countries sometimes exhibit in the Board. In the past, such assumptions have led some Executive Directors of developing countries fiercely to resist attempts at increasing the effectiveness of the Board.

In the long run, however, all institutions suffer if the body to which they are formally accountable is not effective or credible, or if its influence on shareholders is lower than that of management.

In all organizations, finding an adequate balance in the relationship between the Board and management is difficult. If boards coddle management and depend too much on it, their effectiveness is eroded and the institution is not well served. Situations where boards are too antagonistic to management are equally harmful, even though a certain degree of tension between board and management is inevitable and should be welcome. Management, everywhere, has a natural propensity to maximize growth, autonomy and scope for its operations. Shareholders and their representatives tend, instead, to be more worried about minimizing risk, exposure and the need for the next capital increase. When well managed and organized, this contradictory relationship between board members and managers can become the source of great strength for any organization. When this is not the case, it can lead to an environment of distrust, resentment and inefficiency, and could even reach the point of inducing fundamental distortions in the behaviour of the institution.

It is increasingly obvious that some of the explicit rules and informal arrangements that now govern the relationship between Board and management at the Bank are perilously outdated. Rituals, rules and procedures that in the past provided adequate solutions for specific situations involving the role of the Executive Directors, or served to define expectations and realities about the division of responsibilities between top management and the Board, are losing their effectiveness at great speed. In the case of developing countries, the erosion of the relevance of their traditional arrangements, practices and even attitudes towards the Bank is probably the most acute, given the drastic changes in the world scene, in the industrialized countries and in the developing countries themselves.

On the other hand, the Bank's policies, their impact in developing countries and the way shareholders and borrowers influence the institution, are also determined by its organizational culture.

E. *The influence of the G-4 in the Bank: the impact of unwritten rules*

While the G-7 has a substantial influence in shaping the content of the policies pursued by the Bank, the "G-4 effect" greatly shapes the way these policies are executed. The G-4 is not a grouping of countries. It is the designation of the United States visa of the non-United States citizens employed by the Bank. Together with other benefits to which Bank employees are entitled, it creates a critical dependency on the Bank and significantly shapes its internal culture. In turn, the organizational culture of the Bank affects policy implementation and creates internal rigidities that limit its range of strategic options.

More than 60 per cent of the almost 7000 people employed by the Bank have a G-4 visa. Upon termination of their bank-sponsored residency they - and their family - have only a few weeks to leave the United States (as do their nannies and housekeepers with the G-5 visa accorded to foreign household employees of G-4 holders).

Losing a job is always a traumatic experience. The trauma increases with the length of the tenure in the job being lost (average tenure at the World Bank is ten years and a large number of staff is recruited at mid-career, when they are in their late thirties and early forties). When the job loss also entails the instantaneous loss of the G-4 visa, the tax exemption status, education and health benefits and the rest of the perquisites enjoyed by Bank staff, it becomes an event of catastrophic proportions. This extreme dependency transcends foreigners, affects all the staff equally and is a pervasive and crucial element of the Bank's culture. The Bank pays very well and offers benefits that are not easily found elsewhere. Furthermore, for many, the Bank is one of the few places in the world where there is a demand for their highly specialized skills. The point is that the G-4 effect is a metaphor for an institutional characteristic that makes Bank staff more dependent on their employment by the Bank than is normally the case in other professional organizations where job mobility is less rigid and traumatic. The G-4 effect varies with nationality and profession. For example, for European and Japanese staff members the pull of the G-4 effect is often less intense than for staff from developing countries. Also, a staff member specialized in finance may have many more equivalent job possibilities outside the Bank than a specialist on issues of women in development. This naturally influences the feelings about job dependence and, in turn, organizational behaviour.

Therefore, while job retention tactics influence behaviour in all organizations, at the Bank such tactics acquire an importance that overrides all other concerns. The G-4 effect greatly heightens the importance of office politics. It stimulates the emergence of clan-like groups whose members support and promote each other in a muted, but intense, rivalry with members of other clans. It encourages the building of informal coalitions and mutual support groups, raises the aversion of individuals to taking risks, and increases the resistance to organizational change. The sensitivity to unwritten rules of behaviour is amplified and the importance of informal, but deeply grounded, routines, codes and values create a very powerful organizational culture. Together with the significant autonomy the Bank enjoys vis-à-vis its clients, the Bank's culture makes promotion and job stability much more dependent on the person's internal reputation than on the opinions of those outside the organization.

A strong internal culture has many positive effects. The widespread attachment to common, albeit unwritten, values and implicit codes of conduct makes an organization more cohesive. In as large and complex an organization as the World Bank, which is subjected to powerful centrifugal forces that erode cohesion and make internal coordination very burdensome, a shared culture acts as a glue that helps to hold together the disparate pieces of the system. But a strong organizational culture is also a formidable impediment to the internal changes that all organizations have to undertake periodically to adapt to changes in their environment. A strong internal culture is seldom the factor that prevents the adoption of a new organizational structure. But a strong culture can certainly undermine the effectiveness of any new arrangement that, while attuned to the new environmental demands, may run counter to the tacit understandings that are embedded in the organization and are critical in shaping its functioning.

The staff "know" that in order to progress in the Bank ideas are more important than actions, solid technical writing is more important than public eloquence, economic reasoning is respected while the "soft", sociological type of analysis is belittled, and the opinion of colleagues and others in Washington matters more than the opinion of clients. The staff also know that concentrating on one problem or one country for too long is too risky and that, therefore, moving every few years is necessary for rapid career advancement. The organization has also learned from experience that every new President reorganizes the Bank and that, given the periodic reshufflings, it is important for employees to build mechanisms for self-protection. Becoming an accepted member of one of the many pyramidal clans in the Bank, usually with a senior manager at their apex, is therefore a good idea. So when a new President arrives and moves boxes around in the organizational chart, in practice he has been moving the different informal clans. The arrangement of boxes may look different. But after some time, the same general clusters of people tend to regroup, replicating in the new arrangements their same old values, habits and operating styles. Thus, actual behaviour inside the boxes is not likely to have changed much.

Given this internal culture, it becomes only natural for Bank staff to have an internal - inward looking - set of organizational values and habits. Under the circumstances prevailing at the Bank, it is crucially important for staff members to concentrate attention on what others inside the Bank are up to and to build a constituency of contacts, friends, allies and mentors throughout the organization. Again, this propensity is not exclusive to the Bank and can be found in most large multinational organizations. But very few other organizations

have the combination of extreme job-dependency, lack of competition and aloofness from the clients that allow the internal culture to be as self-absorbed as that of the Bank.

The strong internal orientation of the Bank's culture is reflected in actual practices. An internal - albeit limited and statistically not representative - study showed that during a specific week a division chief spent 81 per cent of the time interacting with colleagues (52 per cent) or documenting his or her work (29 per cent). Time spent interacting with borrowers was 2 per cent. According to the same preliminary study, a task manager spent 81 per cent of the time talking to others (36 per cent) and documenting the work (45 per cent). He or she also spent more time with borrowers than a division chief: 7 per cent in total. Perhaps this much interaction with others at the Bank has something to do with the long time it takes to approve a loan. A survey of 12 projects showed that, on average, it took slightly more than 300 days for a project to move from its initial appraisal to its approval by the Board.

Quality control, project complexity, weak borrowing institutions, overwork and congestion at the Bank are very likely to explain such long gestation. But it is hard not to suspect that what we have called the "G-4 effect" may also have something to do with the number of meetings and time spent on "interacting within the Bank".

Paradoxically, internal incentives in an institution that has the promotion of the private sector as one of its main priorities, are not very dependent on results. The long gestation and execution of projects and the short time spent by staff in any one position, make it almost impossible to link individual performance with practical results. In the rare instances where problems are clearly attributable to mistakes made by the Bank, the staff members responsible for the problem have long since moved on to another department and might have even been promoted to senior positions.

The implication of these observations is not that the Bank's performance can be improved by changing the visa status of its non-United States employees. It is, rather, to use the G-4 effect to highlight the importance of subtle, but powerful, forces acting within the Bank that are often ignored when discussing grand plans about the Bretton Woods institutions. In practice, these almost invisible factors often get in the way of such grand designs. The challenge is to alter the more dysfunctional aspects of the Bank's culture without losing the advantages derived from the strong sense of attachment, long-term commitment and institutional loyalty that is common among its staff.

F. Developing countries as shareholders: the Development Committee as a case study of their policies, attitudes and effectiveness in respect of the World Bank

Our discussion in the preceding pages shows that, in fact, there are many forces that constrain the influence of the developing countries in the World Bank. But the discussion also illustrates that the nature of the Bank, its governance system and its internal culture offer many opportunities for leadership and influence on the part of developing countries. The picture drawn in these pages shows the Bank as far from being an impenetrable monolith dominated by the industrialized countries or an impervious bureaucracy captured by any one group or constituency.

An interesting opportunity for developing countries to shape the agenda of the Bank and gain some added influence arose in 1974 with the creation of the Development Committee. Twenty years later, the Committee - which was created as a temporary body - continues to exist, but the opportunity was missed. The irrelevance of the Committee is only exceeded by its longevity. The strong presence of developing countries in this Committee, its original mandate and its meager impact, highlight some interesting facets of the interactions of developing countries with the World Bank.

In 1974, as a result of the drastic changes taking place in the international monetary system, a Ministerial Committee of Governors of the IMF was created - on an interim basis - to analyse the new situation and make proposals to deal with it. This Interim Committee - as it continues to be called two decades after its creation - was centred on the IMF and had as its main focus the reform of the international monetary system. Therefore, as noted before, a committee to "protect" the interests of developing countries was also established in 1974: the Joint Ministerial Committee of the Governors of The Bank and the Fund on the Transfer of Real Resources to Developing Countries. Not surprisingly, its official name was seldom used and it became known as the "Development Committee". The Committee was to review the consequences of the new monetary arrangements on the transfer of resources (real,

of course) to the developing countries. Originally,

> it was intended to be a temporary body, with a specific work program ... for a limited period during the transition to a new monetary system. Because the work program and timetable were extremely intensive and because the new Committee spanned both the Bank and the Fund, it was given an independent secretariat.[5]

The Committee is formed by 24 ministers, with one of them serving as chairman, usually for a two-year period.[6] It meets twice a year, in spring and autumn, and the latter coincides with the annual meetings of the World Bank and the IMF. The meetings consist of a morning plenary session in which each minister reads a prepared statement about papers prepared for the meeting, a private luncheon session attended only by the ministers or their representatives, and an afternoon plenary session where a communiqué is endorsed, followed by a press conference by the chairman. Of twelve ministers or former ministers that are or have recently been members of the Development Committee (including three former chairmen), nine considered these meetings useless.[7] The Executive Secretary of the Committee reports that in 1993, the international press made precisely one reference to the Committee (*The Guardian*, London, in May 1993), despite pre-meeting press briefings and a formal press conference.

Closer constituencies of the Committee do not seem to pay much attention either. In 1992, for example, the Committee endorsed a set of "Investment Guidelines" about the legal framework for treating foreign investment. After six months, the executive secretariat of the Committee surveyed the almost 200 shareholding governments of the Bank about the guidelines. Only 11 governments replied and just two reported having taken any action in this respect. Executive Directors at the Bank very seldom refer to the statements of their ministers in the Committee in their interventions during Board discussions.

Over the years, five formal attempts have been made to increase the effectiveness of the Committee or even to abolish it. Since 1976 three ministerial "review groups" were created to assess the work of the Committee, and one to analyse the functions and role of the Executive secretariat. In all instances the review group could not reach a consensus on a major overhaul of the Committee and issued recommendations centring on minor procedural changes. A fourth review group established in 1993 has yet to complete its report, but preliminary evidence indicates that it will not depart from the tradition established by its predecessors.

Defenders of the Committee argue that its value should be measured in other, more subtle, ways. A senior official of the Bank that has had ample experience with the Committee notes, for example, that

> it is a mistake to measure the value of the Committee by the meetings themselves. They are always a let-down. Rather, more important is the degree to which the process in governments facing up to the issues raised by the papers prepared for the Committee and the President's [of the Bank] reports serve to educate officials and bring some progress in the debate - on trade and development, on environment and development, on women and development, etc.[8]

This is a vision of the Committee as an instrument to educate ministers from industrial countries about the issues facing developing countries and as a mechanism to launch new initiatives and mobilize public opinion around them. Others see the Committee as yet another international arena in which to pressure donor countries for more funds for development aid. Throughout the years, ministers from developing countries have constantly used their statements at the Committee to exhort the industrialized countries to meet the United Nations target of allocating 0.7 per cent of their GNP to aid. (The average has tended to be around half of that.) Other observers argue that the Committee adds respectability to debates that would, otherwise, only take place in the less influential and more politicized bodies of the United Nations in Geneva or New York. Finally, others dream or aspire that the Committee could really become a conduit for influencing the Bank's policies.

This is very likely to continue to be an aspiration or a dream forever. A very senior World Bank official had this to comment about

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5 Interview with Peter Mountfield, Executive Secretary of the Committee, 1993.

6 The chairmanship of the Committee rotates among regional groupings (Africa, Latin America, Asia, etc.). By convention, the Executive Secretary of the Committee - a full time job sited at the World Bank in Washington - is a national of a developed country. Since its creation the Committee has had nine chairmen and six Executive Secretaries.

7 Interviews conducted by the author.

8 Private communication.

the possibility of transforming the Development Committee into a more influential body:

> People can renovate old houses, not old committees. The Development Committee is full of historic baggage - of the wrong kind. If you want to strengthen the Governors' influence, say so and spell out how it should be done. Abolish (or at least forget about) the Development Committee. Say there should be an Executive Committee of the Governors. Spell out what their mandate would be and how they would come to conclusions. In order to do this or to make the Development Committee 'a true policy making body', constitutional changes would be required. This cannot be done through the backdoor.

As already noted, yet another attempt at reforming the Committee is currently under way and does not show any promise either of abolishing the Committee or making it more relevant. Why has the Committee been so ineffective? Why is it so difficult to dismantle a body that, while perceived as necessary by some, is largely regarded as useless? Answering the first question sheds some light on the answers to the second.

Some of the main sources of the Committee's problems are the following:

1. Lack of ownership

No shareholders or group of shareholders are really identified with the Committee or have had a long-standing commitment to its effectiveness. The industrialized countries have been divided between "development activists" (like the Nordic countries, the Netherlands, Belgium and, increasingly, Canada) and the members of the G-7. , The former have occasionally shown an interest in loosely using the Committee to mobilize opinions in favour of their development agenda, and the latter are driven instead by "damage control" in the sense of trying to avoid that the work of the Committee result in further financial commitments for them. For their part, developing countries have not had a clear agenda for the Committee other than using it to ask for more money. These are, of course, caricatures of much more elaborate and nuanced positions that have varied over the last 20 years. None the less, a review of the written legacy of the work of the Committee clearly points to these as the constant threads in its activity throughout its existence. The point, then, is that no influential actor really has a significant vested interest in the effectiveness of the Committee, and the behaviour of the developing countries in the Committee has been too fragmented, inchoate and improvised to have any impact.

2. Lack of incentives for the Governors

The Committee also suffered from the importance of its members. Ministers are busy individuals and their incentives and future lie much more at home than in a Committee without a clear mandate or authority to implement anything other than a communiqué. Why devote much time or effort to prepare for the Committee or its follow up? In recent years, globalization and regional integration in Europe and elsewhere has spawned a myriad of international meetings which ministers have to attend, thus forcing them to spend considerably more time away from their countries than two or three decades ago. Developing countries' ministers are also burdened by heavy agendas, lack of support and short tenures. In Latin America, for example, ministers last, on average, less than a year in their job (Naim, 1994). Why would a minister with such a short time horizon develop strong ties with the Development Committee? Herein lies, therefore, much of the ritualistic nature of the proceedings of the Committee. Rituals and protocol are always powerful ways to mask lack of preparation and interest or significant deficits in the substance of the deliberations. Furthermore, and in contrast to their developed country counterparts, ministers from developing countries seldom have the experienced staff support to provide continuity and follow up to the meetings.

3. The nature of the Committee's meetings

As noted, the meetings of the Committee are highly formalized, ritualistic events where no incentives exist for departing from the preestablished routine. An additional problem for the Committee is that it meets at the same time as the annual meetings of the Bank and the Fund. This is an occasion in which too many other important events are simultaneously taking place. Ministers usually use the annual meetings to organize innumerable other meetings with their colleagues from other countries with whom they have bilateral affairs to discuss, with the management and staff of the IMF, the Bank and all the other international institutions that attend the meetings and, increasingly, with NGOs and private bankers or investors. In this context, spending the day at the Development Committee involves high

and increasing opportunity costs. Usually ministers only show up at the meeting when they are scheduled to deliver their prepared speech, and leave shortly after that. Attendance at the private ministerial luncheon hosted by the chairman has also been declining.

4. Isolation from the Bank

The Bank's management attitude towards the Committee has also been one of damage control. The main concern was to ensure that the Committee would not erode the autonomy of the Bank. While the Bank works closely with the Committee and its secretariat, it has kept it at arms length, making sure that the Bank's operations are not even remotely affected by the exhortations of the Committee. Even though, since the beginning, the Committee had only a vague advisory role, it was natural for the Bank's management to worry - as all managements do - that a committee formed by 22 Governors could soon escalate, deliberately or not, its scope of activities and begin to encroach into issues that had always been in the preserve of the Bank's management. The Board of Directors felt the same, albeit less intensely.

Why, then, has such an extravagant paradigm of wastefulness proven to be so difficult to dismantle? The answer is that while nobody really "owns" the Committee, probably no single actor or constituency has the power to force its dismantlement. Also, no actor seems to have the incentive to incur the costs associated with the initiative of building the coalition that would be necessary to end the Committee's long existence. In fact, for some important actors, the disappearance of the Committee poses the risk that sooner or later another, more effective ministerial committee may be created. The Bank's management may fear that a revamped ministerial committee may be chartered in ways that, without altering the Articles of Agreement, could increase its influence on policies. The G-7 may worry that a more effective committee with a strong developing country representation could add to their already difficult balancing act in a world undergoing complex transitions.

For their part, ministers from developing countries fear that even though the Committee is ineffectual, it is after all their only forum to discuss with their peers from the industrialized countries issues related to the World Bank, a sentiment that is certainly shared by the "development activists" among the industrialized countries and among a few staff members of the Bank. A former chairman of the Committee had a more blunt and cynical explanation for the Committee's resilience: "dismantling it just takes too much work; nobody has time for that".

The Development Committee provides an excellent example of an opportunity for developing countries to increase their influence on the World Bank that was partly missed by their propensity to behave more like borrowers than shareholders. By centring their attention almost exclusively on calls to increase aid flows, developing countries created an inertia that, for all practical purposes, made it almost impossible for the Committee to discuss the transfer of resources to developing countries and the role of the Bank in this process from more realistic and, perhaps practical, angles. This attitude also underlies much of the general behaviour of developing countries towards the Bank.

G. Conclusions: the possibilities of developing countries as shareholders

The fact that the 50th anniversary of the Bretton Woods institutions coincides with a time of radical changes in the world order will certainly inspire bold new ideas. New institutions will be proposed, as will drastic redesigns of existing ones. Reality, however, is very likely to foil the actual adoption of radical changes. Effecting radical change requires a degree of consensus and international leadership that does not currently exist. In the 1990s the world lacks a rallier of nations that can mobilize the many governments crippled by weak electoral mandates, rising unpopularity and severe domestic problems.

This does not mean that major progress cannot be achieved in improving the relevance of the Bank to new world conditions or augmenting the influence of developing country shareholders on the Bank. Some of the changes may be viewed as too small or "managerial" at a time requiring revolutionary measures. But concentrating on these "small" changes has the advantage that they are much more likely to generate a return. Also, while small in comparison to grandiose ideas, they may amount to quite a revolution compared with the current situation. This perspective also opens new opportunities for developing countries. Developing countries have assumed for too long that the Bank is structurally impervious to the influence of its non-industrialized shareholders, or that the main theme that borrowing coun-

tries can afford to pursue with the Bank's management only relates to their loans. If, instead, these countries adopt an agenda and a time horizon more akin to those of an enlightened shareholder committed to the long-term strength of the institution, and organize accordingly - both internally and with other governments sharing the same approach - they may well be surprised to find that the space for their influence is wider than was generally assumed. They may also be surprised to find that their own agendas as borrowers are easier to pursue by shifting from supplicant to shareholder.

Developing countries could, for example, initiate some of the actions that they have traditionally abdicated in favour of the larger shareholders. One step in the right direction would be to build a wider consensus about the precise role of the Bank. For this exercise to yield a more focused strategic direction, it is as important to define what the Bank should ***not*** be expected to be, as to define a more precise role for it. In theory, clarifying the primordial nature of the Bank should facilitate the definition of a narrower and more focused set of priorities. At the same time, however, this definition is made difficult by the highly fractured nature of the Bank's constituencies, the variety of expectations and needs to which the Bank has to respond, the confusion resulting from the many and simultaneous political, economic and institutional changes that are currently taking place in the world, and the subtle but powerful internal forces that shape the organization's behaviour.

It is certainly necessary to come up with a reasonably valid statement about the Bank's role, and the operational mission and goals that flow from that role. We will not, however, attempt to do so here. It is almost irrelevant to define missions and principles without also making sure that such definitions will really serve, in practice, as the generally accepted principles that guide the Bank's operations and its interaction with the external environment.

From our perspective, the *process* through which roles, missions and goals are debated, sorted out and eventually adopted, is as important and merits as much attention, if not more, than the definition of a statement that may sound right to those proposing it.

For this process to be relevant - or even possible - significant changes in the governance of the World Bank should take place. Hurried Governors cannot be expected to become too distracted with Bank affairs. But an enlightened group of Governors from developing countries could decide to form a coalition with their counterparts in the developed countries aimed at taking decisive action to upgrade the governance system of the Bank. Among other measures they may consider the following:

1. Strengthen the role of the Governors

Ministers should be enrolled more effectively and systematically in the governance of the Bank. It is probably a good idea to have an executive committee of Governors to provide long-term political guidance to the Bank. While this proposition may sound simple and obvious enough, in practice it is very difficult to implement. It is both legally and politically burdensome. It requires that the constitution of the Bank be modified, and that almost 200 countries agree on a sub-group of Governors to represent all of them for a given period. Despite these and other difficulties, a mechanism has to be found to strengthen the goal-setting and oversight roles played by shareholders. One small step in that direction could perhaps be the redefinition of the structure and the functioning of the Development Committee. The urgent need for a complete overhaul of the Committee is evident. It is indispensable to make it less ritualistic, unpredictable and irrelevant. A biannual occasion for Governors to meet and discuss the Bank should not continue to be the missed opportunity that it has hitherto been. The Development Committee could increase its role as one of the bodies through which the Governors convey policy guidelines to the Board and the management of the Bank. On the other hand, recent attempts at reforming the Development Committee in limited but useful ways have encountered so much resistance that a major reformulation of the role of this body is also bound to be a titanic task.

2. Upgrading the Board of Executive Directors

Governors should also agree to upgrade the level of their representatives to the Board of the Bank. This might seem a subtle change with minor bureaucratic consequences. None the less, given the circumstances that will be faced by the institution in coming years, it could well prove to be a momentous decision. Among other effects, the appointment to the Board - even by two or three shareholders - of individuals with high visibility and prestige, is bound to spur similar decisions by others, thus creating a quantum leap in the relevance of the Board.

3. *Extending the tenure of Executive Directors*

Board relevance would certainly be enhanced by increasing the tenure of Executive Directors. A minister who has to appoint an Executive Director for an extended period of time (four years?) and who cannot remove the director once he or she is appointed, is probably going to pay more attention to the selection of the candidate. Also, as noted, directors will have the time that they now lack to become effective interlocutors before their term of appointment to the Board ends.

4. *Redefining the functioning of the Board*

Major improvements in the Bank's governance can be achieved through the modernization of the Board's procedures, support systems and general organization. Board committees have great limitations in their capacity to induce the drastic changes in procedures that the Board urgently needs. An external consulting company, with experience in the design of working methods, support systems and organizational design of boards of directors of complex organizations, should be retained. It should report its recommendations to a special committee of the Board of Governors.

These are some of the specific avenues that can be explored in order to strengthen the governance of the Bank. For some, agreeing on the role of the Bank, finding creative ways to engage Governors in serious discussions about the long-term objectives of the institution, recruiting Executive Directors with high internal and external credibility and influence, and re-designing the role of the Board, its operations and its relationship with management, may be minor "technocratic" changes. They will, however, be hard to achieve and are, perhaps, unrealistic. Yet, without, these small, difficult changes, lofty ideas about the Bank are very likely to remain only ideas.

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13

GOVERNANCE OF THE FUND

Alexandre Kafka

ABSTRACT

The division between (a) Fund members expected to dispense with the Fund's services as a financial intermediary or provider of a "good housekeeping" seal of approval to catalyze other lenders and (b) other countries (developing countries and more recently, former Soviet Union and Central European countries) has decisively reduced the institution's influence over the former group of countries. The Fund's analytical competence and the information which it can supply could restore its lost influence over the former group of member countries. This purpose could be promoted by improvements in Fund organs and through the intensified exchange of senior staff between the Fund and member countries.

Though nobody seems entirely happy with the international monetary system, closer consultations between major member countries in the forum of the Fund may be needed, banal though it sounds, rather than a new system. Other systemic issues comprise the increasing mobility of capital at the same time that capital controls are becoming less acceptable and the transformation problem of the former centrally-planned economies has come to the fore. The latter question is entirely different from that of reducing excessive state interference in market economies, or even in those where the present generation has a memory of the functioning of a market economy, and poses a particularly difficult problem of preserving the Fund's evenhandedness as between different groups of countries.

A. Summary and conclusions

This paper discusses the governance of the Fund in the context of its development tasks. Section B describes the structure of governance of the Fund. Section C relates this structure to the Fund's tasks.

The structure of governance of the International Monetary Fund has changed in many respects during the last 50 years, both in form and, particularly, in substance. The statutory organs - Board of Governors, Executive Directors, and Managing Director and staff - remain.

In addition to its statutory organs, the Fund has, over time, created other organs that are in fact decision making, although formally they are only advisory. Of these, the Interim Committee continues. Outside the Fund, though connected with it, there is the G-7 (in addition to the G-24) which aims to coordinate the economic policies of its members, while the G-10 has lost relative importance.

Influence in the Fund - despite the enormous rise in its membership of developing countries and countries in transition - continues to reside in the main industrial countries, with the United States paramount. This is not simply the consequence of the Fund's weighted voting system and of the formula used to determine quotas. A country's influence reflects also its standing in the international financial community, particularly its creditor or debtor status.

The Fund has a monarchial system of governance. Executive power is concentrated in the Managing Director, though far less so than in the President of the World Bank. This system endows the Fund with an unusual degree of flexibility, but also constitutes a heavy burden on the Managing Director and his sole

Deputy. Doubts are voiced with increasing frequency whether this structure can survive.

The Fund has been able to maintain a staff of extraordinarily high quality. At the outset of the Fund's existence it could hire very senior staff from a large pool of people who had acquired considerable experience in their national governments in dealing with political as well as technical problems. But, unavoidably, the institution lost some of its earlier flexibility in hiring and promotion.

The Fund's resources have become smaller in relation to the demands put on it. As many more countries have become capable of obtaining resources from the capital markets, so long as their policies are supported by the Fund, the latter's role has increasingly become that of a provider of the "good housekeeping" seal of approval. But its value has been somewhat limited by the absorption of financial resources by the national demands of the richest countries. This has often meant that major countries attempt to shift to the Fund risks that should more properly be assumed by themselves, which is not to suggest that the Fund should shy away from risks where it can acquire appropriate safeguards. For the latter, it relies on the phasing of drawings and the observance of performance clauses. It has never used its statutory power to accept collateral.

What is the relationship of Executive Directors with their governments? While appointed Executive Directors can be dismissed *ad nutum*, elected Executive Directors cannot legally be dismissed. The position of an elected Executive Director is therefore extremely strong vis-à-vis those of his Governors of whose country he is not a civil servant.

The Fund's responsibilities can be divided into two groups: the management of the international monetary system existing at any time, and the system's adaptation to changing circumstances.

The first mission consists of assisting its members in correcting balance-of-payments disequilibria, to avoid current payments restrictions, while helping them to achieve price stability and growth as well as full employment. This task initially required no heroic decisions. Criticisms are sometimes voiced as to the excessive numbers of checks on performance; by contrast, the need for checks - conditionality of drawings in one form or another - can hardly be questioned.

There was then - as distinct from today and except for the United States - no dividing line between countries that were not expected in the foreseeable future to require financial support by the Fund, or a "good housekeeping" seal of approval, and others that were.

This division, while not permanent - and clearer in the depth of the debt crisis than today - is, nevertheless, a major development and requires adaptations in the running of the IMF. It means that access to the Fund's financial resources as an incentive to observance of its code of conduct has lost weight for a more important group of countries than ever before. The Fund must try to use its analytical competence and the information it can supply to induce the major countries to carry out the Fund's purposes. With their desirability they do not, essentially, disagree.

The machinery for effective surveillance over major countries consists in the first place of the Fund's consultations with these members and the World Economic Outlook (WEO) exercise in which some peer pressure can be exercised. It consists additionally of confidential communications and, possibly, meetings by the Managing Director with ministers and central bank governors of these countries to emphasize the advice tendered in the consultations and through the WEO discussions; and it consists of the Managing Director's - and, in a preparatory role, staff - attendance at part of the G-7 "summit meetings".

One can think of improvements in the use of existing Fund organs to ameliorate management of the international monetary system. Thus, more active participation of non-G-7 Executive Directors in the WEO debates and the Informal Sessions on World Economic and Market Developments, would be helpful in making the Fund's advice to members, including major members, more useful. Improvements in the governing organs of the Fund could also be contemplated. The Executive Board may be too large effectively to perform its functions.

One could argue that the work of the Executive Board requires even closer contacts among Executive Directors than now exist; and it probably requires a group as involved in the work of the Fund as the present Executive Directors, while being closer to the national authorities than at present: a difficult combination. Could the number of Executive Directors in Washington be reduced so that they could interact more closely with each other? This would make it easier to apply peer pressure among the members of the smaller group in the management of the Fund. The smaller group could be established as an advisory committee of Executive Directors to the Executive Board, and could have single country

members as well as multi-country members, whose representatives could rotate.

Other changes in governance could improve the functioning of the present international monetary system. One concerns the exchange rate system. While there has been no formal change, the Fund has become much more free to include suggestions on exchange rate changes in its consultations.

To reduce mistakes in the Fund operations, the establishment of an evaluation office for Fund programmes has been suggested. Such an initiative may comprise risks - i.e. possibly make the staff excessively conservative - but may, on the other hand, lead to the avoidance of mistakes.

A very delicate matter concerns the use of publicity to encourage members to adapt their policies to the Fund's objectives. It is necessary to steer a middle course between using publicity to produce pressure on governments without discouraging frankness in consultations.

One of the most important avenues through which the Fund influences the international monetary system is the schooling which it provides to officials of member countries. This could be strengthened through expanding the work of the IMF Institute, as well as attempting to intensify the exchange of senior staff between the Fund and member countries.

The Fund has had to face up, not only to the management of the international monetary system existing at any one time, but also to the challenge of transforming that system continually. The systemic changes which do seem to fall clearly within the purview of the IMF include the abandonment of the single gold price (for both official and non-official transactions) after 1967, the creation of the SDR, the abandonment of gold convertibility by the United States in 1971, and the establishment of a new grid of exchange rates among the G-10 in the Smithsonian Agreement in 1971, followed in 1973 by abandonment of the par value system. The gold price split and abandonment of gold convertibility took place essentially without reference to the IMF. They occurred in the middle of the attempt by the Group of Twenty to reform the international monetary system, an attempt which has - at least for the time being - been abandoned. Though nobody seems entirely happy with the system which we now have, what is needed perhaps is not so much a new system but closer consultations between major countries.

Another problem, by its size and nature a systemic one rather than a mere balance-of-payments problem, was the first oil shock of 1974. To prevent a widespread fall into protectionism, if not deflation, the OECD promoted a non-protectionist commitment by its members, and the IMF established its 1974 and 1975 oil facilities.

A major problem for the Fund arose as the result of the debt crisis and the related problem of member countries' arrears to the Fund. The Fund, at first, approached the debt crisis as a liquidity problem and only very gradually came around to dealing with it as a major systemic problem, requiring debt reduction for its solution. It developed new facilities in this context, such as the Rights Accumulation Programme. A quicker solution could perhaps have been found if the Fund had been able to intervene by making larger resources at longer maturities available to the debtor countries. One aspect of the funding problem concerned the periodic increases in quotas required by the Fund, which often involved prolonged discussions before a decision, as does the allocation of SDRs. Even where the Fund's liquidity appears high, it may be inadequate to meet unexpected crises quickly.

Among other new problems which have arisen, one is the increasing mobility of capital at the same time that capital controls are becoming less acceptable. Should the Fund be given jurisdiction over approval of capital movements which can currently be instituted freely? Such a change, if at all desirable, would require a system of *ex-post* approval as a minimum, which would be something of a new departure for the Fund.

Of the new problems, the most difficult is, undoubtedly, the "transformation" problem of the former communist economies. It requires an entirely new approach, which is not at all comparable to reducing excessive State interference in what were largely market economies. There have been increasing pressures on the Fund in the context of this problem to interpret the principle of evenhandedness as between countries extremely broadly.

To deal with systemic problems, the Fund, since 1974, has been equipped with the Interim Committee as a practically permanent organ. The Interim Committee may be too large for dealing with the problems committed to it. The result is that these problems tend to be dealt with by the G-7, which is even less representative of the international financial community than would be a smaller Interim Committee, perhaps one shrunk along the lines

discussed earlier in relation to a possible shrinking of the Executive Board.

B. The structure of governance

I discuss the structure of governance of the IMF[1] in the following order:

1. Statutory organs
2. Other organs
3. Executive Board and management
4. Board committees
5. Staff and management
6. Executive Board and government

1. Statutory organs

The statutory organs of the Fund are its Board of Governors, its Executive Board, to which most of the powers of the institution have been delegated, and the Managing Director and staff.

As in all international financial institutions (IFIs) the voting power of each member country is proportionate to its financial contribution, basically its quota.[2]

The Fund is, however, not exclusively financed through members' quotas.[3] A country's contribution to the Fund's financing can influence the governance of the Fund both formally[4] and informally, as lenders and potential lenders can be given special consideration. In any case, a country's influence is not simply a reflection of its voting power, but depends also on its general standing in the international community. Even though the Articles of Agreement allow no appeal from the Fund's decisions to any outside authority, it is - or, at least, has so far been - understood that decisions cannot diverge clearly from the letter of the Articles of Agreement.[5]

Another aspect of the Fund's governance derives from the fact that most of its powers are delegated to the Executive Board where each member, representing a multicountry constituency, casts the votes of the countries he represents as a unit. In many such constituencies, directors are mostly chosen from major members of the constituency, and can cast their votes - within reason - for the views expressed by their own countries of origin.

Most of the voting power, as well as the influence, of the members of the IMF resides in its major industrial members, as the result of the formulas used to determine quotas (and, therefore, voting power). The non-industrial countries, plus the former socialist countries, dispose jointly only of 40 per cent of the voting power, and Executive Directors representing only such countries less than that (because some Executive Directors from industrial countries represent non-industrial ones). There are no steady voting blocs in the Fund.

2. Other organs

In addition to its statutory organs, the Fund has created others, formally of advisory, but often effectively of a decision-making nature. It has done so when major changes in the

1 Along with the World Bank and the International Trade Organization (ITO), whose birth - as the World Trade Organization (WTO) - was delayed half a century, the IMF was one of the triplets that were to help run the post-World War II economy. The GATT, technically not an organization but an agreement, came into being when the attempt to establish the ITO failed.

2 Voting power is adjusted to a minor extent according to the Fund's holdings of a country's currency (Article XII.5(b)).

3 It has been authorized to borrow from member countries' governments and central banks, but never from the market. One alleged reason for this - that the Fund should not be subject to influence by the markets and, therefore, disproportionately to influence by those countries whose actions have a major impact on the markets - is unconvincing, since those countries are also those from whose governments and central banks the Fund borrows. Since the early 1960s, the Fund has been authorized to borrow under the so-called General Arrangements to Borrow (GAB) from the Group of Ten, plus Switzerland. The use of these resources was initially reserved exclusively for lending to members of the Group of Ten. Only later (in 1987) did it become allowable to lend these resources also to other countries and did borrowing take place from other countries. During the discussion of the Articles of Agreement of the IMF, the Canadian authorities had proposed to give the Fund the right to borrow from any member country up to 50 per cent of that member country's quota.

4 See Article XII 3(a).

5 Since 1968, the IMF has been allowed to issue - technically to "allocate" (as well as cancel) - SDRs, in strict proportion to each country's quota. Ridiculously small amounts have been allocated and no allocations have been made since 1981. It has occasionally been suggested that allocations or part of them should be placed at the disposal of the Fund and that they should not be freely disposable by recipients, i.e. provide unconditional finance. It has also been suggested that allocations should take place in order to place new members on a par with old ones, but should be compensated by cancellations so as to redistribute rather than increase the volume of SDRs outstanding.

international monetary system were contemplated.

For example, the requisite changes in the Articles of Agreement to establish the SDR were suggested by the so-called Joint Meetings of the Deputies of the Group of Ten and Executive Directors, jointly presided over by the Chairman of the Deputies and the Managing Director.[6] Final decisions on the SDR not settled in the Joint Meetings were, however, taken by a Ministerial Meeting of the G-10, with complete neglect of the non-G-10 members, who were - at best - represented by IMF staff and the Managing Director.

A new organ was called into being also in the failed attempt to reform the international monetary system, which culminated in 1972/1974. The Board of Governors appointed the Committee of Twenty for this purpose.[7]

The Committee of Twenty presented a final report in 1974, but no complete reform proposals, and it was only in 1978 that the Articles of Agreement were amended formally to abolish (for the time being) the par value system. However, already in 1974, two committees had been established to continue the work of the Committee of Twenty: the Interim Committee and the Development Committee.[8]

A few additional groups in the field of the international monetary system have since been established. The oldest among them is the Group of Twenty-Four under whose auspices we are meeting today.[9]

The major industrial countries (the United States, Japan, Germany, France and the United Kingdom) started meeting as the Group of Five, though a Group of Three, i.e. the first three of these countries, continues to hold decisive influence. This is the case, though the G-5 has transformed itself into the Group of Seven, including also Italy and Canada. The G-7 aimed to coordinate the economic policies of its members. Even before the G-7, important questions were frequently the province of understandings among the major Fund members. The G-7 also has begun to meet with Russia. The G-7 became an ostensible - if not always effective - decision maker, more so than the Interim Committee (not to mention the Board of Governors); but the G-7 is far from being a monolithic body, and the influence of the United States remains paramount.

The Executive Board remains charged with the day-to-day management of the IMF and is the forum in which the opinions of the non-G-7 are expressed for conveyance to the G-7 with the help of the IMF staff or Managing Director. It must be emphasized, however, that this method of conveyance is imperfect, not only because the feelings of the excluded members are conveyed indirectly, but also because the channels of transmission are clogged; thus, even the Managing Director is excluded from the decision-making meetings of the G-7 ministers and governors. He can, of course, partly compensate for this by his direct access on a personal basis to these major decision makers.

6 This ad hoc body basically dethroned the G-10 Executive Directors in favour of their masters, hid the irrelevance of the Fund as a whole vis-à-vis the G-10 for purposes of major changes in the international monetary system, and yet gave a degree of voice to the non-G-10 member countries through their Executive Directors. It worked quite well. The United States was the moving force behind the constitution of this curious body, since it feared the excessive conservatism of the European majority among the G-10 and thus, in effect, called on the developing countries to dilute their weight; the latter were more inclined to risk creating a new international currency than the Europeans (the United States has since soured on the SDR).

7 This body operated at two levels. The Committee consisted of 40 representatives, two each for the 20 existing constituencies represented on the Executive Board of the IMF, usually one the finance minister, the other the central bank governor. An assembly of 40 deputies (again one often from the finance ministry, the other from the central bank) plus the 20 Executive Directors, would do the preparatory work for the Governors. The Governors' meeting was chaired by a developing country Governor, Ali Wardhana of Indonesia, while the Deputies and Executive Directors worked under the direction of a "Bureau" composed of a chairman (Jeremy Morse from the United Kingdom) and four vice-chairmen, from Brazil, Ghana, Japan and the United States.

8 In 1978, the Articles of Agreement were changed to enable the Fund, with an 85 per cent majority, to permit the establishment of par values and to establish, instead of the Interim Committee - which was, like all committees, merely advisory to the Board of Governors - a decision-making council. This has not, so far, been set up.

9 The developing countries established the G-24, representing the so-called Group of 77, i.e. the United Nations' members which were considered less developed, to deal specifically with international monetary affairs. This group meets twice annually preceding meetings of the Interim and Development Committees, and tries to focus the attention of the developing countries on the international monetary and development problems most pertinent to their economies. This group was constituted as a counterpart of the G-10, i.e. outside the Fund, but intended to influence it. Later on, the "G-9", composed of the 11 Governors and Executive Directors representing exclusively developing countries was constituted; it meets before Interim Committee meetings. Still later, a second Group of Twenty-Four was established for the purpose of dealing not with international monetary affairs, but with matters more related to the problems of the former Soviet Union, and composed of the member countries of the OECD, which are 24 in number. Working Party 3 of the OECD and the G-10 are older.

3. Executive Board and management

Decision making is not a matter for the various collective organs of the Fund alone, except in a formal sense. The Managing Director is, obviously, a decision maker with respect to the subjects which he presents to the Executive Board (and to the Interim Committee, to the Board of Governors and, even, to the G-7). Thus, it is unheard of for any country financial proposal, e.g. to grant a stand-by arrangement, to be presented to the Executive Board except by the Managing Director.[10]

There is no question that the power of the Managing Director vis-à-vis the Executive Board has become stronger than it was at the beginning of the Fund's operations. This is a natural phenomenon in any organization as the scope of its operations expands and details cannot be left to the deliberations of a relatively large body like the Executive Board, whose size has, moreover, grown from the original 12 to 24. The Fund has a tradition of courtesy which sometimes makes it difficult to discern the precise meaning of a criticism. Thus, dissatisfaction with management policy may express itself in a low vote supporting such essential decisions for the running of the IMF as the annual budget, yet being careful to avoid withholding a (bare) majority.[11]

The use of warning signals rather than definitive votes is also prominent in other respects. Thus, the Executive Board has never refused to approve an arrangement (stand-by or extended) submitted to it by management. When the Board is dissatisfied with the nature of the arrangement, it will generally limit itself to expressing doubts and warnings against a repetition of a management proposal similar to the criticized one. There is a sensible basis for this way of proceeding on the part of the Executive Board. If the Board refused arrangements negotiated by the staff under authority of the management, it would deprive the staff of the authority, for all practical purposes, of negotiating agreements until they had first been approved, at least in outline, by the Executive Board. This would consume an inordinately large amount of time of the Board and could jeopardize some arrangements altogether.

Naturally, also, the independence of the Managing Director vis-à-vis the Board varies very much according to the subject matter which may be involved. Thus, general policy changes of importance are discussed carefully and sometimes at much greater length by the Executive Board than financial arrangements. The formulation of a new policy guideline is often expressed in a detailed decision in which the Executive Board engages, not only in indications of its general desires, but in detailed drafting. However, there is an increasing number of instances where a decision is formulated in the summing up of an Executive Board discussion by the Managing Director as its chairman. In those cases, it easily loses the precision one would prefer it to have.

4. Board committees and management

The Fund's system of governance is complemented by five standing committees of the Executive Board, as well as ad hoc committees on admission of new members and committees of the whole. The standing committees are the Committee on Interpretations, the Committee on Executive Board Administrative Matters, the Committee on Administrative Policies, and the Committee on Liaison with the Contracting Parties to the GATT. The Board has recently established a Budget Committee. In the Fund, all committees established so far have been open committees in which all Executive Directors, or rather chairs, could participate, even though the sense of a committee (there is no voting in committees) would generally differentiate between the majority view of the committee members and other views. Committees of the whole are established where quota increases are to be decided on, and there are ad hoc committees on the admission of new members, and also, for preparation of the agenda of the Development Committee. Joint committees of the Bank and Fund have been established on rare occasions to deliberate on administrative questions affecting both institutions, such as the system of compensation. It may be asked what the difference is in the Fund between a committee of the whole, on the one hand, and a more limited committee on the other hand. The answer is that committee members - or rather the chairs participating in committees - have generally been understood to have accepted implicitly an obligation to immerse themselves more closely than other chairs in the subject within the purview of that committee. Among the standing committees, there has been little if any ro-

[10] Although it would be legally possible for an Executive Director to present such a case directly to the Executive Board.

[11] Thus, in 1993 the 1994 administrative budget was passed with a bare majority of the Executive Board's voting power as an expression of the latter's doubts as to whether the rise in the Fund's expenditures and increase in staff were not excessive.

tation of membership. Thus, a certain expertise has been developed by those whose chairs have been long-term members of any committee. Among the committees, that on Administrative Policies is chaired by the Managing Director, and so is the Budget Committee. These chairmanships indicate the importance of giving management adequate influence in matters which concern it as closely as administration and budgetary policies.

5. *Staff and management*

The relationship between management and staff has not changed much, despite the growth in the size of the staff, which has doubled in recent years. There is still only one Deputy Managing Director. Doubts are voiced with increasing frequency whether this structure can survive. But it must be recognized that the monarchial style of management endows the IMF with an important degree of flexibility. The increase in staff and tasks has led to the establishment of new entities, such as staff committees and technical secretariats, which have not yet demonstrated that they do not merely serve to delay decisions.

The extent of delegation from management to staff depends not only on the technical quality of the staff, which is generally considered to be extraordinarily high, but also on its political sensitivity and propensity to innovate. When the Fund started its existence it was possible, even easy, to recruit an adequate number of people who had had experience in highly responsible positions in their governments, where they had learned to deal not only with the technical, but also with the political, aspects of the problems which institutions such as the Fund face, and had acquired the habit of taking risks. The experience of these early staff members was useful in formulating early policy and perhaps even more so somewhat later when the Fund's operations became more important and difficult. The Fund's needs were smaller in relation to the pool of people available, and there was no need to respect the seniority claims of staff members without experience in government. Of course, political sensitivity is also acquired by Fund staff over long service.

The IMF's ability to recruit senior people to its staff is limited by the fact that it needs to have a civil service and, therefore, afford it the security of employment and promotion which this implies. There is no straightforward solution to this problem. Recruiting senior people for fixed terms is not easy. Lending permanent staff to national governments to acquire experience on how these function has also not been found easy. They are not likely to be seen as part of the national team. Something could be done by creating senior advisory staff positions for people recruited from national governments; some progress has been made in this direction in recent years, through the hiring of long-term consultants. One thing, however, is entirely untrue: the staff are not coaxed into cowardice by the fact that losing their jobs would mean also a painful move back to the home country. The staff do not fear loss of jobs; in the Fund one can count on one hand the people who have been dismissed. The worst one can say is that in a bureaucracy, risk taking and innovation are not at a premium.

It has sometimes been suggested that it would be helpful to recruit to the staff specialists in fields other than economics. But if there is any problem with the composition of the staff it is not the lack of sociologists or political scientists; it is more likely to be the absence of people used to moving in a politically charged atmosphere and finding compromises without neglecting technically essential principles, as well as explaining to both sides - management and member countries - why concessions have to be made. This task has become more difficult as the Fund's resources have become smaller in relation to the demands put on them. It is true that as many more countries have become capable of obtaining resources, as long as their policies are supported by the Fund, the role of the latter has increasingly become that of a provider of the "good housekeeping" seal of approval to pry loose other countries' support to a Fund programme. But that development has been somewhat stymied by the simultaneous absorption of financial resources by the national demands of the richest countries, of which the main sign is the dramatic, but sustained, fall of national savings. This has often meant that major countries attempt to shift to the Fund risks that should be more properly assumed by themselves, which is not to suggest that the Fund should shy away from justifiable risks. The Fund's conditionality is one way of limiting risks; another - the pledge of collateral - has never been used.

With the increase in the number of Fund members, more countries now apply for Fund financial support or its seal of approval. At the same time, however, the development of international capital markets has meant that a larger number of countries has become able to eschew the need for support by the Fund.

What is still needed may be advice and coordinating action. Advice and coordination is what the IMF has always dispensed. That it lost coercive power when it lost the ability to

withhold financing from major countries, may mean greater difficulty in selling its advice. It must, in other words, be increasingly seen to be more capable than national establishments, or international or regional entities like the European Union, of supplying such advice. No doubt that technically there are now more competent economists available in all countries than earlier. Nevertheless, IMF technical assistance does not seem to be more dispensable today than it was 40 years ago. Analysis backed by the prestige of an international institution, intimate acquaintance with a country's situation and with the interconnections between countries, as well as with the experience of other countries and the absence of prejudice, can supply a dimension otherwise unavailable.

6. Executive Board and governments

What is the relationship of Executive Directors with their governments? Appointed Executive Directors can be dismissed *ad nutum*, whereas elected Executive Directors cannot legally be dismissed.[12] During his two-year term, the position of an elected Executive Director is therefore extremely strong vis-à-vis his Governors, particularly those of whose countries he is not a civil servant. While appointed Executive Directors will often get very detailed instructions about which they may argue with their superiors, elected Executive Directors will ask for detailed instructions only when they are aware that a matter is of particular importance to a member or members of their constituency. These Executive Directors, moreover, have the obligation to reconcile divergent views among their constituency and, therefore, even in the presence of instructions from each one of them, have considerable autonomy in balancing the divergent points of view which may have been expressed to them. They will not necessarily be expected to perform this function by being guided merely by the preponderance of the voting power among their constituency.

The original professional staff of Executive Directors' offices was conceived as consisting of directors and alternates, so that a continuous presence of each chair could be assured at Fund headquarters. There was also some idea at the beginning of the Fund's existence that Executive Directors might come to Washington only to participate in major decisions, while the day-to-day function of each chair would be performed by the alternate. Less than half of the chairs ever followed this pattern; some chairs that did accumulated the function of central bank governor with that of Executive Director. Obviously if that pattern had become generalized, the power of the Executive Board would be much greater than that of Executive Directors as mere envoys of their countries or constituencies, rather than independent decision makers in their own countries. But this idea of Keynes can hardly be resurrected in its original form.

The Executive Board has become younger and technically more competent. It is with almost no exception recruited from civil servants of one kind or another. The average period of service of Executive Directors has generally become shorter than it used to be. This has reduced the chances of Executive Directors learning the precedents, and has probably weakened them in relation to the management and staff.

C. Governance and mission

How well is the Fund's governance adapted to its mission? This paper takes it for granted that there will continue to be something like the present Fund and asks how its governance can be best adapted to its present mission and to the way its mission may evolve. One can - with some artificiality - divide the Fund's responsibilities into two groups: the management of the international monetary system existing at any time, and the system's adaptation to changing circumstances.

1. Management

The first mission - which was the only one until roughly the early 1960s - the Fund has carried out satisfactorily. This mission consists of assisting its members to correct balance-of-payments disequilibria and avoid current payments restrictions, while helping them to achieve price stability and growth, as well as full employment. This task initially required no heroic decisions. The Bretton Woods design of rare parity adjustments (except for developing countries) was particularly well suited to this mission. There were no major

[12] Although there have been rare cases in which the countries electing them, and in particular their own country, have prevailed upon them to resign before their two-year mandate expired (sometimes, an Executive Director of a multi-member constituency is elected with the understanding that he will resign before the end of his mandate to make place for a representative of another nationality).

shocks for major countries. There was nothing which an outfit could not perform quite well whose decision-making personnel were recruited - as those of the Fund increasingly were - from national civil services. Such people are trained to examine situations objectively and to be alert to the fact that what today is needed for one country may tomorrow be required by their own, a clear incentive to non-discrimination. Mainly, however, there was then - as distinct from today, and except for the United States - no dividing line between countries that are not expected in the foreseeable future to require financial support or a "good housekeeping" seal of approval from the Fund, and others that do.

This division, while not permanent - and clearer in the depth of the debt crisis than today - is, nevertheless, a major development and requires adaptations in the running of the IMF. The Fund's financial resources, as an incentive to observance of its code of conduct, have lost weight for a more important group of countries than ever before, which does not mean that with the rise in Fund membership the Fund's clients have not become more numerous. For the former group, the Fund's analytical competence and the information it can supply have become more important. The Fund is faced with the necessity - if it is to remain relevant to the major countries and, hence, to the world economy as a whole - to use these abilities to induce the major countries, especially the G-7 (or the G-3), to carry out the Fund's purposes. With their validity they do not, essentially, disagree. But it must be recognized that they also do not, always, ascribe to them overriding importance. One occasion when they apparently and successfully did so was the 1985 Plaza Meeting, which led to the correction of the disequilibrating trend in the value of the United States dollar.

The machinery for effective surveillance over major countries was never perfect, but now the group over which this imperfection applies is larger. The machinery for effective surveillance over major countries consists in the first place of the Fund's consultations with these members, and the WEO exercise from which some peer pressure can result. It also consists of confidential communications and, possibly, meetings of the Managing Director with ministers and central bank governors of these countries, to emphasize the advice tendered in the consultations and through the WEO discussions. And it consists of the Managing Director's - and, in a preparatory role, staff - attendance at part of the "summit meetings" (beyond more informal contacts). The participation of the non-G-7 world is only indirect through the Fund representative, unless some of the non-G-7 have direct lines of communication to representatives of the G-7. It would be a retrograde step to establish a G-7 (or G-3) secretariat as has sometimes been suggested. Such a body would dispose of no better knowledge or analytical insight than the Fund staff and management.

One can think of improvements in the use of existing Fund organs. Thus, more active participation of non-G-7 Executive Directors in the WEO debates and the Informal Sessions on World Economic and Market Developments, would be helpful in making the Fund's advice to members, including major members, more useful. Improvements in the governing organs of the Fund could be contemplated. It is worthwhile to enter into some detail on this matter.

The Executive Board may be too large to perform its functions effectively. One could argue that its work, if it is not *de facto* to be delegated to a considerable extent to the staff, requires even closer contacts among Executive Directors than now exist. And it probably requires a group as involved in the work of the Fund as the present Executive Directors.

Instead of having 24 Executive Directors in Washington, could one select among the Executive Directors a smaller number so that they can interact more closely with each other? The change proposed would make it easier, in particular, to apply peer pressure among the members of the smaller group in the management of the Fund, perhaps the only practical substitute for the absence of the power of the purse over an increasing number of important countries. The smaller group could be established (at least initially) as an advisory committee of Executive Directors to the Executive Board by decision of the latter, without any change in the Articles; its power would be based on consent. It could have single country members - not necessarily seven - and multi-country members, whose representatives could rotate. Such a smaller group could be of a size (perhaps 12) sufficient to be representative of the entire membership, and yet be small enough to be an effective managing body and have enough intimacy to be tolerated by the G-7 (or G-8). Such a smaller group might be able to realize the frequently voiced desire that the Executive Board husband its time more carefully. Obviously, this idea requires considerable fleshing out before it could be presented as a practical proposal.

Apart from such a basic organizational change, what other ones could improve the functioning of the present international monetary system? One concerns the exchange rate

system. As long as the par value system prevailed for the major countries, exchange rate changes could be left to the initiative of each country (except for the anchor country, the United States, as was eventually realized). Today, there is a real problem of which country should take the initiative to change its exchange rate, even where a misalignment is generally perceived to exist. This was discussed in the 1970 report of the Executive Directors (IMF, 1970). While there has been no formal change, the Fund has become much more free to include suggestions on exchange rate changes - in a carefully formulated way - in its consultation reports. This new practice can be helpful, although fears are sometimes expressed that such power could be used asymmetrically; it would be more correct to say it could impact asymmetrically as between larger and smaller countries.

Another point may be relevant in this connection. The Executive Board's advice can hardly be expected to be immune from mistakes of emphasis. As one example, Prime Minister Chernomyrdin of Russia has warned against what he has called "market romanticism".

One way of minimizing the repetition of mistakes in the Fund's policy advice could be the establishment of an evaluation office. It could not be an exact copy of the World Bank's (and other's) Operations Evaluations Office, since the emphasis of a Fund's evaluation office would be purely on policy and not at all on projects. Also, establishment of such an office in the Fund, as elsewhere, may well comprise risks, e.g. making the staff more hesitant to engage in new initiatives than it would otherwise be. But closer Board control over IMF operations through such an office would surely have offsetting merits, and might just as easily lead to avoidance of delays in facing up to problems.

A very delicate matter concerns the use of publicity to encourage members to promote the Fund's objectives. It is necessary to steer a middle course between using publicity to produce pressure on governments without discouraging frankness in consultations. The Articles of Agreement (Article XII, Section 8) require a 70 per cent majority of the total voting power to authorize publication of a report to a member regarding its economic situation which directly tends to produce a serious disequilibrium in international payments. The Fund may not publish a report involving changes in the fundamental structure of the economic organization of members.

One of the most important avenues through which the Fund influences the international monetary system is the schooling which it provides to officials of member countries. It does so through recruiting and training individuals who later return to the economic teams of their own countries, after spending time on the staff of the Fund or as students in the Fund's varied training courses. The passage of an individual through these stages is apt to create a strong identification between his viewpoint and that of the IMF staff. At the same time, the passage of people from member countries as trainees through the staff opens the eyes of the latter to country problems they might otherwise not perceive. This interaction is a powerful tool for furthering the Fund's influence. It is, certainly, not exploited to the full extent possible. It is not clear, however, to what extent this defect could be corrected without offsetting disadvantages.

This problem is particularly significant in relation to the Fund's attitude to the problems of developing countries, and even more so, perhaps, to those of countries in transition. It is perhaps still easier to find well-trained economists familiar with the problems of industrial countries than with those of countries in transition or, even perhaps, developing countries. The best way of meeting these problems would be by expanding the work of the IMF Institute.

2. *The systemic problems*

In addition to managing the international monetary system existing at any one time, the Fund faces the challenge of transforming that system continually in order better to serve the international community, which is making changing - and increasing - demands on it. Among these new tasks are some whose attribution to the IMF may seem questionable. They may include tasks such as taking into consideration, in carrying out the institution's policies, environmental concerns, where the competence of a financial institution may not be readily apparent. The problems posed in connection with such tasks will not be considered here.

The earliest of the systemic changes which did seem to fall clearly within the purview of the IMF was the abandonment of a single gold price - for both official and non-official transactions - which had been maintained by sales of the central banks constituting the gold pool, and which ended in 1967. Central banks continued official gold transactions at the established par values. Nevertheless, the abandonment of the single price was a signal of impending changes in the international monetary system. These changes took place without reference to the IMF.

The next major change after the creation of the SDR was the abandonment of gold convertibility by the United States in 1971 and the establishment of a new grid of exchange rates among the G-10 in the Smithsonian Agreement in 1971, followed in 1973 by the abandonment of the par value system. The latter happened in the middle of the attempt by the Group of Twenty to reform the international monetary system.[13]

No satisfactory solution for the construction of an international monetary system has been found. Possibly none is necessary since no major catastrophe has yet occurred under the "exchange rate system of the kind prevailing on January 1, 1976" as it is called in Article IV, section 2b. Nevertheless, nobody seems entirely happy with the system which we now have. Perhaps, however, what is needed is not so much a new system but - banal as it is - closer consultations among major countries, concomitant with paying due regard to the interests of the entire international financial community. The G-7 supplies only the former need.

The next major problem, by its size and nature a systemic one rather than a mere balance-of-payments problem, was the first oil shock of 1974. To prevent a widespread fall into protectionism if not deflation, the OECD promoted a non-protectionist commitment of its members, and the IMF established its 1974 and 1975 oil facilities. These made it possible to finance continued oil imports with Fund credit under generous conditions. The facilities were amply used by both developed and developing members, almost the last time that one of the former requested Fund credit. It was a major demonstration of international cooperation in monetary matters.

A major problem for the Fund arose as the result of the debt crisis, from which all major debtors seem by now to have emerged. It is well known that the Fund, at first, approached the debt crisis as a liquidity problem, and only very gradually came around to dealing with it as a major structural problem requiring debt reduction for its solution. It was the United States through the Brady approach which pointed the way to the solution of the problem. To deal with arrears, which arose in this context, the Fund developed new facilities, such as the Rights Accumulation Programme. A quicker solution could perhaps have been found if the Fund had been able to intervene by making available to the debtor countries larger resources over longer time periods.

Among other new problems which have arisen, one is the increasing mobility of capital at the same time that capital controls are becoming less acceptable. The question has even been raised in the Fund whether the Articles of Agreement should not be changed so that the presently existing freedom to impose controls over capital movements would be abolished and the Fund given jurisdiction over approval of such restrictions, just as it has jurisdiction over the establishment of current account restrictions. There can be no question that controls over capital movements do not remain effective for any length of time. On the other hand, they can be helpful temporarily to protect a country from the impact of large capital movements. Certainly by their nature, any restrictions over capital movements, in order to be effective, would have to be available at very short notice, so that any lengthy approval procedure by the Fund would have to be avoided. In fact, if any approval by the Fund were to be required at all, it would probably be necessary to maintain a country's right to impose restrictions without approval for a limited period, rather than to require prior approval. This would obviously be something of a formal innovation for the Fund.

Of the new problems, the most difficult is, undoubtedly, the "transformation" problem of the former communist economies. It requires an entirely new approach, not at all comparable

[13] The matters to be looked into in the context of reform of the international monetary system would include those which have been examined in connection with the efforts by the Committee of Twenty and indeed even before that Committee in a report by the Executive Directors to the Board of Governors (IMF, 1970). The earlier report of Executive Directors had rejected floating rates, par values with substantially wider margins and par values adjusted on the basis of pre-determined formulas. It had suggested three types of adaptations of the par value system: permitting adjustment of par values, without necessarily obtaining the concurrence of the Fund even if the changes in par values were larger than those which could originally be made by a member country on its own initiative; a slight widening in margins around parity; and assurance to members that no action would be taken against them if they deviated temporarily from their par values in the context of appropriate safeguards. It was also mentioned that these adaptations might depend on the possibility of member countries accepting controls over international capital movements. A later report of the Executive Board looked beyond the immediate crisis created in 1971 and temporarily solved by the Smithsonian Agreement. It stressed the need for compatible policies of Fund members if any monetary system was to work properly, endorsed the possibility of small exchange rate changes, and discussed the possibility of giving the IMF power to recommend par value changes. It also discussed the conclusions of and conditions for replacing the existing liability settlement system by an asset settlement system, and explored the financing and control of capital movements. It also emphasized the relationship of monetary reform to the development of the developing countries. This matter has, for the time being, been laid aside.

to reducing excessive State interference in what were largely market economies. There have been increasing pressures on the Fund in the context of this problem to interpret the principle of evenhandedness broadly enough to enable it to face up to it. In this context, the Fund has established the Systemic Transformation Facility, which is a relatively quick disbursing instrument to be used before, and in addition to, what could otherwise be handled by a stand-by arrangement. A quick disbursing facility would, however, also be helpful for other countries either facing a self-reversing balance-of-payments problem, or one where the country is expected to be able relatively soon to qualify for a stand-by or extended arrangement.

To deal with systemic problems, the Fund as such is now - as distinct from earlier - equipped with its Interim Committee, and the international financial community disposes also of the G-7 and G-10. The Interim Committee may be too large even for dealing with systemic problems. The result is that these problems tend to be dealt with by the G-7, which is even less representative of the international financial community than would be a smaller Interim Committee, perhaps one shrunk on the lines discussed above in relation to a possible shrinking of the Executive Board.

REFERENCE

IMF (1970), "The Role of Exchange Rates in the Adjustment of International Payments", a report by the Executive Directors (Washington, D.C.).

Comments

Güillermo C. Mungi

Alexandre Kafka has prepared a comprehensive paper for us, with the authority afforded by his long and productive term on the IMF Board of Directors.

The purpose of the Fund is to promote international monetary cooperation and exchange-rate stability. It is an organization with regulatory, consultative and financial functions, which should be exercised in an equitable manner. However, the IMF has been plagued by a fundamental problem since its creation; namely, asymmetry in dealing with its members. As Kafka notes in his paper: "Influence in the Fund continues to reside in the main industrial countries, with the United States paramount". Basic asymmetry will probably worsen, unless an effective way is found to reverse or halt its advance. The problem is that financial resources, as an incentive to observance of the IMF conduct code, are not as important to many countries as was the case when the institution was founded.

To improve asymmetry, Kafka suggests the Fund use its other "assets"; that is, its analytical proficiency and information, to induce major countries to accomplish its purposes. Yet, were these assets not already being used, possibly with less emphasis that Kafka suggests, and to no positive end? For more than a decade, the comments and technical or moral arguments put forth by the IMF and other bodies were insufficient to persuade the United States to reduce its fiscal deficit. This had serious consequences for the world community. High interest rates paid on the external debts of developing countries were a direct result of the mix of economic policies applied by the United States authorities.

Let us hope that in the future, the Managing Director of the IMF will have more of a say at the meetings of G-7 ministers and governors. As Azizali Mohammed remarked, the G-7 should be genuinely interested in cooperating with developing countries, as is evident in the impulse given by them to the industrialized countries' exports, which has reduced the impact of recession in these countries.

To enhance the work of the Executive Board and exert more of an influence on the IMF management, Kafka suggests that a smaller group of directors be established as an advisory committee to the Executive Board. The idea is interesting, but his arguments fail to convince us that another committee would be able to influence management executives and, through appointed directors, their bosses.

Another suggestion is to create an evaluation office for IMF programmes as a way to reduce operational errors. This unit could provide IMF staff members, management and its Executive Board with valuable information on positive and negative experiences in relations between the Fund and its members. However, as Kafka says, it might make the staff more conservative. In any event, it would be useful to consider the experience of the World Bank Evaluation Office, particularly regarding the impact of non-economic conditionality, which is being increasingly applied.

A point not given much consideration is the use of publicity to encourage members to promote IMF objectives. This could be a powerful instrument with developing countries, which are usually the ones to use IMF resources the most, and with the industrialized countries as well, which do not need them. The general public in developing countries does not regard the IMF in a positive light. This contributes to difficult and sometimes lengthy negotiations between national authorities and IMF staff members. If the Fund were to explain its role in correcting economic wrongs, and attempt to persuade people that the policies it supports are for everyone's benefit and that it does not represent the interests of a few economically powerful countries, its image in the developing world might change and life would become easier for everyone, the IMF and national authorities alike. On the other hand, an open, frank and aggressive presentation of its opinion on policies pursued by some industrialized countries would help to build the

sort of public pressure required to adopt corrective measures, particularly if it reveals the negative consequences of inadequate policies for the country in question, as well as the price to be paid by the rest of the international community.

According to Kafka, it is questionable as to whether certain tasks are suited to an international financial institution. He specifically mentions environmental concerns. However, there is another important moral concern, the human rights issue, which is easier to manipulate and is used widely by industrialized countries for political reasons. The problems posed by the human rights issue are not necessarily included in formal agreements with international financial institutions, but are part of negotiations which are exposed to subjective opinions, distorted information, internal political squabbling, etc. These political considerations should be eliminated from negotiations with international financial institutions, and addressed at diplomatic and political forums.

Moises Naim presented a complete and provocative paper on governance of the Bank. Goal congestion is one of the many fascinating topics he raises when noting that legislatures in donor countries are exerting more and more influence on the Bank. This certainly increases political considerations in terms of its relations with recipient countries, undoubtedly to the detriment of the economic and social aspects which should be the main consideration. As Naim says, countries with limited bargaining power are obliged to accept conditions and objectives which acquire considerable visibility and priority within the Bank during a given period. On the other hand, strong countries can, and often do, persuade the Bank to be more lax on conditions that are not fundamental to the loan under negotiation. The Bank loses its moral authority when it applies human rights policies in a selective manner. As noted in its charter: "Only economic considerations shall be relevant, and these considerations shall be weighted impartially in order to achieve the purposes". Naim suggests a number of ways to improve the Bank, but after reading his document one is inclined to conclude, as he himself notes in the end, that they may be unrealistic.

VII. THE REGIONAL DEVELOPMENT BANKS AND THE WORLD BANK

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THE EVOLUTION OF THE MULTILATERAL DEVELOPMENT BANKS

Devesh Kapur and Richard Webb

ABSTRACT

This paper traces the evolution of the MDB "system" over the past half-century. It highlights the importance of the original model - the World Bank - whose success, and weaknesses, led to the replication of the model through the creation of the Regional Development Banks (RDBs). The RDBs initially sought to differentiate their lending policy from that of the World Bank, but a broad convergence has occurred over the decades. While the World Bank's pre-eminence in this system has remained mostly unchanged, the model itself has seen major changes, partly the consequence of the introduction of concessional funds and partly as a reaction to changes in the global economy.

A. *Introduction*

This paper traces the evolution of the principal multilateral development banks (MDBs) - the World Bank, the Inter-American Development Bank, the Asian Development Bank and the African Development Bank - over the past half century. The account will examine the changing relationship between the World Bank and its regional counterparts (the regional development banks (RDBs)), but the principal questions will have to do with the evolving context and character of the MDBs as a group. These organizations are a singular innovation in international relations, aspiring at once to establish a degree of multilateral governance, increase the economic and social welfare of poor nations, and achieve those objectives by operating, in a businesslike way, as banks, raising most of their funds in the world's capital markets.

The main questions concern the way in which the governance, financing, and objectives of these institutions have evolved since their origin. For the most part, their present character owes little to the Bretton Woods blueprint for the first of these banks, the World Bank. Thus, they lend directly, rather than guarantee private capital; they discriminate among countries according to relative income, "graduating" the better-off; they provide concessional funds in addition to loans on market terms; and they make advice and arm-twisting as much their business as lending. Nor did Bretton Woods envisage the multiplication of MDBs (table 2 lists 16 banks created by 1993). In this paper we will try to account for the changing circumstances and organizational responses that shaped, and continue to change the World Bank and the three principal regional MDBs.

Section B of the paper is an account of the origins of the MDBs. The argument is that their design owes as much, or more to the political and financial circumstances that shaped the World Bank during its first years, as it does to Bretton Woods. Section C traces the replication of the 1950s World Bank "working model" in the creation of regional development banks, a process that involved both borrowing from and reacting against that model. Section D presents a statistical overview of the evolution of main aggregates. Sections E and F examine lending, allocation of lending and MDB

funding. The concluding section G comments on the MDBs in the 1990s.

B. *Origins*

The World Bank was created with two principal objectives in mind: the financing of European reconstruction, and what Keynes called its "second primary duty", economic development, by which he understood the bringing into production of productive capacities throughout the world. The charter does not rank these objectives, and some delegates objected to Keynes's definition, but when American officials sought congressional approval for the Bank's funding, and when the institution first set out to lend, the principal concern was European recovery, not development of other lands. The Bank was seen less as an individual actor with independent objectives than as a part of a postwar international economic system, the whole of which would encourage the recovery of trade and capital movements between countries. The Bank's part in that system was to promote and encourage capital flows to Europe and to other capital-scarce areas, by acting as a guarantor for private investments, and by lending directly "when private capital is not available on reasonable terms". Development, moreover, was understood more in terms of physical productive potential than of human needs. It was entirely in keeping with the spirit of the Conference and of the Articles of Agreement that the Bank's principal borrower for development purposes over its first decade was Australia, and that the first loan to that country was justified to the Board by drawing attention to the fact that Australia already enjoyed one of the world's highest levels of income per person.

Despite its multilateral trappings, it was accepted that the major voice in the institution would be that of the United States, which had the fiscal capacity to finance a substantial endowment, and with a capital market that could be tapped for overseas investments. Funding would be obtained largely in private capital markets, and borrowed funds would be backed by a full government guarantee, up to the amount of callable capital, of the member countries. Though subscribed capital amounted to an impressive $10 billion, only 20 per cent was to be paid in, and of that amount, it was understood, only about $750 million - mostly from the United States - would be made available in the form of convertible currencies during the initial years. The other 80 per cent of the capital subscription was to be subject to call by the Bank only to meet obligations.

The original plans for the IBRD underwent radical change during its first two years of operation. Due to delays in the ratification of its charter and administrative organization, the Bank was unable to assist Europe during her period of most critical need: the first two years after the end of the war. By the time four reconstruction loans were made over the summer of 1947, the Truman Doctrine, committing the United States to military and economic aid to Greece and Turkey, and the more ambitious Marshall Plan, had been announced; the Cold War was beginning. The Bank suspended lending for 16 months to reassess its role vis-à-vis the Marshall Plan.[1] At the 5 November 1947 Board meeting, Bank President John McCloy stated: "I think we are going to be driven [sic] into a very different field sooner than I thought, into the development field". The lending interruption was used to gear up for the new task. The President and staff took long trips to developing countries; consultants were sent on major survey missions; research and data collection were begun. In early 1949 the Bank launched its career as an MDB.

McCloy, President for two years, was responsible for another lasting change in the character of the institution. His predecessor, Eugene Meyer, had been unable to act as the Bank's principal authority. The charter was vague on the roles of Executive Board and President, and, during the Bank's first year of operations, the United States Executive Director had succeeded in investing the Board with a major say in operational decisions. McCloy, who was in a position to bargain, agreed to replace Meyer on condition that only management could take lending initiatives, and that the United States Executive Director be replaced by his own candidate, Eugene Black. McCloy, and his successor Black, established a tradition of strong presidencies, and of managerial rather than Board initiative, a tradition that is in marked contrast to that of the IMF.

From 1949-1960 the World Bank operated as a development bank, but with the accent on "bank", financing $2.8 billion in loan disbursements, largely by raising $2.2 billion in the market through the sale of bonds, loans and loan participations. The dependence on Wall Street reflected itself in the Bank's cautious lending policy. It ignored pressures from developing countries and its own donors, ex-

1 With two small exceptions: the Bank's first development loan, a $16 million credit to Chile, and $12 million to the Netherlands, both approved in March 1948.

panding slowly, and assigning half of its funds to OECD countries or to their colonies. Loan applications by developing country borrowers were often postponed if prewar debt arrears were not settled, or if annual inflation threatened to exceed single-digit figures, or if development expenditures were not adequately "planned". In addition, almost 80 per cent of its loans to developing countries were restricted to large-scale power and transport projects; lending for agriculture was minor, and fell over the decade, and the social sectors were taboo. This loan policy was considered to constitute a sound development strategy: infrastructure investments would act as catalysts for private investment in the productive sectors; agricultural development was seen as necessary, but development and modernization were largely equated with industrialization; and "welfare" expenditures on drinking water, education and health would have a high opportunity cost in more productive investments.

But the principal reason for the Bank's restrictive loan policy during this period was not doctrinal; it was the need to establish the Bank's own creditworthiness. An operational tool, the specific investment project, became a key instrument in creating an image of creditworthiness. By contrast with the apparent fungibility and anonymity of funds provided through programme loans for broad categories of development expenditures, the specific project loan appeared to give the Bank a high degree of control over the final destination of its funds. Specific projects provided a maximum degree of visibility, verifiability and apparent productivity, and thus, of quality and soundness in its loan portfolio.

The concern for its own creditworthiness was also a factor in the importance attached by the Bank to technical assistance, and to the development of an interventionist and tutelary style of lending. Pressed to lend, the Bank continually objected that developing countries lacked "absorptive capacity". Its own creditworthiness was put at risk by weak civil services and institutions, dearth of project expertise, and undisciplined financial management at the national level. As the *Annual Report* for 1948-1949 noted, "if [the Bank's] loans are to be sound and productive, it must aid its underdeveloped member countries".

The Bank's smallness and dependence on the market gave it a considerable degree of managerial and political independence. In volume of economic aid to the developing countries, the United States Government provided about $1,800 million per year, and the IBRD about $250 million, and the disparity would be far larger if measured by the grant component. In technical assistance the Bank was overshadowed by the prestige and spending of the specialized agencies of the United Nations, and of private sources of assistance, such as the Ford and Rockefeller Foundations. In development economics, the United Nations and universities played the leading role, while the Bank consciously downgraded its research role. Though consultations with the State Department were a regular feature, and though some of its lending (and non-lending) bore a visible political stamp, the Bank used its smallness, dependence on the market and multilateral character, as arguments to fend off much of that pressure. Certainly, its reputation as a non-political, technically rigorous lender grew through the decade, in the financial market and among borrowers. The success of this strategy was recognized by the market, in 1956, with a triple A rating, which opened the door to large-scale financing at the lowest available market rates, and by the donor members, in 1959, with a general capital increase which more than doubled the amount of Bank borrowing that would be guaranteed by member governments. In effect, the Bank was able to follow a niche strategy, as a quality lender, differentiating itself from the large-scale, politically-motivated, soft aid provided by the United States Government, and from the political advocacy associated with the United Nations.

In following this strategy the Bank helped to legitimize aid. By lending at market rates, insisting on high project standards, supervision and borrower creditworthiness, providing hands-on project assistance and advising on general economic policies, the Bank created a model of international economic assistance that appeared to be genuinely productive, relatively disinterested, and inexpensive to taxpayers. In that way the 1950s World Bank prepared the way for the RDBs, showing that aid could be businesslike, and providing an operational blueprint.

Before the World Bank model came to be replicated in the form of regional MDBs, however, the design was subjected to a major modification with the decision, taken between late 1958 and mid-1959, to create a soft window in the Bank, the International Development Association (IDA). The decision was largely political; the new fund was intended to increase and soften multilateral assistance to developing countries; and its location in the World Bank, where voting power was weighted by capital contributions, rather than the United Nations' one-country one-vote basis, was a means to retain political control. The Bank had strenously objected to soft lending from the moment the idea was first mooted at the beginning of the decade. Black (1953, p. 7) argued that:

> Loans of this kind are, in essence, part loan and part grant. They have the inherent fault that they are not always apt to be regarded as serious debt obligations. Like all other 'fuzzy' transactions, they therefore tend to impair the integrity of all international credit operations.

But the Bank finally agreed to manage the fund, partly because acceptance was seen as preferable to the creation of a separate, United Nations-managed fund, and partly because the Bank's own future lending prospects were suddenly put into question by the balance-of-payments crisis that affected many borrowers during 1957-1958: IDA terms would allow the Bank to continue to lend to countries such as India, despite their debt burdens and foreign exchange problems.

In a sense, the creation of IDA within the World Bank was a further recognition of its success as a model; political approval was made easier by the Bank's share-weighted version of multilateralism, and because the Bank had demonstrated that, with proper management, money spent on aid could indeed be productive. Paradoxically, by introducing "fuzzy" loans, and greatly increasing the share of Bank funding provided out of member government budgets, rather than from market borrowings, IDA altered two of the principal features that had been perceived as important to that success: the lender and borrower discipline associated with market interest rates, and the shield against political interference that resulted, also, from dependence on the market.

C. *Replication*

The late 1950s saw a multiplication in the number of international organizations created to finance - and/or advise on - economic development. The International Finance Corporation (IFC) was established in 1956, as a World Bank affiliate, and as mentioned, IDA was approved in 1959. Other new organizations were the United Nations Special Fund (1958), the European Investment Bank (1958), the European Development Fund (1958), and the Inter-American Development Bank (1959) which arrived with an attached soft window, the Fund for Special Operations. Though not a financial institution, the United Nations Economic Commission for Africa was added to other United Nations regional organizations during this period (1958).[2]

Two reasons may be suggested for this sudden expansion in the number of institutions and the size of the financial effort for development. One resulted from an evolution in foreign policy, as the geographical scope of the Cold War broadened from Europe to the wider theatre of Asia and the Middle East, and as the initial reliance on the nuclear deterrent was transformed into a competition for political allegiance based, in part, on economic aid. Indeed, the perceived association between poverty and communist advances in Asia was already being extrapolated to Africa and Latin America, an argument that was encouraged by Nasser's turn to the Soviet Union and the imminence of Castro's victory in Cuba. The political motivations that had driven the Marshall Plan began to be transferred to new institutions and increased assistance to developing countries in general. A second probable factor behind the multiplication of development institutions, and in particular, the MDBs, was the conclusion drawn from the experience of the World Bank, that development financing, with considerable reliance on market funds, technical assistance and heavily supervised lending, was a viable method for achieving development.

The first regional development bank modelled on the IBRD was the European Investment Bank (EIB), established in 1958 under the framework of the European Economic Community. The EIB's charter resembles the Articles of Agreement of the World Bank, but its lending, which currently exceeds that of the World Bank, is almost entirely restricted to Europe. The creation of the EIB, however, was accompanied by that of a concessional source of funds, the European Development Fund (EDF), whose principal function was to provide grant-aid in substantial volumes to francophone Africa. The EDF, created before IDA, has been a steady and major provider of concessional funds, with a volume of lending that has risen during each decade from about half of IDA lending in the 1960s, to about 80 per cent during the 1990s.

Like IDA, the Inter-American Development Bank (IDB) was to some extent made possible by the success of the World Bank, but, at the same time, and in the same way as IDA, its establishment was in part a reaction to the political discomfort created by the Bank's re-

2 The Economic Commission for Latin America (ECLA) had been established in 1948, and the Economic Commission for Asia and the Far East (ECAFE) in 1947. These were later renamed, respectively, the Economic Commission for Latin America and the Caribbean (ECLAC), and the Economic and Social Commission for Asia and the Pacific (ESCAP).

strictive lending policies. As Mason and Asher put it (1973, p. 578) in their history of the World Bank, the creation of the IDB was "at once a tribute and a rebuke to the World Bank". Proposals for an IDB were made through the 1950s by spokesmen for Latin American governments, who argued that a regional bank would increase the flow of capital to the region, permit a more liberal lending policy, not restricted to specific projects, nor to foreign exchange costs, nor to government-guaranteed private investments, and that it would promote regional integration through its investments, as indeed was one of the principal purposes of the EIB. But the United States opposed the idea, and pre-empted one of the Latin American arguments - the need for credits to the private sector that did not require a government guarantee - by approving the establishment, in 1956, of the International Finance Corporation (IFC) in the World Bank. The World Bank also objected to the proposal, "convinced that the regional bank would operate under lower standards and, in accordance with Gresham's law, would ease the World Bank out of Latin America" (Mason and Asher, 1973, p. 579). However, political events during 1958, in particular Nixon's disastrous trip to South America and the imminent success of Castro's revolution in Cuba, changed the Eisenhower administration's position, and were followed by the rapid approval and opening of the IDB in December 1959.

The charter of the IDB, though similar in many respects to that of the World Bank, contained some noteworthy innovations. One was the incorporation of concessional resources, the Fund for Special Operations (FSO), along with the Bank's ordinary capital funds. One result of this capital structure has been that regular negotiations for increases in the IDB's capital cover both its ordinary capital and concessional resources. The launching of the Alliance for Progress in 1961 led to a once-over increase in the IDB's concessional funding, with the creation of the Social Progress Trust Fund. Moreover, the objectives of the IDB charter differed from those of the World Bank. Thus, the IDB was permitted to lend without the requirement of a government guarantee, a liberty which the World Bank could only enjoy through its affiliated IFC. Also, the IDB was enjoined to lend for "social overhead projects"; and regional integration was made an explicit objective. Finally, IDB membership was restricted to members of the Organization of American States (OAS), and the borrowers had a formal majority. Canada was allowed to join in 1972, and non-regional countries in 1976.

The proposal for an African Development Bank (AfDB) emerged out of the United Nations Economic Commission for Africa (ECA). It was approved in 1963, and began to operate in 1966. Its charter went a good deal farther than the IDB in attempting to reform, or improve on, the World Bank model. Above all, and in consonance with the highly nationalist temper of the early 1960s in the continent, it excluded non-African countries from membership, and thus from influence in its governance. In addition, it was authorized to make concessional loans and equity investments, finance local currency costs, lend for industrial and agricultural projects and to the private sector without a government guarantee, provide technical assistance, and lend for multinational projects that would contribute to regional integration. The Board was given a greater voice in operations, vis-à-vis the President, than in other MDBs, and managerial autonomy was further reduced by the fact that its five Vice-Presidents were elected by the Board.

The Asian Development Bank (AsDB) was similarly conceived in the womb of the United Nations, by the Economic Commission for Asia and the Far East (ECAFE). Like the IDB, the proposal was discussed for several years until political events, in this case the escalation of the Vietnam war, brought a sudden increase in the priority of economic development in the region, a rapid approval of the proposal in 1965, and start of operations in 1966, a few months after the AfDB. Mason and Asher (1973, p. 578) saw the creation of these institutions as reflecting "the iron law of international organizations that prohibits establishing machinery in one-region without establishing, sooner or later, comparable machinery in other regions".

The design of the AsDB, however, was closer to that of the World Bank, perhaps because Eugene Black, acting as Lyndon Johnson's special advisor on South-East Asia after having served 13 years as President of the World Bank, played an active role in the process. Also, given Japan's deference to the United States on international issues, and her positive experience as a World Bank borrower, Japanese influence in the institution reinforced the tendency to design a charter that would resemble that of the World Bank.[3] The strong interest of donors in the creation of the AsDB assured that its capital structure and governance would provide for majority partic-

3 In addition, the AsDB's first President and Vice-President were previously Executive Directors of the World Bank (representing Japan and India respectively), and drew on the World Bank's experience with operating procedures.

ipation and control by non-borrowing countries, though the fact was partially disguised by giving "regional" members a 60 per cent majority, the regional group including donor nations such as Japan, Australia and New Zealand. But, like the IDB, the AsDB incorporated powers that in the World Bank, for reasons of historical accident rather than logic, had come to be distributed amongst legally separate entities, the World Bank, IFC, and IDA. Thus, the AsDB charter allows the institution to lend to the private sector without a government guarantee, and to make concessional loans.

Each of the three RDBs created between 1959 and 1966 was designed with varying degrees of differentiation from their common model. That model was the World Bank as it had come to operate by the late 1950s, including the recently grafted on IDA, rather than as it had been intended to operate by its charter. The most radical departure was sought by the the AfDB, and the least by the AsDB. But, notwithstanding those modifcations, the three shared the principal features of the 1950s World Bank; as vehicles for aid to developing countries, their contribution was to act as financial intermediaries, using government guarantees, technical assistance, and close supervision of their loans to reduce risks and borrowing costs, and to increase the flow of funds. In each case, the institutions were to some extent motivated and justified by the perception that the World Bank had proven to be a successful model for aid and development.

D. *Evolution of multilateral development bank lending*

The evolution of the four main MDBs, as measured by the structure of voting power, administrative size, and financial resources, at three moments of time - in 1970, 1980 and 1992 - is shown in table 1 below.

The overall picture is one of substantial and relatively balanced growth. The rankings in terms of total lending, subscribed capital, paid-in capital and size of professional staff, remained unchanged over the 26 years of operation, between 1966 and 1992. The structure of voting power, however, changed in all institutions, most dramatically in the AfDB, where the developing country share fell from 100 to 66 per cent, and in the AsDB, where the developing country share rose from 36 to 44 per cent. The relative size of concessional resources also changed, with faster growth in Africa and Asia than in Latin America or the World Bank.

It bears reminding that the MDB system includes a large number of much smaller banks that are not shown here, due in part to their size, but also to the difficulty in obtaining statistics and information on their behaviour. None the less, table 2 below lists those banks and provides a measure of their relative size.

The subsequent tables provide a more detailed view of the broad trends in lending volume (tables 3-6), and lending allocation (table 7).

Table 3 summarizes the growth of the MDB system, excluding the smaller banks, showing its expansion from an annual average lending (commitment) volume, in constant 1992 dollars, of $2.4 billion during the 1950s, to $16.2 billion during the 1970s, when all four banks were in operation, and its continued, but decelerating, growth through the 1980s and early 1990s. The overall cumulative growth rate between the annual lending in the 1950s and the current (1990-1993) annual level is 7.8 per cent per year, but somewhat lower, 6.4 per cent, for the World Bank. The growth of the system as a whole, however, has been slower over each time period, falling from 11.6 per cent between the 1950s and 1960s, to 8.4 per cent and 5.9 per cent over the next decade annual averages, and has been only 3.6 per cent per year between the mid-1980s annual figure to that of the early 1990s.

The rapid growth of MDB loanable resources through the 1970s and 1980s was favoured by several factors. With minor interruptions, such as the AfDB's inability to obtain funding in its first years, and a governance conflict that paralyzed the IDB in the mid-1980s, the system's overall capacity to lend increased steadily. Both market investors and government providers of concessional funds responded positively to the MDBs' image as a quality aid vehicle, successful in steering funds towards high-yielding investments, and in raising the quality of borrower development efforts. The image was in part due to their business-like style of management and lending, but it was also the result of comparison with other aid instruments. Bilateral aid was distrusted by borrowers who saw political and commercial motivations. Grant aid was distrusted by public opinion in donor countries for its image of loose control and bureaucratic waste. In the case of the United Nations, major donor governments, in turn, were reluctant to lose control over their aid contributions by endowing an institution over whose governance they had limited power, and which, in addition,

THE EVOLUTION OF THE MULTILATERAL DEVELOPMENT BANKS

	Established	*Headquarters*	*President*
African Development Bank	1964	Abidjan	Africa
Asian Development Bank	1966	Manila	Japan
Inter-American Development Bank	1959	Washington, D.C.	Latin America
World Bank (IBRD)	1945	Washington, D.C.	United States

	1970 [a]				*1980* [a]				*1993* [a]			
	AfDB	*AsDB*	*IDB*	*IBRD*	*AfDB*	*AsDB*	*IDB*	*IBRD*	*AfDB*	*AsDB*	*IDB*	*IBRD*
Governance												
Voting power												
G-7	0	47	42	53	0	42	55	51	25	42	44	45
United States	0	17	42	25	0	11	35	21	6	13	35	17
Developing countries [b]	100	36	58	36	100	43	43	37	66	44	54	38
Administration												
Number of professional staff	58	159	491	1166	220	416	672	2474	645	645	1171	4005
Administrative expenses ($ million) [c]	3	7	29	61	26	40	106	238	134	164	273	1241
Number of members	32	35	23	113	50	43	43	135	76	53	46	176
Number of borrowers	13	14	17	60	45	17	21	48	40	25	23	118
Resources ($ billion)												
Ordinary capital resources												
Capital subscribed [d]	0.22	1.00	3.15	23.16	1.62	8.83	11.77	39.96	20.97	23.08	54.20	165.59
Capital paid in [d]	0.11	0.50	0.48	0.88	0.40	1.74	1.20	2.60	2.56	2.78	3.17	10.53
Outstanding debt	0.00	0.04	0.92	4.57	0.41	1.87	3.04	29.67	8.18	12.25	23.42	96.26
Reserves [e]	<0.01	0.01	0.10	1.33	0.08	0.39	0.77	2.60	0.87	4.18	3.15	11.14
Net income	<0.01	0.01	0.03	0.21	0.01	0.13	0.16	0.59	0.07	0.57	0.40	1.13
Concessional resources [d f]	<0.01	0.13	3.40	2.96	1.50	2.92	8.85	20.77	9.88	16.75	9.91	81.19
Cumulative loan commitments ($ billion)												
Non-concessional	0.02	0.33	1.49	14.85	1.33	5.65	9.47	62.65	17.35	32.85	49.61	239.00
Concessional [f]	0.00	0.06	2.58	3.01	1.05	2.52	8.37	21.63	10.49	14.86	13.36	80.15
Total	0.02	0.39	4.07	17.86	2.38	8.17	17.84	84.28	27.84	47.71	62.97	319.15

Source: AfDB (1964-1993), AsDB (1966-1993), IDB (1959-1993), World Bank (1946-1993).

a For all regional development banks fiscal years run from January to December. For the World Bank fiscal years run from July to June.
b For the World Bank developing countries are Part II members.
c Includes concessional facilities. For the World Bank excludes IFC.
d For IDB in 1970 does not include the capital increase which was approved in 1970,but not put into effect until 1971.
e Accumulated general or ordinary reserves created out of annual net income and used to finance new lending. Excludes reserves for loan losses. Includes translation adjustment for IDB in 1992.
f All concessional facilities.

Table 1

was handicapped by its role in the North-South debates of the period. Moreover, the reputation of the United Nations agencies as centres of professional expertise and developmental commitment, excellent in the early postwar years, had been eroded by poor management. MDB growth was favoured as well by the political tide of the Cold War; the IDA, the IDB, and the AsDB were each triggered and then supported by the rising priority of economic aid and development as instruments to forestall communism and to win allegiances in developing areas.

Moreover, three key features of the MDBs turned out to be particularly well-suited to the political circumstances of the period. One was their multilateral character, which acquired a premium with the decolonization and the spread of nationalism and non-alignment. In this context, the MDBs offered a less compromising, face-saving means to provide and receive aid, and to obtain much of the political benefit sought through bilateral aid. From the point of view of this diplomatic objective, the fact that the multilateralism of the MDBs was circumscribed by their voting and staffing arrangements was of less consequence than the image of international participation. The AfDB's initial exclusion of donors was an exception.

The second, historically favourable characteristic of the MDBs was their happy quality of fiscal cost-effectiveness: by borrowing under government guarantees, the MDBs multiplied small fiscal contributions, in the form of paid-in capital, into large financial transfers to the developing countries. The multiplicative powers of their subscribed, but not paid-in, capital became the more appealing as external aid budgets in the industrialized countries diminished, in the face of general fiscal tightness and a weakening of external aid as a governmental priority. In the face of this trend, the good reputation of the MDBs as quality lenders became increasingly valuable as a way to legitimize the aid effort in general to constituents, and to preserve an effective executive tool for donor governments, despite a dwindling aid budget. This image was being challenged on a variety of political grounds, from both the right and the left, by the late 1970s, and indeed the incoming Reagan administration set out to clip the wings of the MDBs. But the traditional usefulness of the MDBs to donor government executives, mostly to the respective foreign ministries, was suddenly enhanced during the 1980s, when the MDBs were mobilized by G-7 treasuries to contribute to the management of the debt crisis.

A third reason that may be suggested for the success of MDB fund-raising, particularly with respect to concessional funds, up to the late 1970s, was their intergovernmental character during a period in which both donor and borrower governments supported an important state role in the development effort. Despite the clear intention of the Bretton Woods delegates that the World Bank finance private sector activity, and the capacity that each of the four banks has had - since the creation of the IFC - to make non-guaranteed loans to the private sector, the MDBs have in practice operated almost exclusively as lenders to governments. One of the arguments that led to the creation of the IDB was that the World Bank was failing to lend to the private sector, yet the IDB, as also the AsDB and AfDB, have themselves lent almost exclusively to governments. This concentration of MDB support for state institutions was justified, by their managements and boards, on grounds of risk and creditworthiness.

Table 4 contrasts the performance of the World Bank and the RDBs within the system as a whole. The World Bank has been proportionately most prominent in Asia, though the relationship would be far more equal in a comparison that excluded India and China, which began borrowing from the AsDB in 1986 and 1987 respectively; China began borrowing from the World Bank in 1981. Conversely, the World Bank has been least prominent in Latin America, especially in the 1970s and 1990s; the IDB lost ground in the 1980s.

The level of MDB net concessional lending has grown at a similar rate, and kept a similar level to the concessional resources of the United Nations, since the mid-1960s. Gross disbursements by MDBs (not shown), however, have grown more rapidly than United Nations resources. The share of MDBs in total concessional disbursements fell substantially, from 47 per cent to 37 per cent, between the mid-1980s and the early 1990s. The MDB share of total multilateral disbursements has fluctuated between one half and two thirds, recording its lowest level at the end of the period, in 1991-1992, though high variability makes any projection risky. A major cause of the 1990s fall is the collapse in World Bank net lending, though it is partly compensated by a jump in IFC net flows.

Despite their political and media prominence, the share of MDBs in the total net resource receipts of developing countries has been relatively small, averaging 8.5 per cent over 1970-1992. The share rose in the 1980s but fell again in the 1990s, with the recovery of private capital flows. These aggregates hide

Table 2

MULTILATERAL DEVELOPMENT BANKS

(Billions of dollars) [a]

	Year established	Number of members	Subscribed capital	Assets
World Bank	1948	173	168.4	172.0
Regional development banks				
African Development Bank	1961	76	*	18.1
Asian Development Bank	1963	52	23.1	27.6
Inter-American Development Bank	1959	46	34.5	42.2
European Bank for Reconstruction and Development	1990	47	11.9	4.7
European Investment Bank	1958	12	*	112.4
Sub-regional development banks				
Andean Development Corporation	1968	5	0.4	2.0
Arab Bank for Economic Development of Africa	1974	17	1.0	*
Banque Ouest-Africaine de Développement	1973	7	0.5	*
Caribbean Development Bank	1970	25	0.1	0.3
Central African States Development Bank	1975	6	*	*
Central American Bank for Economic Integration	1961	5	*	*
East African Development Bank	1967	3	0.0	0.1
Islamic Development Bank	1974	43	2.5	4.4
Nordic Investment Bank	1976	5	0.3	8.0

Source: Standard and Poor's (1993), Bankers' Almanac (1994), IMF (1993).
a Exchange rate conversions are as follows: ECU: $1 = ECU 0.83; Kuwait dinars: $1 = KD 3.40; CFAF: $1 = CFAF 264.69; SDR: $1 = SDR 0.7273.
* Not available.

the important role of MDBs in many individual countries, and at particular moments, for instance, in South Asia in the 1970s, and in Africa during the 1980s. In addition, it is often claimed that such figures miss the catalytic rôle of MDB flows.

E. Allocation of lending

The allocation of MDB lending by sector has evolved from the World Bank's early concentration on economic infrastructure, especially in the fields of energy and transportation, to an increasingly diversified portfolio (table 7). Power plants and highways provided the World Bank with what appeared to be highly productive, catalytic investments that were, at the same time, particularly attractive to market buyers of World Bank bonds. Diversification had an energetic start with the establishment of the IDB. During its first decade in operation, the IDB allocated 51 per cent of its lending to social infrastructure and agriculture, activities that received only 3 per cent of World Bank lending during the 1950s, and 17 per cent of combined World Bank and IDA loans during the 1960s. The IDB was responding to pent-up frustration among Latin American governments over the World Bank's unwillingness to fund social activities and its caution with regard to agriculture in the region. The IDB's venture into these fields was made easier by its generous start-up concessional funding, and also by the emergence of a more supportive political and doctrinal conception of the development process. The Cuban revolution led to an upgrading in the palliative and distributive purposes of economic aid within the hemisphere; social reforms, education, health, and even urban housing expenditures, became major items on the development agenda. Political analysts added legitimacy by stressing the modernizing and stabilizing role of the middle classes. An-

Table 3

MDB LENDING COMMITMENTS PER ANNUM

(Billions of 1992 dollars)

	World Bank	RDBs: IDB	RDBs: AfDB	RDBs: AsDB	RDBs: Total	Total MDBs	RDBs as per cent of total
1950-1959	2.4	--	--	--	--	2.4	0
1960-1969	5.2	1.7	--	--	1.7	6.8	24
1970-1979	12.0	2.7	0.3 [a]	1.2 [b]	4.2	16.2	26
1980-1989	20.8	3.3	1.8	2.9	8.0	28.8	28
1990-1993	22.3	5.4	3.1	4.8	13.3	35.6	37

Source: AfDB (1964-1993), AsDB (1966-1993), IDB (1959-1993), World Bank (1946-1993).
Note: Includes concessional and non-concessional lending.
a 1967-1979.
b 1968-1979.

other facilitating factor was the IDB's more liberal attitude to local cost financing.

More gradually, the World Bank also began to diversify its lending in the 1960s. As in the IDB, the availability of concessional funding was a major facilitator, after the establishment of IDA, but innovation was also made easier by the solid prestige that the World Bank had acquired in financial markets by the late 1950s. From 1963, a new President, George Woods, accelerated the trend, by encouraging loans for agriculture and secondary and vocational education, and city water systems. In a much smaller way, the World Bank was also venturing into loan and equity financing for private enterprises, after the creation of the IFC in 1956. On the other hand, though the World Bank had made several programme loans during the 1950s, it was reluctant to extend such loans to developing countries in the 1960s, and the IDB followed suit.

The allocation of MDB lending during the 1970s was remarkably uniform, despite the establishment of two new regional banks, a much more volatile economic environment, and the conceptual changes that were overtaking development doctrine. World Bank lending was pushed sharply towards both agriculture and the social sectors by President McNamara, as part of the Bank's explicitly poverty-oriented strategy. In fact, the World Bank overtook the IDB during this decade, assigning 40 per cent of its loans to these sectors, against 38 per cent by the IDB. All four MDBs divided their lending, in similar proportions, between the main sectors; in each case, the largest share was allocated to economic infrastructure, and the second largest to agriculture, and the four partook, in comparable proportions, in lending to industry, local financial institutions and the social sectors.

Though the four MDBs were authorized to lend to the private sector, with or without a government guarantee, none availed itself of the opportunity to more than a minor extent; IFC loans and investments accounted for 3.8 per cent of World Bank lending over the decade, and the percentage was closer to 1 per cent in the RDBs. Similarly, all MDBs restricted most of their lending to specific projects over this period; the principal exception was the World Bank, which used programme loans to assist oil importing developing countries, particularly in South Asia, through the oil crisis.

A more detailed look at the 1970s reveals that, in addition to a major increase in the share of agricultural lending by the MDBs as a group, from 16 per cent in the 1960s to 27 per cent in the 1970s, all institutions also participated in attempts to redirect agricultural lending to smallholders, an initiative that was largely led by the World Bank; and, though energy lending continued to be a quarter of all lending, it shifted from an almost exclusive preoccupation with the power sector to the development of energy resources: coal, oil and gas. There were similar changes within the transport and industry sectors. Rural roads, for

Table 4

WORLD BANK AND REGIONAL DEVELOPMENT BANK LENDING, BY REGION

(Billions of 1992 dollars per annum)

	Commitments								
	Africa [a]			*Asia* [b]			*Latin America and the Caribbean*		
	1970-1979	*1980-1989*	*1990-1993*	*1970-1979*	*1980-1989*	*1990-1993*	*1970-1979*	*1980-1989*	*1990-1993*
World Bank	2.4	4.4	4.6	4.3	8.8	8.2	2.7	5.3	5.9
AfDB	0.3	1.4	3.1						
AsDB				1.3	2.8	4.8			
IDB							2.6	3.6	5.4
	Gross disbursements								
	Africa [a]			*Asia* [b]			*Latin America and the Caribbean*		
	1970-1979	*1980-1989*	*1990-1993*	*1970-1979*	*1980-1989*	*1990-1993*	*1970-1979*	*1980-1989*	*1990-1993*
World Bank	1.4	3.3	3.9	2.6	6.2	7.0	1.8	4.1	4.9
AfDB	0.1	0.8	2.1						
AsDB				0.5	1.5	2.9			
IDB							1.8	2.8	3.2

Source: AfDB (1964-1993), AsDB (1966-1993), IDB (1959-1993), World Bank (1946-1993).
a Including North Africa (Algeria, Egypt, Libyan Arab Jamahiriya, Morocco and Tunisia).
b India started borrowing from the AsDB in 1986; China began borrowing from the World Bank in 1981 and the AsDB in 1987.

instance, received more attention than before, and lending for small and medium industries through financial intermediaries grew in importance. In the same way, the expansion of lending for urban development, education, population, nutrition and health was accompanied by attempts to redesign projects to reach lower income groups, for instance, by shifting attention from tertiary education to literacy and primary schooling, and to financing sites and service projects for the urban poor in place of middle-income housing blocks. Relatively little effort was made, however, to use that lending to achieve a broader redirection of government expenditures towards the poor.

The 1970s pattern of lending was largely repeated in the 1980s, though some differentiation began to develop as a consequence of the World Bank's almost unique role in adjustment lending. That lending absorbed 18 per cent of the Bank's credit over the decade, up from 4 per cent in the 1970s, and led to roughly proportional cuts in its allocations to agriculture, economic infrastructure and industry. None the less, despite its shift into structural adjustment and programme lending, the World Bank allocated a slightly larger share of total resources to the social sectors during the 1980s (15 per cent), than it had during the 1970s (12 per cent). The move to structural adjustment was not followed by any of the RDBs, which continued to lend for specific projects.

With the commencement of structural adjustment lending by the RDBs, there was again a broad convergence in the pattern of lending, with the exception of the AsDB whose foray into adjustment lending has been very limited. This convergence is likely to be reinforced in the future as a consequence of the agreements surrounding the recently approved

Table 5

MULTILATERAL ORGANIZATIONS: NET DISBURSEMENTS, CONCESSIONAL AND NON-CONCESSIONAL FLOWS, ANNUAL AVERAGE

(Millions of dollars)

	1950-1951	*1955-1956*	*1960-1961*	*1965-1966*	*1970-1971*	*1975-1976*	*1980-1981*	*1985-1986*	*1991-1992*
Concessional									
IDA	--	--	--	271	225	1198	1731	2963	4573
RDBs	--	--	--	--	222	378	623	963	1697
Total MDBs [a]	--	--	--	271	447	1584	2451	3945	6269
UN	*	*	161	226	529	1355	2668	3050	5625
EEC	--	--	20	108	208	611	1251	1347	3817
IMF [b]	--	--	--	--	--	--	1043	-418	853
Others [c]	--	--	--	--	--	302	447	446	459
Total concessional	--	--	181	604	1184	3852	7858	8369	17023
Share of MDBs in total	--	--	--	45	38	41	31	47	37
Non-concessional									
IBRD [d]	80	183	300	290	585	1768	3385	5230	477
IFC [e]	--	--	10	18	62	180	403	125	1385
RDBs	--	--		-38	137	536	1048	1952	3714
Total MDBs	80	183	310	270	784	2484	4835	7306	5575
EEC	--	--	--	--	34	42	249	171	270
Others [f]	--	--	--	20	--	104	199	373	268
Total non-concessional	80	183	310	290	818	2630	5282	7850	6113
Share of MDBs in total	100	100	100	93	96	94	92	93	91
Total net disbursements	--	--	491	894	2002	6482	13140	16219	23135
Share of MDBs in total	--	--	63	60	61	63	55	69	51

Source: OECD (1973-1994), World Bank (1946-1993).
a Including concessional loans from the IBRD's Third Window facility.
b IMF Trust Fund, SAF and ESAF. In the 1980-1981 annual average the 1981 figure was estimated.
c Including IFAD, Arab Funds, the Caribbean Development Bank and Council of Europe (social loans). Figures for IFAD for 1992 are estimates.
d In fiscal years for 1950-1951 and 1955-1956.
e 1992 data were not available. 1991-1992 annual average was estimated.
f Including Arab Funds and others.
* Not available.

capital increases of the AsDB and the IDB in April-May 1994, as well as the IDA-10 agreement in 1993, all of which have placed a 40 per cent floor as the minimum level of lending the MDBs must direct to social sector lending.

The World Bank continued to raise the share of programme and adjustment loans in its total lending, from 18 per cent in the 1980s to 24 per cent over 1990-1993. At the same time, however, it increased lending to the social sectors from 15 per cent in the 1980s to 23 per cent, renewing its commitment to poverty reduction as a principal objective. These increases were absorbed by reductions in all of its more traditional lending areas: economic infrastructure, agriculture and development finance institutions. By contrast, the AsDB scarcely participated in adjustment lending (2 per cent), and reduced an already low share of lending to the social sectors from 16 to 13 per cent. Instead, it dedicated almost all (84 per cent) of its lending to economic infrastructure and to the directly productive sectors, especially agriculture and industry. However, as a consequence of donor mandated conditionality introduced in the latest capital increase, the AsDB has been instructed to increase its lending to the social sectors (including environment) to 40 per cent.

Table 6

NET RESOURCE RECEIPTS OF DEVELOPING COUNTRIES

	1970-1979		*1980-1989*		*1990-1992*	
	$ billion	*Per cent*	*$ billion*	*Per cent*	*$ billion*	*Per cent*
MDBs	**31.3**	**6.8**	**97.9**	**9.5**	**35.1**	**8.2**
of which: World Bank	16.0	3.5	70.7	6.9	19.0	4.4
Other multilateral	21.8	4.7	60.6	5.9	13.8	3.2
Bilateral	130.8	28.3	344.3	33.5	141.6	32.9
Private	125.3	27.1	457.7	44.6	212.0	49.3
Export credits	62.4	13.5	73.2	7.1	8.0	1.9
FDI	69.5	15.0	146.0	14.2	75.7	17.6
Other	20.8	4.5	-152.9	-14.9	-55.9	-13.0
Total	461.9	100.0	1026.8	100.0	430.4	100.0
Annual average	46.2		102.7		143.5	
Annual average (in 1992 dollars)	110.6		142.2		148.2	

Source: OECD (1973-1994).
Note: Figures may not add up to totals due to rounding.

The IDB and AfDB were drawn into a sudden, large expansion of adjustment lending, most of it in the form of cofinancing with the World Bank, prompted by the lack of a project pipeline, and in the case of the IDB, by the terms of the 1988 general capital increase. The AfDB was driven to policy based lending in association with the World Bank, in this case due to the problems plaguing its project lending (lack of counterpart funds), and to the need to increase disbursements. This cofinancing of adjustment operations has led to formal and explicit cross-conditionality. The IDB and the World Bank also began specific lending for debt reduction operations. None the less, like the World Bank, these two banks maintained a relatively high level of support for the social sectors. In the case of the IDB, it is notable that the lending level to the social sectors was sustained during the 1980s and 1990s despite a reduction in its access to concessional resources (table 11 below). On the other hand, the IDB accommodated to the reduction by reallocating those resources to its poorest borrowers. The net result of these trends in IDB lending was that, in significant contrast to the AsDB, the IDB assigned only 42 per cent of its funds to economic infrastructure and production over 1990-1993.

The return of poverty to the top of the lending agenda at the end of the 1980s was a recognition of the magnitude of the social havoc of the 1980s, and a measure to protect the political sustainability of adjustment. This interpretation is supported by the fact that the increase in poverty lending has largely taken the form of spending on the social sectors, while credits to agriculture have declined, most notably in Latin America.

Though the founders of the IDB and AfDB had envisaged a role for their banks as promoters of regional integration and sources of finance for regional, as distinct from strictly national projects, such lending has played a minor role in either of those institutions, or in the MDB system as a whole. In the case of the IDB, support for regional energy projects, and for sub-regional development finance institutions, has accounted for between 3 and 4 per cent of its lending, though all RDBs have indeed provided grants to fund regional agricultural research and other research and promotional activities directed at integration.

A similar result met the expectation that the MDBs would finance the private sector by using their authority to lend without requiring a government guarantee. IFC lending grew rapidly during the 1980s, yet remained at only

Table 7

LENDING COMMITMENTS PER ANNUM BY SECTOR

(Per cent)

	Agriculture and rural development	*Infra-structure* [a]	*Industry and finance* [b]	*Social sectors* [c]	*Programme and adjustment*	*Other* [d]
1950-1959						
Total	3	64	14	--	19	--
World Bank	3	64	14	--	19	--
1960-1969						
Total	16	56	14	10	4	1
World Bank	13	64	13	4	5	1
RDBs	24	29	18	27	--	2
IDB	24	29	18	27	--	2
1970-1979						
Total	27	38	17	13	3	1
World Bank	28	36	17	12	4	1
RDBs	24	41	18	15	--	1
IDB	23	42	18	15	--	3
AfDB [e]	25	41	13	22	--	--
AsDB [f]	27	40	20	14	--	--
1980-1989						
Total	22	33	14	16	14	1
World Bank	20	32	13	15	18	1
RDBs	26	38	14	18	3	1
IDB	22	42	14	20	--	3
AfDB	29	31	13	18	10	--
AsDB	30	38	15	16	1	--
1990-1993						
Total	15	31	7	22	22	4
World Bank	14	28	6	23	24	4
RDBs	15	36	10	19	17	4
IDB	8	29	5	23	26	8
AfDB	21	28	18	18	15	--
AsDB	17	54	13	13	3	--

Source: AfDB (1964-1993), AsDB (1966-1993), IDB (1959-1993), World Bank (1946-1993).

a Including transportation, telecommunications, power and energy.

b Including development finance companies and mining.

c Including water supply and sanitation, urban development, education, population, health and nutrition and environment. Figures for AfDB lending for water and sewage are approximate.

d Including tourism, public sector management, multisector investment projects and unclassified.

e 1967-1979.

f 1968-1979.

4.1 per cent of the World Bank Group's gross resource transfer, while the proportion of private sector lending was even lower in each of the three RDBs. This frustrated objective, and the donors' thrust towards the private sector during the 1980s, led each of the RDBs to set up private sector affiliates on the lines of the IFC. Thus, the AsDB created the Asian Finance and Investment Corporation (AFIC) in 1988, though it already had a private sector department. Yet, despite the regional boom in private sector investment, the affiliate has found it difficult to lend; less than 5 per cent of the Asian Bank's total lending over the last five years has been to the private sector. The IDB's private sector affiliate, the Inter-

Table 8

LOAN PORTFOLIO CONCENTRATION IN MDBs, 1992

	AfDB	*AsDB*	*IBRD*	*IDB*
Number of borrowers	46	15	91	24
Per cent share of:				
Largest borrower	14	36	12	18
Five largest borrowers	49	82	46	66
Seven largest borrowers	59	95	52	75

Source: As for table 7.

American Investment Corporation (IAIC), has also made slow headway, despite the boom in private capital flows to Latin America in the last few years.

The allocation of lending by countries raises the issue of the relationship between the World Bank and the respective RDB. The RDBs have tended to develop steady and close relationships with their members. The IDB has maintained offices in each member country, and the AfDB set itself the goal of making at least one loan to each member every year, a goal that it has been unable to meet.

Though generally not visible at the aggregate country level, some division of labour between the World Bank and the RDBs has often emerged in practice, without resort to formal agreement. Country size has been the principal factor in creating specialization; the World Bank has found it harder to maintain a presence in small countries; conversely, in lending to the larger countries, the RDBs have been forced to accept a limit imposed by portfolio concentration, a bigger issue for the RDBs than for the World Bank.

Even where two MDBs operate in the same country in the same sector, a spatial differentiation has emerged. In Sri Lanka, while both the AsDB and the World Bank have been engaged in water projects, the former has concentrated on secondary towns while the World Bank has focused on Colombo. In Indonesia while both have been engaged in the power sector, the World Bank's attention has been on Java, with the AsDB focusing on the outer islands (Kappagoda, 1993). In Latin America, a study of lending to Costa Rica, Bolivia and Argentina shows greater continuity by the IDB than by the World Bank (Tussie, 1993). The IDB has been more important than the World Bank in smaller countries of the region. In Costa Rica it has provided 70 per cent of MDB credits. In Bolivia it provided 66 per cent, and doubled its lending during the crisis years of 1982-1985, while the World Bank ceased to lend. During the 1980s, when aggregate World Bank lending to Latin America was nearly 50 per cent greater than that of the IDB, the regional bank provided nearly twice as much credit to the smaller countries than the World Bank.

With India and China not borrowing in the 1970s, the AsDB's lending shifted from South-East Asia to South Asia between the 1970s and the 1980s; South Asia's share rose from a third to a half, while that of South-East Asia dropped from a half to 43 per cent. Like other MDBs, per capita lending of the AsDB has been inversely correlated with per capita income. Hong Kong, Singapore and the Republic of Korea graduated in 1988.

The World Bank's lead in shifting to adjustment lending in the early 1980s, an initiative justified by its relative experience and expertise in macroeconomic issues, and by its long-established coordination role, suggested an emerging division of labour. At the same time, it reinforced the World Bank's perceived lead agency role. By the end of the decade, the RDBs reacted by increasing their own macroeconomic capabilities and policy based lending, needed in any case to increase disbursements. One result was a sharp rise in cofinancing. For instance, in the case of the AfDB, of 68 cofinanced projects between 1988 and 1991, 40 were structural adjustment loans (SALs).

The generally successful economic performance of Asia meant that both the World Bank and the AsDB's operations in that part progressed relatively smoothly. In contrast to other regions, the changes with past lending strategies were more gradual. For the World Bank, China's entry in 1980 opened up major new opportunities. The World Bank's initial

Table 9

RATIO OF PAID-IN CAPITAL TO SUBSCRIBED CAPITAL

(Per cent)

	AfDB	*AsDB*	*IDB*	*IBRD*
Initial	50.0	50.0	50.0	20.0
Last general capital increase	12.5	5.0	2.5	3.0
Current average	12.0	12.1	5.9	6.4

Source: As for table 7 and Standard and Poor's (1993).

role was largely didactic and low key, a strategy that eventually proved influential. A similarly low key approach characterized operations in most Asian borrowers, with much more limited recourse to overt SAL-type conditionality. Lending to the other giant borrower, India, continued without any significant changes except one: an almost complete reversal in the World Bank/IDA blend from 1980 to 1990, due to a combination of factors: donor pressures (particularly from the United States and France), rapidly increasing demands (especially from China and sub-Saharan Africa) in the face of cuts in the size of IDA, and India's improving economic performance.

F. Finance

1. Non-concessional

The initial design of the MDB financial structure, with a minor fraction of the subscribed capital paid-in and the rest callable, has proven to be a wonderfully simple device for leveraging financial flows with small fiscal investments. For those governments with large capital shares, the leveraging was even larger if measured by the capacity to influence borrowers that was purchased by those shares; the influence of majority shareholders was leveraged by the share capital of the minority owners.

Moreover, the multiplier, or degree of leveraging, grew steadily over the decades, as successive general capital increases (GCIs) for all MDBs reduced their ratio of paid-in to subscribed capital, as is shown in table 9 below. In the AfDB the initial ratio of 50 per cent fell to 12.5 per cent in its most recent GCI; in the AsDB and IDB the original ratios of 50 per cent fell even more, to 5.0 and 2.5 per cent respectively; and in the World Bank the reduction was from 20 to 3 per cent. Given their well established credit ratings, reinforced by their large reserves, this decline has not affected the risk perceptions of the markets.

The financial reputation of the MDBs has continued to grow over the decades. The World Bank secured an AAA rating in 1956, but shortly thereafter, in the 1960s, ran into a political constraint to market borrowing. Faced with mounting balance-of-payments problems, the United States Treasury curtailed the Bank's access to United States markets. Moreover, to the extent that borrowings did occur, the Bank was barred from using the funds for loans, and was required instead to invest them in United States government bonds, as liquid reserves (Rotberg, 1994, p.16). As a result, and given the rising balance-of-payments surpluses in Europe, particularly in Germany, the World Bank began to diversify its borrowings away from the United States.

The gradual shift to new markets was sharply accelerated in the late 1960s. Given the need to seek the consent of the country in whose market or in whose currency the World Bank could borrow, it sought to protect its institutional autonomy through aggressive diversification of its borrowing, in terms of countries, markets, instruments, terms and maturities. The strategy was designed both to raise additional resources and broaden the markets and currencies of borrowings.

An extraordinary financial leverage has resulted from falling paid-in capital ratios, and an expansion in borrowing. The share of borrowings in loanable resources in the MDB system as a whole increased from half to more than four-fifths between the 1950s and the 1990s. This pattern was repeated in the World

Table 10

NON-ACCRUAL LOANS/DISBURSED LOANS

(Per cent)

	AfDB	*AsDB*	*IDB*	*IBRD*	*IFC*
1986	5.1	0.0	0.0	0.5	23.6
1989	3.1	0.0	8.0	3.2	5.2
1992	12.0	0.1	0.0	2.4	8.6

Source: As for table 9.

Bank and in each of the RDBs. At the same time, the growth in borrowings, which became the principal source of loanable resources, was accompanied by a large increase in reserves, which now substantially exceed paid-in capital, except in the AfDB, and which have also contributed to the leverage of paid-in capital.

While the World Bank sharply increased lending in the 1970s, its relative growth, in the perspective of overall capital flows to the developing countries, was more modest than commonly assumed. As table 6 illustrates, the MDBs as a whole barely maintained their position relative to other sources of financing, and even the World Bank's role in net resource transfer scarcely changed in relative terms.

Like the World Bank in its initial years, the RDBs began their borrowings on a cautious note, as they sought necessary legislative approvals in various markets. Quite naturally, their initial focus was on the particular markets they were closest to, with the IDB emphasizing United States markets,[4] the AsDB Japanese markets and the AfDB European markets. The effort was most protracted for the AfDB. For most of its first decade, it struggled with woefully inadequate paid-in capital (about $100 million by 1971). In 1973 (nine years after its establishment), the AfDB's resources were bolstered by interest free loans from Canada, Sweden and Austria. In 1975, it began its first borrowings by issuing short-term (two-year) central bank bonds, principally to African central banks. Market borrowings began in 1977, with borrowings in Kuwaiti dinars, and by the end of the decade the AfDB was for the first time borrowing in medium-term instruments in Euromarkets. The 1982 extra-regional capital subscriptions, however, opened the door to a triple A rating in 1984, and to the long sought access to long-term fixed rate borrowings. But the level of borrowing was limited by a self-imposed restriction, that total outstanding bonds not exceed 80 per cent of the callable capital of its AAA shareholders, coupled with the limitation of non-regional participation to one third of the shares of the Bank. In order to overcome this hurdle, the AfDB, alone among the MDBs, has both a senior and a subordinated debt; it has continued to borrow on the basis of the callable capital of its entire membership, but has subordinated these borrowings to its senior debt.

One less visible consequence of the borrowing operations of the MDBs has been their contribution to the deepening of international financial markets. Their borrowings have resulted in the creation of new market segments, and, by steadily increasing the size of their issues in particular market segments, to enlarging the liquidity of these markets. From an earlier emphasis on dollar borrowings, the MDBs diversified the currency composition of their borrowings over the last two decades. However, with the introduction of currency swaps in the early 1980s, the currency of borrowing has declined in significance; and with the World Bank's pioneering of global bonds in the late 1980s, the earlier salience of market and currency of borrowing has dwindled in importance, a reflection of the broader changes in international financial markets.

Changes and volatility in financial markets in the late 1970s also affected the MDBs. The World Bank found itself exposed to large interest rate risks at the turn of the decade. It continued to lend at fixed interest rates, shielding its borrowers from interest rate volatility, resorting to greater, lower-cost, short-term borrowings; and, to safeguard its financial health, resorted to an upfront commitment fee on all loans (thereby sharply increasing its

[4] The Samurai bond market refers to yen bond issues by foreign borrowers in the Tokyo market.

short-term cash flow), and to loan disbursements in low interest rate currencies (yen, mark and Swiss franc). Starting with the World Bank in 1982, the MDBs shifted from fixed interest rates to variable interest rate loans, revised periodically.

The debt crisis also exposed the MDBs to large portfolio risks (table 10). This was particularly true of the IDB and the AfDB, since their portfolios were concentrated in the most adversely affected regions. The IDB's situation was aggravated by the lending decline which resulted from a struggle over policy between United States and Latin American shareholders. For the AfDB, lending through the hard window was increasingly concentrated in North Africa, as non-concessional lending to sub-Saharan Africa was curtailed by high debt ratios. The status of its portfolio continues to pose a much more severe problem for the AfDB relative to the other MDBs.

A further fall-out of the debt crisis for the MDBs was a weakening of their preferred creditor status. The preferred-creditor share in developing country debt rose from around 16 per cent in 1982 to 38 per cent in 1991 for MDB non-concessional loans, and from 37 per cent to 65 per cent for loans from the concessional windows.[5] This risk from an increase in the share of "inflexible debt" is receding with recent increases in private flows.

2. *Concessional*

Concessional funds were initially grafted on to the MDBs, with the establishment of IDA. Later, the RDBs were born with soft windows. Indeed, the IDB commenced operations with an exceptionally large endowment of concessional funds. The importance of concessional resources has grown for all MDBs except the IDB, as a source of loanable funds, but also as a factor in their governance. Over time, replenishment of the major soft resource funds, and the raising of other concessional resources, have come to occupy the attention that MDB managers once devoted to raising market funds.

The replenishment process for concessional resources became particularly demanding in the late 1970s. Unlike the longer time periods between capital increases, concessional funds face short replenishment periods (three years in the case of IDA), meaning that the institutions are subjected to frequent, renewed debates by shareholders with respect to policy. During their first quarter century, the United States, as the principal donor to MDBs, acted to increase the contributions and participation by other potential donors. The United States is now the less willing donor, yet reluctant to relinquish voting power, while other donors are less willing to put in resources without commensurate changes in voting shares.

The growth of concessional resources is shown in table 11. Figures for gross disbursements are close to net disbursements, except for IDA and the FSO. In the case of IDA, reflows currently account for nearly 25 per cent of its resources. The only case where concessional resources have fallen, even in nominal terms, has been the IDB where the ratio of concessional to total resources fell from 50 per cent in the 1960s to 25 per cent in the 1970s, and to barely 8 per cent in the 1980s.[6] The recent addition of a new separate fund, the $1.2 billion Multilateral Investment Fund, may reverse the trend at the IDB.

The Multilateral Investment Fund at the IDB is the latest example of a proliferation of earmarked funds at the MDBs which are fragmenting their governance and threaten to undermine their principal concessional windows. While the $2 billion Global Environmental Facility (GEF) is the most well known of these concessional multilateral funds,[7] "trust funds" have mushroomed at the MDBs.

G. *The MDBs in the 1990s*

The recent evolution of the MDBs is to some extent a continuing adaptation to changes in the economic and political environment that began a full decade ago. At the same time, further changes in the environment have been appearing, requiring additional adaptation. This is not a new development; each

5 Figures are unweighted averages.

6 While 50 per cent of these concessional resources (the FSO) went to the most affluent Group A countries in the 1960s and only 25 per cent to the Group D (the poorest), the share of the latter rose to 75-80 per cent in the 1970s and 100 per cent in the 1980s.

7 Unlike other funds, the GEF incorporates modest movement in its governance structure for obvious reasons. The recently adopted $2 billion replenishment agreement adopted a "double majority" system in which decisions would have to be passed by 60 per cent of weighted votes and 60 per cent of member States, i.e. a combination of the voting rules of the MDBs and the United Nations (*New York Times*, 1994, p. A7).

Table 11

CONCESSIONAL LENDING RESOURCES OF MDBs[a]

(Millions of dollars)

	World Bank	*AfDB*	*AsDB*	*IDB*
Main soft loan window	***IDA***	***AfDB***	***AsDB***	***FSO***
Established	1960	1973	1974	1960
Annual average disbursements				
1960-1969	160	--	--	99
1970-1979	837	15	74	372
1980-1989	2847	311	868	574
1990-1993	4526	660	1036	384
Grant element (per cent)				
1974-1978	83.1	81.7	67.9	70.4
1986-1990	79.8	78.0	58.6	70.5

Source: AfDB (1964-1993), AsDB (1966-1993), IDB (1959-1993), World Bank (1946-1993).
a Figures include all concessional resources used by each institution in addition to those of the main soft window.

decade since the 1950s has brought a new context. Yet, the hybrid institution that evolved between Bretton Woods and 1959, when the IDA was grafted onto the IBRD, has flourished for most of the period since then. More political compromise than technical blueprint, a multilateralism qualified by the voting arrangements, half bank and half developmental donor, the World Bank formula was soon replicated in the three major regional development banks which have been examined in this paper, and also in a large number of smaller multinational institutions that define themselves as development banks.

The "MDB system" has expanded through both internal growth and reproduction. Perhaps the most notable addition is the creation of the European Bank for Reconstruction and Development (EBRD) in 1991. The EBRD's articles, with explicit political criteria for lending, reflect both the changing times and the evolution of the MDB concept. The growth of the MDB system has decelerated, but was sustained through the instability of the 1970s and the debt crisis of the 1980s, and, at least in absolute terms, the system is by most criteria larger and perhaps more influential in the 1990s. Measured over three decades, its growth has been significant. In a postwar context of limited private capital flows, the MDBs have provided funds directly, and, by taking a lead and strengthening many economies, have probably contributed to the gradual recovery of private flows. Large-scale international aid was born as an instrument of the Cold War, but the credibility of the MDB concept has helped to keep open fiscal purses for the aid effort when Cold War motivation has flagged. The recent creation of the EBRD adds another large component to the system, and amounts to an expression of confidence in the MDB concept. Certainly, Eugene Black's gloomy prediction that any bank making "fuzzy loans" was doomed to rapid extinction, was, at the least, precipitate, as he himself seemed to admit in changing his mind and agreeing to the incorporation of the IDA in the World Bank. None the less, it seems appropriate to ask whether the MDB concept will be suited to the 1990s environment.

Perhaps the most difficult challenge arises out of the increasingly pluralistic governance of the MDBs. Through the 1950s and 1960s, the World Bank was governed largely by its management; intervention by its shareholders was for the most part limited to an influence on the choice of borrowers. This style of governance gave management the freedom to define a lending strategy and operational procedures that evolved gradually, remained relatively unchanged over a long period, and were tailored to the institution's own requirements, in particular the need to project an image as a quality lender. Though formal control by the United States has been greater in the IDB than in the World Bank, the IDB was nevertheless given considerable operational latitude, and it benefited as well from the favourable economic

context of the 1960s, and from its large initial endowment of soft funds. The 1970s, if anything, were even more favourable for the World Bank from the point of view of institutional autonomy, due in part to an economic environment that allowed the bank to diversify its funding, but also to the determination and political skills of President McNamara.

The experience of the AfDB and the AsDB from the mid-1960s to the mid-1970s - their first decade - was more particular. The AfDB, reflecting the strongly nationalistic mood of the continent, set out to be African owned and managed. The long-run effect has been that it has a claim to be a truly regional and "borrower's bank", even though the principle was diluted with the establishment of a donor-controlled soft-window in 1974, and by the opening up of its share capital to non-regional members (i.e. donors) in 1982. But the costs of this policy were a long, initial period of financial starvation and managerial weakness. Lacking a dominant donor-shareholder, the Board has been the scene of continuing political competition amongst its African members, spilling over into infighting and instability amongst the management. By contrast, the largely donor-driven creation of the AsDB reflected itself in a style of governance and management that has closely resembled that of the World Bank during its pre-adjustment lending phase. The AsDB has been governed under an informal consensus between the United States and Japan that gave its management much stability and day-to-day operational discretion through the 1970s and 1980s, though policy differences between Japan and the United States began to surface during the late 1980s.

Despite some early efforts at differentiation, especially by the IDB and AfDB, the MDBs developed considerable uniformity in their structure of governance and operation. The RDBs followed the World Bank lead in several ways, especially in operational style, financing methods and lending policy. With the African partial exception, the banks have been controlled by donors, though management was allowed considerable autonomy. Through the early 1980s, all banks concentrated on the specific project as the principal lending mode, and even during the more recent adjustment years, three quarters of World Bank lending has taken the form of projects. Convergence in operational and lending policy has been encouraged by the strength of the donors, by the growing practice of cofinancing, and by the acceptance of the World Bank's "lead" role in most countries and sectors. The RDBs, moreover, have allowed the World Bank to dominate the research effort and to exert an intellectual leadership over the system.

The evolution of the MDB system in the 1980s and early 1990s, however, contains several new elements. Effective ownership is less concentrated, principally as a result of the importance of concessional funds. The original, almost exclusive control over the main features of MDB policy by the United States Treasury and the State Department is increasingly being shared with G-7 finance ministries, with the United States Congress and other G-7 parliaments, with other donors, and, in less measurable ways, with non-governmental organizations, and even with public opinion expressed through the media. As in the experience of the AfDB, a more democratic governance is also turning out to be a more intrusive governance. Many "owners" are leading to many objectives, and also to greater management by rules and targets, in place of managerial discretion. Paradoxically, this undercurrent towards a broadening in the sources of effective influence over the MDBs coincided, during the 1980s, with a particularly interventionist and aggressive United States administration that sought, with some success, to impose policy and even administrative preferences on the MDBs. Those efforts, which came to bear on each of the principal MDBs, and which perhaps redirected the institutions in desirable ways, may turn out to have a cost to the system in the long run, by setting an example of ownership intervention and lack of sensitivity to the importance of institutional ethos and managerial discretion, and by stimulating conflict amongst the owners. One reaction by non-United States owners, for instance, has been to earmark an increasing proportion of their contributions, especially in the form of trust funds, which have proliferated in the MDBs, reducing managerial flexibility and institutional autonomy.

Many owners, with differing priorities, may be cause and consequence of the growing critique of MDB projects. Major criticism began with regard to environmental effects, in the late 1970s, and escalated with the publication of an internal World Bank review, the Wappenhans Report. Subsequently, the RDBs commissioned reports which have come up with similar findings (IDB, 1993; AsDB, 1994; and a forthcoming report on the AfDB). These reports attribute the declining quality of the project portfolio to several causes. One is external: the worsened economic environment in which these projects were embedded in the 1980s. But the reports attribute much of the problem to internal problems in the MDBs: a loan culture which has favoured the upstream end (loan commitments) of the project cycle

with few incentives for supervision; staffing changes, with fewer technical specialists and more generalists (especially economists); and projects overloaded by a proliferation of objectives and goals.

These shifts in MDB governance are occurring in parallel with other changes in the economic and political context. One is an almost universal weakening in fiscal capacity. Though MDB concessional lending is higher in the 1990s than in the mid-1980s (table 5), it is being sustained in part by increasing reflows, since recent soft window replenishments are no longer growing in real terms. Moreover, the effective financial contribution and influence of the MDBs must be measured against the size of borrower population, income levels, and import and investment needs. By those measures, with rising gross output in developing countries, and with the enormous increase in borrower needs created by the incorporation of China and Eastern Europe, the MDB contribution has fallen in real terms. On the borrower side, fiscal weakening is affecting the MDB role by reducing the capacity of developing country governments to increase net borrowing, partly for lack of counterpart funds, and partly because of the fiscal burden of debt service. At the same time, privatization of public services and industrial production has reduced the traditional clientele for MDB loans. Another parallel change in the economic context of the 1990s has been the resurgence of private capital flows, a trend with mixed implications for the MDBs, since it is reducing the need for MDB non-concessional lending, and, to some degree, MDB policy influence, but, at the same time, is creating a greater use for the guarantor function of the MDB system. For the less desperate borrowers, however, the growing availability of private funds has combined with the high transactions costs associated with present borrowing from the MDBs to reduce the demand for MDB loans. This trend points up another development in the MDB context, which is the growing differentiation amongst borrowers, partly the result of uneven performance, but recently increased by the incorporation of Eastern Europe.

The original impetus of the MDB system was due, in part, to the perceived weakness of other instruments for international economic development, in particular bilateral aid and the United Nations agencies. That weakness in complementary international institutions, however, has now become a handicap to the MDBs, which are being pressed to be the instruments for an ever broadening economic and social agenda at the expense of their effectiveness as development banks. The future ability of the MDBs to serve as stepping stones to a supranational world will depend on the capacity of other institutions to share the burden of that transition.

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15

REGIONAL DEVELOPMENT BANKS AND THE OBJECTIVES OF THE BRETTON WOODS INSTITUTIONS

Delphin G. Rwegasira and Henock Kifle

The emerging world order - based both on global markets and regional blocs - needs two kinds of institutions of global economic governance: those, like the Bretton Woods twins, overseeing the problems and opportunities created by globalization, and competent regional organizations such as the regional development banks, to complement these activities by strengthening the movement toward regional liberalization and integration (Culpeper, 1993).

ABSTRACT

Proposals to establish regional development banks (RDBs) that would promote and enhance intraregional cooperation was an idea that had, for a considerable time, wide support among developing countries. In the case of Latin America, the proposal to establish an Inter-American Development Bank predated the establishment of the Bretton Woods institutions (BWIs) by some 50 years. Although the factors that motivated developing countries to establish the RDBs differed fundamentally from the circumstances leading to the establishment of the BWIs, there were, nonetheless, considerable similarities both in the orientations and operations of the two sets of institutions. In the course of the last three decades, considerable complementarity in the operations of the RDBs and the BWIs has emerged. The paper, after a brief review of the growth of RDBs in the last three decades, examines the manner in which the BWIs and the RDBs have responded to major global and regional developments; and based on such an assessment, it goes on to suggest the relative roles that these institutions could play in meeting future global and regional challenges.

In reviewing the growth of the RDBs, the paper notes the considerable changes that have occurred in both their size and operational orientation. Starting with modest resources, the RDBs have expanded considerably and have, with the support of the developed countries, mobilized sizeable concessional resources. The RDBs have thus become major sources of multilateral finance. The size of the net resource transfers to their member borrowing countries now exceeds that of the World Bank Group, a fact that is in part explained by the larger cumulative commitment of the latter, which, in turn, has resulted in larger debt servicing. The RDBs have also moved from their initial sector orientations to address regional needs more comprehensively. The increasing involvement of the RDBs in policy-based lending is an indication of the broader orientation of these institutions.

The responses of the BWIs and the RDBs to the global and regional challenges of the recent past is indicative of the complementarities in their respective operations, as well as their specific strengths and comparative advantages. The BWIs, as global organizations, were the institutions that had to take the lead in such matters as the international debt crisis of the 1980s, as well as in the financing of stabilization and adjustment policies in developing countries. The RDBs have, however, begun to play a much more active role in financing such policy-based loans, particularly sectoral-adjustment loans; and in matters that specifically affect their respective regions, such as the response

of developing countries to the emergence of trade blocs and enhanced South-South cooperation, the RDBs have naturally been the entities that have taken the lead in promoting stronger intra and inter-regional cooperation. Yet, the magnitude and depth of the development crisis in sub-Saharan Africa has elicited a strong response, not only from the regional institution concerned, viz. the African Development Bank, but from the international community as well.

In addition to reacting to such global and regional developments, the BWIs and the RDBs have responded to longer-term development challenges, such as poverty alleviation, the environment, the gender dimensions of development, market-state relations and governance. While noting the many similarities in the approaches of the two sets of institutions, the paper notes, however, that for maximizing the development impact of the respective institutions, there is a need for greater cooperation in the design and implementation of such programmes, so as to take advantage of existing complementarities, while at the same time take taking fully into account regional needs and specificities.

In assessing the roles that the BWIs and the RDBs may be called upon to play in the future, the paper identifies a number of areas in which specific leadership roles will be expected of the BWIs and the RDBs. It also identifies areas where closer cooperation between the BWIs and the RDBs will be required. Through policy dialogue and by financing adjustment programmes, the RDBs can be expected to play a larger role in helping countries adopt appropriate development strategies. To enable them to play such enhanced roles, the RDBs will, however, need to strengthen their policy analysis capacity. In addition, they will also need to pay continued attention to the foundations for long-term development. This will require the further refinement of policies and lending instruments - in close collaboration with the BWIs - in such critical areas as poverty alleviation and the environment; and with the further strengthening of regional blocs and the emergence of strong South-South economic links, the RDBs will also undoubtedly be called on by their regional members to play a more active role.

On their part, the BWIs can be expected to play an ever greater role in meeting the global challenges that an increasingly interdependent world will undoubtedly generate. In particular, the BWIs will need to give greater attention to the changing economic relations between the industrialized countries and the developing world - for example, in such areas as resource flows and trade - by enhancing their respective surveillance and research functions; and with the emergence of powerful trading blocs, they will also need to work towards maintaining and enlarging rule-based international monetary, financial and trading systems. While the RDBs and the BWIs can thus be expected to have greater areas of specialization in the future, there is, nonetheless, a need to maximize the joint development impact of these institutions, through a more coordinated utilization of their specific capabilities and potentials.

A. Introduction

The idea of establishing the first regional development bank - originating in Latin America with the objective of enhancing international cooperation in that region - predated the Bretton Woods Conference of July 1944 by over 50 years; and, the proposal for an Inter-American Development Bank, which was accepted in February 1940 by the Inter-American Financial and Economic Advisory Committee, though not implemented, in some respects foreshadowed the Articles of Agreement of the International Bank for Reconstruction and Development (IBRD) (Mason and Asher, 1973, p. 15). The ideas of a distinguished United States Treasury official, Harry White, were influential in the 1940 proposal for the Inter-American Bank, as well as in those for the Bretton Woods Conference four years later. Within two decades following the establishment of the Bretton Woods institutions, the three major regional development banks (RDBs) had become operational, beginning with the Inter-American Development Bank (IDB), which was established in 1959.

The original idea - of promoting and enhancing intraregional cooperation - that had motivated Latin American countries as early as 1890 to propose the establishment of an inter-American bank was a major force behind the creation of the RDBs. The Agreement Establishing the African Development Bank (AfDB), for instance, states first among the functions of the Bank the "special priority" to be given to projects or programmes which concern several members; and those that are designed to make the economies of the Bank's members increasingly complementary (AfDB, 1981, Chapter 1, Article 2); and, although this factor of regional

integration might have been less forceful in the case of the Asian Development Bank (AsDB), the Group of Experts that made a case for the establishment of the AsDB saw it as having a specific potential for serving as a focal point for regional activities that would promote economic cooperation (Kappagoda, 1993). The emphasis on regional cooperation for RDBs derived importantly from the economic and political history of developing countries and their determination to forge regional solidarity for accelerated development and greater independence. Beyond cooperation, however, RDBs were seen by their founding fathers as general instruments, based on self-reliance, for mobilizing financial and technical resources to contribute to the broader economic development and social progress of regional member countries. In pursuing these development goals, the RDBs had their own regional specificities, but their envisaged activities could not, however, differ markedly from those of the World Bank Group. Indeed the point made earlier that the proposal for the establishment of the Inter-American Development Bank foreshadowed the Articles of Agreement of the IBRD is relevant here. There were common concerns and objectives for the two Banks in the broad area of development, with the IBRD additionally stressing reconstruction activities, which were pressing at the time of its birth.

The vision that led to the earlier establishment of the twin Bretton Woods institutions (BWIs) was shaped by different circumstances, and reflected the determination to avoid the economic difficulties of the inter-war period. Two key objectives - full employment, and the maximum development of productive resources - were regarded "by practically all countries at the close of World War II as primary" (de Vries, 1986; ul Haq, 1993). The world economy was so far from its attainable output that the strong consensus emerged at the Bretton Woods Conference to put in place major institutions and policies aimed at rapidly expanding world trade and investment.

The BWIs, although initially concerned primarily with the problems of the developed world, became in time concerned also with the development challenges faced by countries and regions that were to be the focus of RDB operations. Since RDBs came nearly two decades later, it can safely be said that they were not only motivated by the objective of regional self-reliance, but also by other considerations, such as additionality in the flow of development resources, specialization in regional development issues, and the need for a larger say by the developing countries in affairs affecting them (Mason and Asher, 1973, p. 578; Gardiner and Picket, 1984, p. 12). In this sense, therefore, they would be pursuing regional growth and prosperity just as the BWIs operating in the same regions were in pursuit of global prosperity. The operations of the two respective sets of institutions would therefore be complementary.

This paper will address these complementary aspects of the relations between the BWIs and the RDBs, while at the same time highlighting those factors that differentiate them. The paper, through the use of some recent experiences, will examine these issues from a historical perspective. It will also indicate the areas where stronger cooperation may be called for, while indicating others where further specialization may be required. The paper is organized as follows: in section B, the political and economic factors that have influenced the growth of regional development banks is briefly reviewed; in section C, the manner in which the BWIs and RDBs have responded to regional and global challenges in the past is discussed; and in section D, suggestions are made with respect to the relative roles that could be envisaged in the years ahead for the two institutions.

B. The growth of regional development banks

1. Political and economic factors

Since their establishment, the RDBs have grown rapidly, particularly in the decade of the 1980s. In the early years, the political will of the founding developing member countries was critical in giving these institutions the needed impetus. Some developed non-borrowing countries were also instrumental in the early process: the United States in the case of the IDB and Japan in the case of the AsDB; and in the case of the AfDB, the opening up of the capital stock to non-regional participation in 1982 enabled that institution to expand its operations considerably. For the major industrial powers, the RDBs were seen as important instruments of foreign policy (Culpeper, 1993), as well as vehicles for expanding international business and global demand, thereby complementing the objectives of the BWIs. In this latter aspect, the RDBs were in recent years expected - especially by their non-regional shareholders - to contribute further to the efforts of the BWIs in helping countries adjust to external shocks, through coordination and financing of macroeconomic and sectoral adjustment programmes. This new role raised a host of issues that at times created major contro-

versies between the borrowing and non-borrowing shareholders of the RDBs. Nonetheless, the rapid expansion of these banks in recent years is significantly explained by the economic adjustment needs of developing countries in the 1980s and the willingness of RDBs to participate in meeting these needs in coordination with the BWIs.

2. *The concessional windows*

The growth in the operations of RDBs as focal institutions can hardly be explained without reference to the soft funds available to them. As in the case of the International Development Association (IDA) established in 1960 - some 15 years after the World Bank - the overarching objective of the soft windows in the RDBs was to provide regional sources of multilateral development finance that would bear less heavily on the balance of payments of low-income countries. The need for such soft funds in the RDBs had indeed been acknowledged in international discussions on development by the 1960s. Thus, the Pearson Commission Report of 1969 pointed to the great need for concessional development finance and the importance of greater internationalization of the aid system that were in part met through the IDA. The Commission had noted, however, that the RDBs performed similar functions at the regional level, and therefore commended themselves to the attention of donors for similar reasons (Commission on International Development, 1969, p. 233).

With the exception of the Fund for Special Operations of the IDB that was started at the same time as that bank, the concessional windows of the AsDB and AfDB followed, years later, the establishment of the two respective RDBs. The emergence of these Funds was highly welcome by the borrowing countries as they, again like the IDA, filled particular gaps in the operations of RDBs. The Agreement Establishing the African Development Fund (AfDF), for instance, states that the purpose of the Fund would be to assist the AfDB in making an increasingly effective contribution to the economic and social development of its members (AfDF, 1981, Chapter II, Article 2). Such assistance was seen as going beyond the provision of additional resources within the institution to addressing the critical questions in resource management, related to country creditworthiness and the financing of "slow-yielding" projects in the social sectors. The increasingly non-concessional resources of the RDBs would have placed quick limitations on lending to low-income uncreditworthy countries and, to a considerable extent, on lending for social sector projects. Importantly also, the establishment of concessional Funds within RDBs enabled the latter to pursue more substantively the objective of assisting borrowing countries to generate development projects, as well as build and strengthen the needed institutions through the provision of technical assistance that was not normally provided through conventional loans.

The rapid growth of RDB operations in recent years in part reflects the mobilization of sizeable concessional resources, predominantly from the industrial country shareholders of RDBs. The deployment of concessional resources (including technical assistance) has been guided by the respective regional needs and, as has been the case with the main RDB institutions, concessional lending in some countries has also been directed at financing sectoral and structural adjustment programmes in coordination with the Bretton Woods institutions. The main shareholders of the latter, who are the major contributors to the regional development funds, have indeed insisted on such coordination; this has necessitated the observance of similar conditionalities (as demanded by the BWIs) by beneficiary countries.

3. *Operations and orientations*

In terms of total resource transfers, the earlier start of the World Bank Group (WBG) has meant a much larger volume of cumulative lending relative to RDBs. However, the rapid growth of RDBs has resulted in a catching-up process on the part of these banks. Thus, by 1991-1992 total annual loan approvals by RDBs averaged about 73 per cent of WBG approvals, with IDB lending to Latin America paralleling that of the WBG to that region. In terms of net transfer of resources (disbursements less interest payments, other charges and amortisation), the RDBs were, for the same period, ahead of the WBG in their respective regions of operation, as can be seen from table 1. This is obviously due to the much larger volumes of cumulative commitments by the WBG in earlier years, translating into larger debt servicing. Furthermore, RDBs are now ahead of the WBG in annual lending operations to some countries, as was, for example, the case in 1992 with Argentina, Brazil, Pakistan, Sri Lanka, Morocco and Nigeria (Culpeper, 1993, p. 12).

Regional development banks have in recent years, therefore, become major sources of multilateral finance. Partly as a result, there have been some areas of conflict with the WBG, but it must be said that there has been

Table 1

MULTILATERAL DEVELOPMENT BANKS' NET TRANSFERS TO DEVELOPING MEMBER COUNTRIES, 1990-1992

(Millions of dollars)

Region/Bank	*1990*	*1991*	*1992*
Africa			
AfDB	1194.8	1383.6	1262.0
World Bank Group	1126.7	632.7	495.7
Asia			
AsDB	1459.0	1631.1	1179.4
World Bank Group	1309.3	470.0	1165.0
Latin America and the Caribbean			
IDB	-437.2	-595.3	-442.8
World Bank Group	-997.5	-2060.0	-3317.0

Source: AfDB (1964-1993), AsDB (1966-1993), IDB (1959-1993), World Bank (1946-1993).
Note: Net transfers are defined as disbursements less payments of interest, other charges and amortization. World Bank Group figures refer to fiscal years.

more of coordination and cooperation in the interests of borrowing countries. This is inevitable given the role that the Bretton Woods institutions play in international finance today. The WBG and IMF are leaders in international policy dialogue for country resource-mobilization from donors, including Paris Club debt rescheduling. Co-financing and similar methods have, in general, been a major activity between RDBs and the WBG; and, the staffs of the WBG and RDBs have liaised closely, not only in the preparation and financing of projects and programmes, but also in enriching developmental approaches in areas such as environmental policy.

In terms of sectoral orientation, there have been notable divergences and specializations among RDBs and between the latter, on the one hand, and the WBG on the other. For instance, support for social development projects - including low-income housing, water and sanitation, and education - and small-scale agriculture characterized lending in the early years of the IDB. These were relatively new areas and different from those on which the WBG had concentrated in the 1960s, namely, infrastructure, transport and communications. The IDB's early involvement in social sector lending and small-scale agriculture may be associated with its later initiatives in assisting micro-businesses that were engaged in production, commerce and services. Sectoral orientations in lending in the AfDB and AsDB did not differ much from that of the WBG in the early years, although the agreement establishing the AfDB had emphasized economic development and "social progress". Social sector lending (health and education) in the AfDB Group came later, with the establishment of the AfDF. Some of those patterns are partly explained by the exigencies of the time. Thus, in the case of the AfDB, the extreme inadequacy of economic and social infrastructure in the majority of African countries in the 1960s meant that substantial attention had to be given to the development of transport and communication networks and to the enlargement of power supply (Gardiner and Picket, 1984, pp. 86-91).

Integration and cooperation projects and, by implication regional integration policies, were very much in the minds of the founding fathers of RDBs, especially the IDB and the AfDB which have been described as "the banks for integration" (Dell, 1972, p. 202, with respect to the IDB). Lending for this purpose, however, has for various reasons (Dell, 1972) - difficulties with respect to the equitable sharing of costs and benefits, weak incentives and planning mechanisms, and legal and technical complexities of multinational projects - remained relatively small and below expectations (AfDB, 1992; Tussie, 1993). But the IDB's record is better than that of the AfDB, both in

terms of financing and institutional support for integration.

Ten to 15 years after their establishment, the RDBs had moved beyond their initial sectoral orientations to address regional needs more comprehensively. The WBG had, by the same time, also expanded its interventions in the social sector in line with its emphasis on poverty alleviation in the early 1970s. Increasingly, therefore, the RDBs and the WBG were moving closer in terms of sectoral orientations. However, important differences remained in terms of emphases and outlooks in RDBs, with respect, for instance, to scale of operations (e.g. in micro-enterprises), support for integration and cooperation projects and programmes, and dominant sectors in regions (e.g. agriculture in Africa).

An important change in the operations of RDBs in the late 1980s was the involvement of these banks in adjustment or policy-based lending, following the WBG's launching of these operations in the early 1980s, in response to the balance-of-payments difficulties of many developing countries at the time. Involvement in adjustment lending by RDBs was seen from different points of view. In the case of Africa, for instance, the Summit of Heads of State and Government held in 1985, saw the need for the African continent to "rethink the orientation and long-term management of its economy and development by drawing up the necessary strategies and policies" (OAU, 1985, Chapter II, p. 23). The Declaration on the Economic Situation in Africa issued at the close of the Summit also explicitly recognized "domestic policy shortcomings" (OAU, 1985) as one of the factors behind the economic crisis at that time. In response to these concerns, the AfDB saw the imperative of being involved with policy advice and the accompanying financial assistance (AfDB, 1986). The AfDB became the first RDB to initiate policy-based lending. In Latin America, on the other hand, there were reservations in some countries with respect to introducing the traditional policy conditionalities of adjustment lending in IDB operations (Culpeper, 1993). At another level, some industrial-country shareholders saw adjustment lending best left to the Bretton Woods institutions which had the staff capacity and leverage to manage this instrument. In the event, the RDBs eventually became active participants in policy-based lending in close liaison with the Bretton Woods institutions, mainly the WBG, although the AsDB and IDB concentrated on sectoral adjustment loans.

C. *Responses to regional and global challenges by the BWIs and the RDBs*

Apart from the foregoing broad trends in the operations of RDBs, those institutions have responded to major developments, particularly in the 1980s, in cooperation and coordination with the BWIs in some areas and independently in others. These responses are discussed with respect to adjustment policies and financing; approaches to the international debt problem; the global movement to regional groupings; the special case of the development crisis in sub-Saharan Africa; development and cross-cutting concerns; and South-South cooperation. The varying responses of the RDBs and the BWIs to these issues are indicative of possible areas of cooperative action and specialization for the two sets of institutions in the future.

1. *Adjustment policies and financing*

The second oil-price shock of the late 1970s and the debt crisis beginning in the early 1980s were global in dimension. Their potential impacts were readily seen as likely to affect adversely not only global output, trade and investment, but, as important, the stability of the international financial system and the viability of commercial banks and other institutions. The BWIs - as global institutions - were the natural entities for providing leadership in terms of policy advice and related actions, including financing, to enable the world economy to come out of the "stagflationary" conditions at the beginning of the 1980s.

Both the IMF and the WBG reacted fairly quickly to the adjustment requirements of developing countries, with the WBG launching its first structural adjustment programme for Kenya in 1980, and the IMF using its traditional resources, as well as new facilities like the Extended Facility, to support medium-term adjustment programmes. Quite early in the process it became clear that no one institution or set of institutions could singlehandedly meet the financing requirements at the global or even the country level. The IMF, therefore, emphasized a cooperative strategy - involving the countries in question, the BWIs, other official creditors and commercial banks - in mobilizing financial resources and restructuring debt. Indeed, in the cases of Mexico and Brazil in 1983, the IMF insisted that commercial banks and official creditors commit themselves to providing the required financing before the Fund approved the coun-

tries' programmes and the associated use of its resources (de Vries, 1986, pp. 187-190). In 1985, the Interim Committee and United States Treasury Secretary James Baker III carried these concepts further to stress growth-oriented strategies for resolving the debt problem. The Baker initiative called, among other things, for a central role for the IMF in conjunction with enhanced structural adjustment lending by the multilateral development banks.

The RDBs, as already indicated, became involved in adjustment lending for a variety of reasons: because of the exigencies of the time, as was clearly the case with the AfDB; because of the need to fill the large resource gaps (the cooperative strategy of the IMF); and because a growth-oriented strategy out of the debt problems required the involvement of RDBs, as might be judged in the case of the IDB. Resources devoted to policy-based lending in RDBs have consequently been comparable in recent years to the proportions in the WBG. For example, adjustment lending in the AfDB Group over 1987-1992 was about a quarter of the total, with the proportion significantly higher in the IDB in 1990-1992 (Tussie, 1993, table 4.2).

Quite understandably, the RDBs were not ready in the late 1980s with the requisite staff (both in terms of numbers and expertise) and well-formulated country assistance strategies, to shift lending significantly from project to policy-based loans. They therefore coordinated their policy lending programmes closely with the WBG, in particular, relying on the latter and the IMF for country macroeconomic frameworks and for defining, to a considerable extent, policy conditionalities. The AsDB and IDB restricted their operations to sectoral lending, but the AfDB undertook structural adjustment lending as well. Since those early days, the RDBs have substantially enhanced their capacities for managing this type of lending, through staff training, recruitment, networking with skilled consultants, and preparing country assistance strategies. They have consequently enriched lending operations in this broad area; for instance as in the IDB participation in debt-reduction assistance to Argentina in 1992 under its Debt and Debt-Reduction Facility that was created in 1990 (IDB, 1992, p. 43). Partly as a result of this progress in RDBs, it has become possible to finance certain programmes without necessarily involving the WBG, although this is much less true in the case of the AfDB. More remains to be done, however, by RDBs, in enhancing their capacities through in-depth sectoral studies, macroeconomic work and other analytical approaches, in order to provide stronger bases for country dialogue and support (Kappagoda, 1993, p. 23, for the case of the AsDB).

In the areas of adjustment policies and financing the RDBs have, therefore, worked closely with the BWIs in pursuing regional and global prosperity. Given the nature and magnitude of the initial shocks, adjustment in developing countries assumed global dimensions and the BWIs had to assume leadership. Their efforts were significantly complemented by those of the RDBs, which provided not only financing, but also regional perspectives on sectoral and macroeconomic issues. An important question, as one looks towards the years ahead, is what role the RDBs should play vis-à-vis that of the BWIs in the areas of adjustment policies and financing. Should the RDBs reinforce their capacities in these areas, or withdraw somewhat back to traditional project financing? These and related issues will be addressed in section D.

2. *Approaches to the international debt problem*

As is well known, the need to design and fund the type of adjustment programmes discussed above was in part necessitated by the debt crisis of the early 1980s. The main approach of the BWIs to the crisis was - under the initial leadership of the IMF - the encouragement of debtor countries to pursue profound adjustment programmes, and creditor institutions to provide financing and, where appropriate, rescheduling of debt under a cooperative strategy. This approach provided some breathing space to both debtors and creditors. However, as the high costs of adjustment in terms of import compression, lost output and declining living standards, became apparent, pessimism was expressed with respect to the adequacy of the approach adopted by the IMF. A number of economic projections indicated that the debt strategy adopted at that time was not sustainable in the circumstances;[1] and commentators referring to the IMF "optimistic" outlook in 1985 saw the likelihood of banks not lending enough and debtors not continuing to pay their scheduled debt service (Lever and Hubne, 1985, p. 83). In the low-income countries of Africa similar fears were being expressed, despite the pursuit of adjustment programmes and reschedulings under Paris Club auspices; some country debts were growing even where no new obligations were being

[1] See, for instance, early projections in IDB (1984).

drawn down, due to rescheduling procedures and capitalization of interest. Increasingly, therefore, it was becoming clear that, apart from supporting adjustment programmes, providing the accompanying finance and pursuing conventional rescheduling, further steps were required.

Possible further measures and actions were indeed explored in academia, government circles, RDBs and elsewhere. In general, it was increasingly realized that depending on the nature of the debts, some of the earlier measures would need to be tailored to the specific circumstances of countries and regions. The search for additional measures led to new official initiatives, such as the rescheduling options announced at the Toronto Summit of 1988 and the Brady Plan of 1989. It was in this context of the search for broader solutions that the AfDB made its "Proposal for Refinancing African External Debt" in November 1987 (AfDB, 1987). The AfDB proposal argued that a radically different approach on the part of creditors was required if the debt problem of African countries was to be solved. The proposal argued that there should be pragmatic expectations about the ability of countries to service their external debt, using only resources which the debtor countries could realistically afford, after taking account of the requirement to pay for imports and capital investment. These two requirements could only be reconciled if the interest rate agreed in a rescheduling process was below market rates and, in some cases, zero. It was further suggested that creditors should be offered collateral in the form of contractual payments into a redemption fund which would grow over the life of the rescheduling agreement to a level sufficient to repay the outstanding debt. Further details were included in the proposal relating to the possibility of securitizing rescheduled debts; the possibility of a once-and-for-all debt restructuring; the opportunity for creditors to share in improved debtor-country economic performance; debt for equity and debt buy-back arrangements; and the maintenance of country policies agreed with the IMF. All these considerations were derived from the specificities of African debt, largely official, although with significant components of commercial obligations in certain cases, and contracted by many low-income, weak-export economies.

As it turned out, the debt restructuring proposals that went into effect largely reflected the initiatives and proposals of the official creditor community; the debtor countries, unfortunately, had no say in the final decisions. But it is interesting to note that the various official schemes that came after the AfDB proposal contained important elements of that proposal. The Toronto menu of 1988 included the option for the creditors to cancel one third of the debt service covered by the rescheduling agreement, while the terms achieved in Morocco in September 1990, following the Houston Summit, allowed official debt to be used for debt-equity swaps for the first time. Commercial banks eventually agreed to debt reduction options, as were included, for instance, in the early Brady reschedulings and debt buy-backs in Bolivia and Chile. In the Paris Club, on the other hand, longer consolidation periods were being granted, thus enabling countries to avoid the time-consuming task of returning annually to the Paris Club.

The approach of adjustment, financing and rescheduling initially espoused by the BWIs to tackle the international debt problem was necessary, but proved inadequate. It had to be supplemented by further ideas and mechanisms to contain the situation. Further thoughts came from various quarters, including the RDBs. The proposal from the AfDB, for instance, can be seen in this sense to have been aiming at supplementing the efforts of the BWIs in the case of African debt and adjustment. Thus the international debt crisis of the 1980s provides an example of a global problem appropriately addressed under the leadership of the global institutions (the BWIs), but demonstrates also that regional specificities and the complexity of problems may require closer cooperation and coordination, not only between the two sets of the institutions, but also within the larger development community.

3. The global movement to regional groupings

In recent years, many developing countries not only had to find ways of resolving their debt problems, but were also forced to face the challenges posed by the emergence of powerful trade blocs. Unfortunately, as has been noted earlier, the results of efforts by RDBs to support intraregional cooperation and integration arrangements have remained below expectations; and while the BWIs could do a great deal to support such cooperation and integration, this has not been one of their principal concerns. Their position is not likely to change unless the developing countries show much greater interest and determination in this respect (South Commission, 1990, p. 169). In the meantime there have been in recent years important moves toward the building of trading blocs in developed countries - the European Union and the North American Free Trade Area (NAFTA) - which will have implications

for developing country competitiveness and trade. Regional cooperation and integration, emphasising developmental and policy aspects that go beyond multinational projects, are therefore more pressing for the developing countries in the world economy of the 1990s and beyond.

RDBs have continued to support regional integration in order to enhance intraregional advantages and to assist regions to compete in world markets. The AfDB, for instance, has reexamined its role in assisting regional member countries establish the Pan-African Economic Community agreed under the Abuja Treaty of 1991 (AfDB, 1992). The Bank has also finalized a major study on Economic Integration in Southern Africa (AfDB, 1993a) in anticipation of a post-apartheid South Africa, indicating policy, trading, and related implications and possibilities under the new politico-economic circumstances; and in the area of supporting intra-African trade and exports, the AfDB took a lead in the establishment of the African Export-Import Bank in 1993. In the case of IDB, the various initiatives undertaken include the active role the Bank has taken in the study and promotion of the Western Hemisphere Free Trade Area (Tussie, 1993); chairing the Regional Consultative Group for Central America; and promoting technology links and transfers among enterprises in a group of countries (IDB, 1992, pp. 15-18). On its part, the AsDB has proposed to take a phased approach in strengthening its support for regional cooperation: firstly by increasing understanding and awareness among regional countries of the potentials for this approach through studies that quantify benefits and costs (of non-cooperation); and then identifying, promoting and selectively financing regional or sub-regional projects (Kappagoda, 1993, p. 144).

The RDBs have, therefore, continued to give intellectual and operational importance to regional cooperation and integration issues. This role will become increasingly demanding as the new forms of integration based on regional liberalization and outward orientation unfold in the 1990s and beyond. The depth and breadth of policies and programmes to be pursued will also call for greater involvement of the BWIs, particularly at the country level, but also at the regional level. Given the nature of the integration question - essentially involving a set of countries in a region vis-à-vis the rest of the world - and the "natural" leadership role which RDBs have assumed for their respective regions, the BWIs could coordinate more closely with RDBs on these matters and complement the policy work and provide supplementary financing.

4. A special case: the development crisis in sub-Saharan Africa

A special case of a problem that is regional in scope, but which required a concerted global response, is exemplified by the development crisis in sub-Saharan Africa. The severity and magnitude of the crisis, particularly in the mid-1980s, was such that it became the concern, not only of the countries in the region, but of the international community as a whole. African leaders, in response to the economic difficulties of the late 1970s, initially drew up the Lagos Plan of Action (OAU, 1981) in 1980, in which they called for the adoption of a more self-reliant development strategy; and as the crisis deepened, they again met five years later in 1985 and formulated the African Priority Programme for Economic Recovery (OAU, 1985). This was presented to the 1986 Special Session of the United Nations General Assembly: the first session of its kind that was devoted to the problems of one particular continent. The General Assembly then adopted the United Nations Programme of Action for African Economic Recovery and Development, 1986-90 (United Nations, 1986). The programme, which was generally taken as a compact between the international community and Africa, set out the types of reforms that were to be carried out by African countries, and the measures that the international community would take in support of the region's efforts at recovery and structural transformation. At the final review of the programme in 1992, it was, however, evident that social and economic conditions in the region had yet to show significant improvements. The General Assembly then followed up in 1992 with the New Agenda for the Development of Africa in the 1990s (United Nations, 1992). This gives priority to fostering structural change in the African economy, reducing its external vulnerability, promoting greater economic dynamism, and increasing the internalization of the development process. It also calls for renewed solidarity within the international community to address Africa's problems jointly.

As indicated earlier, the response of Africa's own regional bank to the unfolding development crisis of the region has been to mobilize concessional and non-concessional resources in support of the requisite adjustment and economic reform policies. In the mid-1980s, the Bank, for the first time, linked the size and content of the resources it requested for its general capital increase of 200 per cent, to an action programme of policy

support and advice to borrowing countries. About a quarter of annual lending over 1987-1991 was proposed for such operations. Following that major capital increase, a strong case was also successfully made for a substantial replenishment of the concessional window of the Bank. A significant and increased component of the replenishment of AfDF was to be utilized for technical assistance to help countries generate viable projects and strengthen development institutions. All these efforts at resource mobilization led to a relatively large transfer of resources by the AfDB Group.

The BWIs have, in response to the development crisis in Africa, been actively involved with helping countries adopt appropriate policies and providing the requisite financing. As an increasing number of countries faced severe balance-of-payments difficulties they have had to resort to the IMF's traditional credit facilities. But as these became unsatisfactory, given the structural difficulties and longer-term nature of the problems faced by the region, new medium-term concessional facilities, such as the Structural Adjustment Facility (1986) and the Enhanced Structural Adjustment Facility (1987), were created by the IMF to address these concerns.[2]

The World Bank issued its first comprehensive report on the region's crisis in 1981 (World Bank, 1981). The Bank called for major market-oriented reforms and started providing fast-disbursing structural adjustment loans. But as the complexity of the development problem became increasingly apparent, the World Bank consulted extensively with African leaders, policy-makers and intellectuals, and issued its long-term perspective study in 1989 (World Bank, 1989). In this study, the Bank has acknowledged that building more dynamic and competitive economies in the region would require more than putting in place the right macroeconomic policies, as important and as necessary as these are. Sustained long-term development would, in addition, require institution building, and adequate investments in such key areas as human resource development and basic social infrastructure. The importance of regional integration was acknowledged. The Bank also mobilized the international community through the Special Programme of Assistance for Africa, set up in 1987, for financing adjustment efforts; both the IMF and the AfDB Group are major participants in this programme.

The response of the BWIs and AfDB to the crisis in sub-Saharan Africa illustrates yet another case of necessary complementarity between these global institutions and the RDBs. The scale of the problem in Africa was such that no single institution could possibly have handled it, even after taking major initiatives. International cooperation was obviously called for. Similar economic problems in other regions - or even in large economies - would also call for close cooperation between global and regional institutions. Such cooperation should include diagnosing the nature of regional problems and formulating appropriate polices, as well as mobilizing resources for financing adjustment and investment programmes. In addition, closer consultation and dialogue between regional institutions and the BWIs would undoubtedly also be helpful in matters related to policy conditionality and financing instruments.

5. *Development and cross-cutting concerns*

The BWIs and the RDBs have not only responded to global and regional developments in the ways discussed above, but have also sought to address other longer-term challenges faced by developing countries. As experience with tackling such problems has accumulated, there have naturally been changes in focus and emphasis in the formulation of development strategies and approaches. In the course of the last two decades, five cross-cutting concerns: poverty alleviation, the gender dimensions of development, the environment, market-state relations and governance, have attracted wide attention. The responses, to date, of the BWIs and the regional development banks to these issues are instructive of how the institutions have addressed these evolving concerns, and how they may also be expected to proceed in the future in addressing such issues in a cooperative and complementary manner.

With the exception of the IDB, which, from the start of its operations, emphasized social development as one of its principal objectives, interest in projects and programmes that deal directly with poverty alleviation grew gradually in the two other regional development banks. They have, however, now become an important focus of operations for all RDBs, particularly for activities financed through their soft windows. Within the World Bank, poverty alleviation became a central concern in the

2 Vito Tanzi (1992) argues that the Fund, in addition to its standard stabilization concerns, has also sought over time to address in its operations growth, poverty alleviation and environmental concerns.

1970s and resulted in a considerable expansion of Bank lending for rural development, primary health care and primary education. But following the second oil shock of 1979-1980, the Bank's attention shifted more to macroeconomic adjustment, and arguments were often made that the problems of poverty alleviation could best be tackled through the removal of market distortions. Interest in direct poverty alleviation measures was, however, again revived when it became apparent that structural adjustment programmes had adverse consequences on some of the most vulnerable groups in society.[3]

Similar emphasis has in recent years been given to a related concern, that of the gender dimensions of development. Cognizant of the enormous social and economic cost of the neglect of women in the development process, all multilateral development banks (MDBs) have responded by setting up organizational units for Women in Development, by formulating policy and operational guidelines, and by conducting seminars for their professional staff to make them more sensitive to these issues.[4] In addition, the units for Women in Development have had the general responsibility of helping ensure that the projects and programmes financed by the MDBs do in reality take into account the needs and concerns of women.

Another issue that has received considerable attention by the MDBs is the adverse impact of production-related activities and population growth on the environment. All the MDBs have sought to enhance their capacities for the analysis of environment-related issues. They have also established internal mechanisms to ensure that there is adequate assessment of the environmental impact of the projects they finance. In this manner, the MDBs have sought not only to minimize the possible adverse impacts of projects, but have also sought to promote projects and programmes that encourage the use of resources in a more environmentally sound manner. The World Bank and the RDBs have also assisted countries to establish national environmental action plans.[5] In addition to such activities at the national level, the international community has established the Global Environment Facility (GEF). This has been used to mobilize funds and to finance projects that address global environmental concerns, such as global warming, protection of biodiversity, and the depletion of the ozone layer. Issues concerning the roles of developing countries and multilateral institutions in the GEF have, however, recently emerged as a source of controversy.

One important shift in development thought in the course of the last two decades has been the rethinking of the appropriate role of the State, and, conversely, the market, in the development process.[6] The response of the RDBs and the World Bank to the changed perception has affected their entire lending operations. The introduction by the World Bank of policy-based lending in the early 1980s, while in part a response to the balance-of-payments difficulties of countries, nonetheless, became an important instrument for promoting market-oriented economic reforms. The subsequent adoption of such lending by RDBs has led in the same direction, such that the operations of the MDBs are increasingly being geared towards supporting the private sector.

Along with the changed perception regarding market-state relations, increasing emphasis is nowadays also given to improving governance in developing countries. Issues of governance, as they relate to matters of accountability, the rule of law, transparency and popular participation, are not matters that have traditionally been addressed by international financial institutions. It has, however, become increasingly apparent that the economic reforms that are being attempted in the developing world will need to be accompanied by reforms in systems of governance, if they are indeed to succeed. The MDBs have, accordingly, become involved in promoting good governance as part of their support to adjustment and economic reform programmes. The World Bank issued its position paper on governance in 1992 which, while demarcating clearly the role of the Bank in this new area, argued that its involvement must necessarily be limited to social and economic concerns (World Bank, 1992). The RDBs have also addressed this issue. For instance, the AfDB has issued a paper on governance and development in Africa (AfDB, 1993b). The paper stresses that in efforts to promote good governance in the region, there is a need for a deeper appreciation of the historical and cultural factors that have influenced governance on the continent. The AfDB has continued to address this "sensitive"

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3 The adverse impact of structural adjustment programmes on the poor, and particularly on children and women, was forcefully raised in a UNICEF study (Cornia *et al.*, 1987).

4 See United Nations (1960) for a comparative review of the activities of the United Nations system and other multilateral bodies in this area.

5 For Africa see, for example, World Bank (1991).

6 This shift in thinking is in part attributed to the emergence in development economics of the Neo-classical Political Economy school. See, for example, Collander (1984).

issue in collaboration with an eminent group of Africans who advise the Bank on broad socio-economic questions. Thus, while the World Bank's position paper on governance has laid down general principles, the AfDB paper has sought to build on these ideas by bringing into consideration the historical and cultural specificities of the Africa region.

The similarity of the responses of the RDBs and the WBG to important and current development concerns highlights both the complementary nature of the responses of the MDBs, as well as the need to take into account regional characteristics and specificities. The emergence of a consensus among the RDBs and the World Bank on the importance of poverty alleviation as a strategic object of development calls, for example, for greater cooperation among the institutions in the design and funding of poverty-alleviation programmes. The Social Dimensions of Adjustment Programme in Africa is a good example of the type of cooperative programme that should be aimed at. This seeks, on the one hand, to take into account the specific characteristics of poverty in the region, while at the same time mobilizing the expertise and resources of the various multilateral institutions.

The other cross-cutting concerns would also call for a similar approach. The environmental challenge, for example, requires global, regional and national approaches. Accordingly, the RDBs may be best positioned to tackle national and regional environmental problems, while the World Bank is obviously in a better position to lead on global environmental issues, but at the same time maintaining close working relationships with the RDBs on the major regional environmental issues. Similarly, with respect to such concerns as the gender dimensions of development, market-state relations, the promotion of the private sector and governance, while there is broad convergence in the approaches of the MDBs, there is a need for greater cooperation in the design and implementation of programmes so as to take advantage of existing complementarities, while seeking to ensure that programmes do, in reality, take into account the cultural and historical specificities of each region.

6. *South-South cooperation*

Promoting South-South political and economic cooperation has been a cherished objective of developing countries through the establishment of such cooperative mechanisms as the Non-Aligned Movement in 1961, the Group of 77 in 1964 and the Group of 24 in 1972. One result of this movement has been the proliferation of political and economic organizations at the sub-regional, regional and interregional levels. Indeed, the establishment of the Regional Development Banks themselves should be viewed as one of the more important expressions of this desire. The other types of South-South economic organization established by developing countries have included: sub-regional and regional organizations for the promotion of economic cooperation and integration; export-import financing and clearing houses for the promotion of intraregional and interregional trade; and organizations for the supply management of commodities. Among the latter, OPEC is perhaps the most outstanding example.

Despite the proliferation of South-South economic organizations, their overall achievement has, with few important exceptions, been rather modest.[7] South-South economic relations, and, in particular, trade did grow rapidly in the 1970s, in part assisted by the various economic cooperation organizations established by the developing countries, and in part due to the sharp increase in the price of oil in 1973. But with the serious economic crisis that engulfed many developing countries in the 1980s, and the necessary attention that most countries had to give to domestic crisis management, there was an appreciable decline in the momentum towards greater South-South trade and economic cooperation in the course of this decade.[8]

Responding to the wishes of their members, the regional development banks have taken a number of measures to promote South-South cooperation. These, however, have largely focused on intraregional cooperation rather than on broader interregional economic relations. The AfDB, for example, has provided technical assistance for the different sub-regional economic groupings, and has been active in supporting trade financing institutions, such as the Eastern and Southern Africa Trade and Development Bank. In addition, and as noted earlier, it has taken the lead in establishing the African Import-Export Bank to promote trade between Africa and other regions; and in cooperation with the Organization for African Unity and the United Nations Economic Commission for Africa, it is also ac-

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[7] See South Commission (1990, Chapter 4) for a treatment of the history of South-South cooperation.

[8] See Folke *et al.* (1993) for a good account of the development of trade and economic relations between developing countries.

tively engaged in promoting the establishment of the Pan-African Economic Community. The IDB has established the IDB Trade Financing Facility and has supported other intraregional trading facilities, such as the Latin American Export Bank. In contrast to the RDBs, the involvement of the BWIs in promoting South-South cooperation has been minimal. However, the importance of regional integration as a vehicle for economic growth has been acknowledged, certainly in the case of Africa.

As South-South economic relations have begun to revive, and as they will undoubtedly begin to take on more significant dimensions, there will be a clear need for the MDBs - and in particular for the RDBs - to respond more vigorously to this development. In addition to strengthening and broadening the more traditional instruments of cooperation, the RDBs will need to consider other measures, such as establishing mechanisms to promote interregional investment, joint ventures and trade, as well as cooperation in science and technology and in human resource development.

D. The road ahead

The origins of RDBs have been shown to be the quest for increased international cooperation within given regions; and the need to establish institutional instruments, based on self-reliance, for mobilizing financial and technical resources to promote socio-economic progress. In the decades ahead, these will undoubtedly continue to be the motive forces behind the actions of RDBs. But RDBs have also grown to become unique instruments of international cooperation: unique in the sense of developing (borrowing) countries, as a group, having the bigger say in these "international" organizations, while at the same time being enriched by North-South partnerships. RDBs are also potential instruments for South-South cooperation, either through membership - as is the case for the AfDB with country members from Asia and Latin America - or through cooperation in possible operational and financial activities.

Despite the very different ideals that were behind their establishment, the operational orientations of the RDBs and the World Bank have become increasingly closer, partly reflecting the overlapping membership in RDBs and the BWIs. Yet, regional needs remain distinct and have to be addressed with some specificity. And as the three regions of the developing world increasingly take their own unique paths, the need for regional specificity will become stronger. At the same time, global challenges will undoubtedly assume increased importance and complexity, partly due to the growing interdependence in the world economy. The world order that will emerge in the decades ahead will require that these distinctions and challenges be kept in view by the overlapping memberships of the MDBs, so that a more efficient division of tasks and pattern of complementarities could also emerge between these institutions. With this in mind, some conclusions and suggestions are made below on the basis of the analysis presented in section C, which selectively looked at how the BWIs and RDBs have responded to past or current global and regional challenges. The suggestions are made with specific references to adjustment, development and policy dialogue; the foundations for long-term sustainable development; the management of global challenges; the resources for RDBs; and regionalism and South-South cooperation.

1. Adjustment, development and policy dialogue

Adjustment lending has, as already indicated, become a significant feature of RDB operations, with emphasis on sectoral adjustment loans. These have involved not only financing, but also macroeconomic work, sectoral studies, and policy dialogue with borrowing countries. Given the regional and international development outlooks for the coming decades, adjustment policies and lending will, in all likelihood, be enriched as an operational process for RDBs for a number of reasons. First, there is growing consensus at both regional and international levels - as a result of the experiences of the 1980s - that strong sectoral and macroeconomic policies should accompany the process of resource transfer in order to maximize the development impact of that process. Therefore, policy analysis and dialogue will have to be enhanced as RDBs transfer growing and sizeable volumes of financial resources. Second, consensus is also growing in the development community that in order for adjustment and development programmes to succeed, they must be "locally" and, by extension, regionally "owned" (Jaycox, 1993; Culpeper, 1993, p. 20). RDBs will, therefore, continue to face the obligation, from regional countries, of providing regional perspectives and support with respect to adjustment problems and policies; and a supportive non-regional membership will increasingly look to the RDBs to participate in the formulation of medium- and long-term

country and regional policies. Third, given the respective volumes of project lending that are likely to be handled by RDBs, they would, in any case, need to enhance their capacities in sectoral and macroeconomic analyses simply on efficiency grounds. Fourth, the involvement of RDBs in major development efforts, such as integration schemes, would require that they also address related matters, such as trade policies and reforms.

Expectations on the role of RDBs in policy analyses and support do, however, go beyond adjustment policies to long-term development concerns. Thus in the case of the AfDB, for instance, a committee (the Committee of Ten) of eminent persons from regional and non-regional member countries called for a bank that should appropriately combine the role of significantly transferring resources to African countries with one of providing a focal point for effectively addressing Africa's development problems (AfDB, 1989, p. 29). The Committee of Ten called for an internationally supported endowment fund to assist the Bank put in place a centre of excellence for the purpose. Similarly, in the case of the AsDB, a study in the 1980s proposed the concept of developing the Bank as a regional resource centre, building up and participating in a series of interlocking information, research, analytical and training networks, and becoming a centre for new thinking on development issues and strategies in the region (Kappagoda, 1993, p. 144). In a similar endeavour, the IDB, in an effort to generate ideas and proposals and refine its contribution to the formulation of development strategies (Tussie, 1993, p. 101), has recently launched and financially supported a research programme by a network of regional institutions.

RDBs have, therefore, become increasingly involved in adjustment lending and policies and will, in all likelihood, continue doing so in the foreseeable future. Additionally, these institutions have been called upon by both regional and non-regional opinions to play a more prominent role in addressing longer-term issues, and in participating in the formulation of development strategies for their respective regions. As the respective roles of RDBs in adjustment lending and in development policy formulation are enhanced, a more balanced relation between the RDBs and the BWIs, and in particular with the WBG, can be expected. To enable the RDBs to assume such an enhanced role, it is essential that their capacities in such important areas as long-term policy analysis be strengthened. This will require both human and financial resources. In the years ahead, therefore, both regional and non-regional shareholders should strive to provide the critical mass of resources necessary to enable RDBs not only to advance towards the various policy and developmental objectives, but also to coordinate better and to liaise more substantively with the BWIs.

2. *Foundations for long-term sustainable development*

In the coming decade, continued attention to the foundations for long-term development will need to be given by the MDBs to help ensure that economic growth is sustained, and that development evolves in desired directions. In this respect, the different regions of the developing world can be expected to have quite varied development trajectories and needs. In Africa, past efforts to put in place the conditions for economic recovery and growth will need to be continued and deepened, while in the other two regions, there is a need to ensure that the rapid pace of growth and the momentum towards structural change be sustained. As noted earlier, ensuring that the conditions for long-term sustainable development are met will require that further attention be given to such cross-cutting concerns as poverty alleviation, the gender dimensions of development, the environment, market-state relations and the private sector, and governance.

Poverty alleviation will remain a principal concern for all MDBs in the coming decades, although the profile of poverty can be expected to change markedly in the different regions. In Africa, the decline in per capita income of the past decade and a half and the continued economic stagnation in some countries, can be expected to result in a continued increase for some time to come in the number of the absolute poor. Poverty alleviation will thus require that the conditions for rapid economic growth, through the deepening and, where required, the modification, of adjustment and economic reform programmes, be put in place. In addition, direct poverty alleviation schemes, such as improved support for the informal sector and financial support for micro-enterprises, will have to be expanded to improve the income-generating capacity of the poor. The AfDB and the World Bank will need to develop further their past cooperative endeavours in this area, while at the same time seeking to take advantage of the complementary nature of their interventions, as well as their respective comparative advantages. In the other two regions, the poverty-alleviation efforts of the RDBs and the World Bank will likely concentrate in the coming decades on ensuring that the fruits of rapid economic growth are equitably distrib-

uted and on mobilizing the required resources for financing investment in the social sectors. The provision of adequate educational and health care facilities, and their spatial distribution in rural areas, as well as schemes to enable the poor to take advantage of the emerging economic opportunities, are likely to be given high priority.

As rapid economic development and continuing population growth put increasing pressure on natural resources, the MDBs will also need to increase substantially their lending for environmental conservation. The nature of the environmental challenge facing the developing world has distinct regional characteristics. The RDBs, in close cooperation with the World Bank and other institutions will, therefore, have to be in the forefront in helping countries tackle their respective environmental challenges at the national, sub-regional and regional levels. Past attempts at developing national (and regional) environmental action plans will need to be deepened, with the RDBs possibly taking the lead in national programmes, but working closely with the WBG on regional and global environmental matters.

Rapid and sustained economic growth in the future will also depend in large part on the strengthening of the private sector. Dynamic and efficient private sectors will be required to enable countries to continue to compete internationally. The MDBs, in recognition of this requirement and the increased global competition, have, as noted earlier, taken measures to deepen their assistance to the private sector. But given current trends, it is likely that more changes will be required of the MDBs. On the one hand, they can be expected to sustain their lending to the public sector to help finance supportive projects for infrastructural and human resource development. On the other hand, they will need to develop and refine their lending instruments for directly financing private sector projects and to assist in enhancing private capital inflows. As with other issues, considerable regional variations can be expected in the evolution of the private sector, and hence in the respective roles the RDBs and the World Bank can be expected to play. In Africa, efforts will be required for some time to come to develop and nurture national entrepreneurial capacity and talent. In the other regions, by contrast, assistance to the private sector may concentrate more on improving the financial, regulatory, and judicial frameworks for the further development of the private sector.

Sustained development will also require continued improvements in systems of governance. As the experience of the rapidly developing countries has shown, the existence of clear rules and regulations that govern commercial activities, their impartial enforcement, and greater accountability and transparency in relations between the State and civil society, as well as between the State and economic agents, will increasingly become binding conditions for further development. As in other areas, the MDBs can be expected to play a greater role in the future to help countries improve their systems of governance. Increased support for projects and programmes that seek to improve systems of governance, such as support for improving regulatory and legal frameworks and for improving the transparency of government through better information systems, will undoubtedly assume greater importance in the future. As governance issues are intrinsically tied to cultural and political factors, the RDBs will, undoubtedly, be called on to play a larger role, if not a leading role, in such matters.

3. *Managing global challenges*

At the global level, the growing interdependence among the countries and regions of the world, which has now been evident for some time, is likely to intensify in the years ahead. The recent successful conclusion of the Uruguay Round of GATT trade talks, as well as the surge of private capital flows from the industrialized countries to selected countries and markets in the Third World, are but the latest indications of this trend. In the light of these fast-paced developments, the BWIs and the RDBs will need to undertake the necessary adjustments in their own operations to assist the international community in improving the management of increased interdependence.

One area to which the BWIs will need to give greater attention is the changing economic relations between the industrialized countries and the developing world. In this regard, the IMF should augment its surveillance responsibility to draw out more fully the implications for the developing world of the economic policy measures taken by developed countries;[9] and the World Bank should re-orient its considerable research capacity towards producing a better understanding of these evolving relations (Helleiner, 1986). These issues should also become major concerns of the Interim and Development Committees. Economic decisions

[9] See, for example, Finch (1993) for a discussion of the inadequacy of IMF surveillance as regards the industrialized countries.

taken by the industrialized countries, in particular by the G-7, are taking little account of their repercussions on the developing world. In an increasingly interdependent world, the management of global economic relations should not be allowed to continue in this manner. Efforts should be made to enable the BWIs to play a greater role in global economic governance, not only to help ensure the stability of global economic relations, but as important, to help ensure that the interests of all countries are adequately represented.

Two important matters arising out of increased global economic interdependence, which will require greater international oversight, are the totality of resource flows to developing countries, and the need to improve the conditions for the growth of world trade. Increased surveillance will be required to avoid the recurrence of the financial and economic crises of the last 15 years. As was noted earlier, it was the commercial banks that, following the first oil shock, largely recycled to developing countries the large build-up of OPEC surpluses in the 1970s; and it was the abrupt cessation of such commercial lending that ushered in the debt crisis of the 1980s. In the last few years, private resource flows to the developing world have again increased rapidly, eclipsing official development finance for the first time in over a decade (World Bank, 1993). While the resumption of private capital flows on such a scale is welcome, improved global economic governance will, however, require its close monitoring by the BWIs to prevent the emergence of new types of international financial crises. The BWIs should thus strive for the implementation of timely international measures, both to ensure the adequacy of external resource flows to developing countries and, as important, to reduce its volatility. In a similar fashion, the BWIs, together with GATT and its successor organization - the World Trade Organization (WTO) - will need to continue to work towards the reduction of the various protectionist measures that the industrialized countries have set up against imports from developing countries.

Other global concerns that can be expected increasingly to draw the attention of the BWIs, and in particular of the World Bank, are the identification and financing of projects and programmes for the protection and conservation of the global environment, and particularly of the global commons. As noted earlier, the establishment of the GEF is an initial response to the clear threat that current production and consumption patterns pose for the global commons. As well as the expansion and reorganization of the GEF, the BWIs, along with the RDBs, will need to develop further their own capacities to promote sustainable development.

The assumption of greater responsibility by the BWIs for monitoring the increasingly complex global economic relationships in general, and between the industrialized world and the developing countries in particular, can, in time, be expected to change the respective responsibilities and roles of the BWIs and the RDBs. With the emergence of the RDBs as major lending institutions, it is likely that a greater share of traditional project and programme lending in countries will increasingly be provided by the RDBs. Both on efficiency grounds and for strengthening the working relations between RDBs and the BWIs, the latter are likely to concentrate on larger development projects and on financing projects and programmes that have regional and global dimensions. Close cooperation between the RDBs and the BWIs will, however, still be required for the larger economies, and for regions facing crises as was, for example, the case of sub-Saharan Africa.

4. Resources for the RDBs

All the foregoing and related concerns call for increased resources. Concessional and non-concessional resource needs in developing countries will continue for a long time to exceed substantially the available supply - even taking into account the possibility that the recent trends toward increased private capital flows to some of these countries will continue - if the international development agenda centred on poverty reduction is to be seriously pursued. Yet, as Culpeper (1993, p. 15) has noted, "the era of rapid growth in the resource base of the multilateral banks is drawing to a close". RDBs will, therefore, have to be more imaginative in utilising the resources they mobilize, and to demonstrate to donors of concessional funds and the shareholders at large that the development impact of the resources is likely to be maximized. It should be stated clearly, however, that the RDBs along with the BWIs, whatever may be their shortcomings, have no readily comparable counterparts in promoting global prosperity and international cooperation. Thus while certain changes are necessary in both sets of institutions to enable them better to meet current and future challenges, the international community will need to extend adequate support in terms of financial resources.

Concessional resource requirements are considerable for meeting the needs of the poorest, particularly in Africa and Asia. Social

progress, therefore, will require the increased support of the non-borrowing members of RDBs through replenishments of the concessional resource windows. On their part, the regional funds will have to focus closely on the needs of the poor, on promoting conducive environments for growth, and on the provision of technical assistance for the lower-income countries.

Existing and projected demand for multilateral non-concessional finance will also remain high in the developing countries as a whole. Continued RDB member support for capital replenishments will, therefore, be necessary, and the RDBs will have to be imaginative and responsive to the varying needs of their respective regions. For instance in the case of the RDBs operating in "emerging market" countries, it would be useful to think of new institutional policies and lending instruments that would maximize the flow of private finance, for example, by covering shortfalls in private sector deals, and extending finance to lengthen maturities (Dallara, 1993). On the other hand, in the case of limited country creditworthiness - a situation that characterizes many of the potential borrowers from the AfDB - the challenge is one of responding usefully to positive changes in creditworthiness that may come through accelerated growth in exports, agriculture and GDP. Additionally, member countries of the AfDB could seek mechanisms that may lower the cost of funds for the lower-income borrowers.

Mobilization of both concessional and non-concessional resources in RDBs will require, as already mentioned, predictable improvements in the development impact of operations. The various, rather similar, shortcomings that have been pointed out in the recent portfolio review reports commissioned by the RDBs themselves will have to be seriously addressed. The principal objectives would be to ensure that existing loan portfolios and future commitments truly assist economies to grow, reduce poverty, and enhance their capacities to service debt. The necessary human and financial resources will have to be committed for these objectives. Similarly, more improvements will be called for in country programming and strategy formulation, as well as in sectoral approaches and policies. All these will, among other things, require improved institutional governance within RDBs.

5. *Regional blocs and South-South cooperation*

Despite the trend towards increased global interdependence, international economic relations are paradoxically also being influenced considerably by the emergence of regional trading blocs. Further, the forces that are making for the emergence of such blocs are likely to gain strength in the coming decade. The European Union will likely be enlarged, not only to include the remaining countries of Western Europe, but a number of countries in Eastern Europe as well. In the Americas, NAFTA will also likely be expanded to include a larger number of countries in the hemisphere; and along with this, another regional grouping for the countries of Central and South America may emerge. In Asia, the further strengthening of existing sub-regional groupings can be expected, while in Africa, substantial progress towards the establishment of the Pan-African Economic Community is likely to take place.

The emergence of regional blocs will pose major challenges to the BWIs and the RDBs. The BWIs, along with GATT/WTO, will need to work towards maintaining and enlarging rule-based international monetary, financial and trading systems. They will also need to help ensure that the growth of trading blocs does not lead to discriminatory practices, or in the worst case, to interregional trade wars, that could result in a slowdown of global economic growth. By contrast, the RDBs can be expected to play an important part in strengthening the economic ties within the blocs. Through such measures as increased financing of multinational projects, expanded support for intraregional trade facilities, as well as through the provision of technical assistance for the harmonization of the economic policies of member states, the RDBs can help promote stronger intraregional economic bonds.

Along with the challenge that greater regionalization poses for the RDBs, another challenge that they will face in the coming decade is that posed by the demands of growing South-South economic relations. Despite the slowdown of South-South trade in the 1980s, the early 1990s have seen a considerable reversal of this trend. Higher rates of economic growth and structural change in East and South-East Asia, as well as economic recovery in Latin America, have resulted in sharp increases in the export of manufactures by developing countries, in the growth of intraregional trade, and in a rise in intra-South investment. Indeed, much of the growth in global output and world trade in the first years of the 1990s is attributable to the dynamism of the economies of the South.

The RDBs, in line with their original mandates, will need to play a greater role in enhancing South-South economic relations. The RDBs have, as noted earlier, played a

considerable part in promoting intraregional economic cooperation; there is at present a clear need, however, to enlarge this role with the purpose of enhancing economic relations between the different regions. There is mutual economic advantage to be had from the advancement of such relations. The rapid growth and diversification of economies in the South indicate a growing complementarity among them, and, hence, increased possibilities for greater trade and investment. The rapidly growing economies of Asia, have, for example, become important consumers of raw materials produced by other countries in the South. They have also accumulated considerable financial reserves, which, under appropriate conditions, can be tapped by other developing countries; and, as an increasing number of countries in the South have succeeded in diversifying their economies, and have developed their science and technology capabilities, other less-developed countries could profit by establishing closer economic links with these economies. The RDBs will need to develop their own programmes for South-South cooperation, as such economic links can improve the growth prospects for their borrowing member countries.

E. Concluding remarks

Regional Development Banks have grown from the original idea of promoting greater country cooperation within given regions to becoming broader instruments of international cooperation, both South-North and South-South. They have in the process not only expanded to handle relatively large financial and technical resources, but have also, by their evolving character, become vehicles for expanding international business and global demand. Reinforced by the overlapping industrial-country membership in the two sets of institutions, they have grown to complement the role of the BWIs in promoting global prosperity. The operational and developmental concerns of the RDBs, however, remain rooted in their respective regions, and both regional and non-regional shareholders in those institutions look upon them to provide regional leadership in key areas of development policy. Their regional character, in political, operational and technical terms, enriched by the non-regional partnerships, places these institutions in a unique position to provide such leadership. The broad membership of RDBs needs, therefore, to equip them with the financial and human resources necessary for playing this role.

On their part, the BWIs will undoubtedly be called upon to play an increasingly greater role in meeting the evolving global challenges that growing interdependence in the world economy will generate. While giving priority to such global concerns, the BWIs will still need to address regional requirements, particularly those of the larger economies and of regions requiring special assistance. With the growth and emergence of RDBs as major development finance institutions, much will be gained by strengthening the working relationships between the BWIs and the RDBs. This should aim at maximizing the joint developmental impact of these institutions, through a more effective and coordinated utilization of their specific capabilities and potentials.

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Comments

Cristian Ossa

The paper by Delphin Rwegasira and Henock Kifle is mostly an up-to-date analytical description of the role of the African Development Bank, the Asian Development Bank and the Inter-American Development Bank and of some of their interrelations with the Bretton Woods institutions (BWIs). The authors discuss, from a historical perspective, the evolving tasks of the three regional development banks (RDBs), highlighting their capacity of response to new challenges, and present the likely road ahead and emerging priorities in the mid-1990s. It is a good synthesis, particularly of the strengths, achievements and the very important future responsibilities of these institutions.

It is difficult not to agree with the authors on virtually all the points raised in the paper. Yet, perhaps a somewhat different approach might have shed more light, particularly, on problems that might arise in fulfilling future tasks. If the paper had addressed the tensions that existed at certain junctures, the competition of RDBs with other financial institutions rather than exclusively their complementarities, the actual progress achieved and not only the expected progress in some areas, and some of the conflicts in priority setting or approaches among shareholders from the North and the South (or key financial supporters and borrowers), the lessons from the past would have been more vivid to the reader. What follows is, therefore, some points in which some controversy might exist, controversy that was often bypassed in the paper.

The question of leadership is one that runs through the whole paper and the authors emphasize the importance of the leadership of the BWIs at the global level and of the RDBs at the regional level.[1] Yet, the cases presented as evidence of leadership are not very strong. Moreover, leaders are not exempt from error, a fact that is not recognized. It is dangerous to assume that leaders tend always to be right. The cost of errors is borne by the followers (borrowers) since, after all, the institutions themselves are largely insulated from loss as they receive priority in loan repayments.

The work of the RDBs is seen by the authors as almost exclusively complementary to that of the BWIs. Yet, the paper itself identifies instances that would indicate competition rather than complementarity. Indeed, competition is not necessarily unhealthy and some degree of competition could be to the advantage of borrowing developing countries.

In the field of policy or reflections on development, any monopoly of views or ideas could be stifling and might lead countries to miss opportunities. Policy makers should not disregard models that - albeit successful - appear heterodox or depart from current fashion.[2] Reflections on development in the RDBs which would be naturally more attuned to regional cultures have been and should continue to be an important contribution to alternative development styles and the evolution of development policies.

The critical role played by RDBs in the integration processes is also stressed by the authors. It is true that RDBs, particularly the African Development Bank and the Inter-American Development Bank (often called integration banks), made major efforts to support integration processes since their very inception. But it is also true that integration processes in Africa and Latin America, when assessed against their primary objectives, have been largely a failure until recently. It is only in the 1990s - with an integration strategy that is less defensive - that new schemes appear to offer real hope in this field.

Self-reliance is seen by the authors as a key objective of national development strategies. Yet, they also see an increased role for

1 Yet, leadership is not defined. Leaders obviously need followers, particularly voluntary followers. Otherwise, leadership might be no more than a power relationship in which one of the actors has the upper hand.

2 Indeed, several successful stories of developing economies - e.g. Chile, the Republic of Korea, Singapore - owe little to the guidance of multilateral development institutions.

BWIs, and particularly RDBs, "in helping countries to adopt appropriate development strategies". Although, the two views are not necessarily in conflict with each other, it is almost unavoidable that some tensions will emerge as more self-confident countries - or successful countries - engage in a policy dialogue with such institutions. Also, at least at the conceptual level, there is some contradiction between the growing consensus about the need for countries' ownership of economic reforms or adjustment programmes, and the more pervasive conditionality that now characterizes structural adjustment lending.

On debt, the story is not yet over. Many developing countries are still constrained by a considerable external debt overhang. The contribution of the IMF in the early 1980s was critical to the stability of the international financial system. But, as the authors point out, the side of the strategy dealing with debtor developing countries was not as successful: "as the costs of adjustment in terms of import compression, lost output, and declining living standards became apparent, pessimism was expressed with respect to the adequacy of the approach adopted by the Fund". Additional studies and policy oriented analysis in academia and international institutions, including RDBs, pointed to the insufficiency of the approach. Thus, by 1985 the Secretary of the United States Treasury, James Baker, proposed a new strategy and, again from the same post, James Brady reinforced that strategy, calling for significant reductions in commercial debt levels - an issue that had been anathema for BWIs - when certain conditions were fulfilled.

On concessional debt, there were also several initiatives, e.g. at the G-7 Toronto Summit. Seen in perspective, the BWIs were leaders as well as followers. The initiatives and pressures of others to anticipate and prevent a costly and excessively prolongued process did influence their views and policies.

The role of the BWIs and the African Development Bank have been instrumental in mobilizing an impressive amount of financial - concessional and non-concessional - resources for Africa. In the words of the authors: "efforts at resource mobilization led to a relatively large transfer of resources by the African Development Bank Group... The BWIs have, in response to the development crisis in Africa, been actively involved with helping countries adopt appropriate policies and providing the requisite financing". But the policies adopted may not have been so appropriate, because performance was clearly sub-par in the last dozen years or so and per capita incomes kept declining. Similarly, the fact that investment rates in Africa have fallen substantially, points to an insufficiency of resources rather than the provision of the requisite financing.[3]

The question of adoption of "appropriate" policies can also be seen against recommendations provided in the World Bank report, *Accelerated Development in Sub-Saharan Africa - An Agenda for Action*, a report cited by the authors. The report, published in 1981, is rather sanguine about fuel and non-fuel primary commodity prices (p. 23). It suggested that African exports of primary products could expand with relatively small effects on prices. This sanguine view, which persisted at least until 1984 (Duncan, 1984), influenced not only the Bank's policies, but also that of African countries. In the second half of the 1980s, later reports of the World Bank indicated that there was excess supply in several primary commodities. The net effect was that many projects in developing countries, particularly in Africa, had a negligible rate of return or one that was even negative in some cases.

Looking to the future of the RDBs, the paper points to the importance of their traditional functions: the mobilization of financial and technical resources required for socio-economic progress. They are also seen as instruments for more intense South-South cooperation and for assisting countries in dealing with cross-cutting concerns, such as poverty alleviation, the gender dimension of development, the environment, market-state relations and governance.

Having started lending some time ago, both the RDBs and the World Bank Group have declining net transfers vis-à-vis Africa and Asia, and negative net transfers vis-à-vis Latin America (table 1, page 5 of the paper). Yet, as providers of long-term capital, they will remain critical sources of finance, especially for countries with limited or no access to financial markets. The authors envisage an enhanced policy dialogue for growing financial commitments, in particular, "that strong and sectoral macroeconomic policies should accompany the process of resource transfer in order to maximize the development impact of the process" and "that in order for adjustment and development programmes to succeed, they must be locally and, by simple extension regionally, owned".

The number of tasks envisaged in the paragraph above might divert attention from the central role that these institutions should play in resource mobilization. Likewise, since

[3] Obviously, it cannot be expected that the BWIs should do the job alone.

activities such as the gender dimension of development, market-state relations and governance, are only indirectly related to gross domestic investment, it appears that what is expected is an increase in the relative importance of policy advice vis-à-vis lending activities.

Finally, looking at the future, I would have liked to see more discussion in three fields: first, the nature of activities of the RDBs in a world economy characterized by liberalization and globalization in financial markets and, quite probably, slow growing or stagnant official development assistance; secondly, their role in regional and sub-regional integration strategies that have become less defensive (outward orientation) and are cutting across the North-South divide (e.g. NAFTA); thirdly, what may be considered as critical development-related activities, such as the assistance of RDBs to increase investments, develop human resources, achieve technological modernization and expand and diversify exports. Whatever the national development strategy, the latter activities should comprise part of the core.

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VIII. THE DEVELOPING COUNTRIES' INFLUENCE WITHIN THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

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DEVELOPING COUNTRY COOPERATION IN INTERNATIONAL FINANCIAL INSTITUTIONS

Lal Jayawardena

The early history of monetary and financial cooperation among developing countries in relation to the Bretton Woods institutions, the World Bank and the IMF, has been set out by Henning (1992). He observes that "the transformation of world politics and economics at the beginning of the 1990s presents new challenges for developing country cooperation in the Group of Twenty-Four" (G-24). Specifically, market-based economic reform in the former Soviet Union and Eastern Europe, the easing of the international debt problem, and the triumph of "market-friendly" policies everywhere, are viewed as posing "new problems of coalition formation among the developing countries". The present paper seeks to explore some options for coalition formation that now confront the developing countries in the new situation. Section A of this paper reviews the working methods of the Group of Twenty-Four so far, and explores the potential for coalitions with both the smaller industrial countries, and the reforming economies of Eastern Europe. Section B examines ways in which the interests of Japan and those of developing countries might converge during the 1990s. Finally, section C outlines a broad substantive agenda in the pursuit of which appropriate coalitions can be constructed on the principle that form must follow function.

A. The potential for coalition formation

When the G-24 first commenced operations in 1971, it functioned on the basis of coalitions of regional sub-groups carried over from the working procedures that the Group of 77 (G-77) had evolved within UNCTAD. Each regional group caucused separately: the Asian Group, the African Group and the Latin American Group. The regional positions formed at these meetings on issues were then brought to the main plenary meeting of the G-24 with regional coordinators being charged with the task of making the principal presentations, before a consensus common to the entire group was hammered out. This procedure was, however, quickly abandoned after, to the best of my recollection, the first two or three meetings of the G-24 deputies.

There were two reasons for this. The limited time available for G-24 meetings, which immediately preceded the meetings, first, of the Committee of Twenty and, subsequently, of the Interim and Development Committees, did not permit the extra time needed for separate regional caucuses. Second, the scope of the substantive issues that needed to be debated in the monetary and financial sphere was much less divisive than was the case with the generality of trade and commodity issues which preoccupied UNCTAD. There was much less scope for regional variations in the approach to issues such as, for example, the most appropriate exchange rate regime, conditionality both of the IMF and the World Bank, the debt problem, and the link between development finance and liquidity creation. It was for these reasons that the G-24 worked at the level of plenary meetings, with the task of communiqué drafting being delegated to its bureau, representative of the principal regions, with the assistance of UNCTAD and IMF staff as appropriate. The draft communiqués would then, of course, be brought back to the plenary meeting for amendment as appropriate, and for eventual endorsement.

As explained in Henning's paper, the G-24 agendas were in their first phase entirely determined by the agendas of the parent meetings of the Interim and Development

Committees. It was only at a later stage that the G-24 felt the need to evolve a comprehensive position as the counterpart to a formal position of the G-10, and this task was eventually entrusted to a Working Group of the G-24 which functioned under the chairmanship of the then Indian Executive Director of the IMF, Arjun Sengupta. However, this working group sought to evolve, with academic and professional inputs from various quarters, including the G-24 technical support group, a common position that was not the aggregation of subregional positions. As a result, as Henning observes, the Group of Twenty-Four had succeeded in placing "before the world a developing country agenda for reform of the international monetary system including the mechanisms and facilities of the IMF and the World Bank". The G-24 had not, however, so far "become the forum through which the developing countries conduct hard headed negotiations with their advanced country counterparts" (Henning, 1992, p. 137) and it is on the opportunities for coalition formation in this latter area that the remainder of section A will focus.

The first requirement for hard-headed negotiations of any kind, and the effective exercise of peer group pressure, is a forum of limited size. One result of experience with the working of the Interim and Development Committees has been the conviction among many participants that meetings of 20 persons or more usually end up by everyone making set speeches at each other, resulting in a kind of multilateral monologue. The first grouping to cut through this difficulty were the developed countries. Within the Group of Ten developed countries (G-10), decision making during the late 1970s and 1980s gravitated towards a Group of Five (G-5), namely, France, Germany, Japan, the United Kingdom and the United States, with in some cases vital decisions being taken within an inner core Group of Three (G-3), Germany, Japan and the United States. The formal machinery of the Bretton Woods system, namely, the Interim and Development Committees and the Executive Boards of the IMF and the World Bank became, in time, vehicles for the rubber stamping of decisions concerning the management of the world economy taken outside this machinery, within the more limited conclave of the G-5. This was eventually widened to become the G-7 with the inclusion of Italy and Canada as full participants.

It was not only the developing countries that were excluded from the decision making process as a result; the smaller industrial countries, in particular, felt marginalized. This included the countries of the so called "like-minded Group" that had functioned at crucial moments in UNCTAD negotiations in resolving deadlocks between the developing and developed countries, i.e. the Netherlands and the Nordic group of countries. Executive Directors from these countries have observed informally, that once an issue had been decided upon within the G-5 or the G-7 and presented to the Executive Boards of the Fund and the Bank, these decisions could not be re-opened, and had to be accepted as *faits accomplis.*

A particular recent example of decision making, in this case outside the ambit of the Bretton Woods institutions, concerned the decisions on both the location and the chief executive officer of the newly formed European Bank for Reconstruction and Development (EBRD) set up to deal with the problems of Eastern Europe. The decisions to locate the EBRD in London, and to have a French national as its President, were taken within the G-7, much to the discomfiture of the Netherlands, whose Finance Minister was a candidate for the presidency. Against the background of experience of this kind, an important objective becomes that of trying to breathe new life into a genuinely multilateral approach to international economic decision making, as contrasted with today's situation where the legally constituted decision making organs of the Bretton Woods system are being systematically bypassed with decisions handed over to them, so to speak, from outside by the G-5 or the G-7, and often taken at their summit meetings. An important WIDER Study Group which included two former heads of the Bretton Woods institutions, Robert MacNamara of the World Bank and Johannes Witteveen of the IMF, elaborated the reasons why changes in a genuinely multilateral direction could not be expected to come from any initiative taken by the G-5.

> In practice, however, it would be naive to believe that the weaknesses in the present institutional set-up are likely to be rectified from the inside - i.e. through leadership from the Summit. Self-selected groups, working without rules or objective criteria, do not adapt their membership in line with changing realities. Existing members will go to great lengths to avoid being excluded. Invitations to new members are stymied by the differing geopolitical interests of the existing members.
>
> Equally, a small oligarchy of major powers is bound to be ambivalent about strengthening the multilateral institutions, since for them it is generally easier to cut deals behind the scenes. They will also tend to rely more on position papers prepared by their own national officials, reflecting their own national and bilateral interests, rather than on analyses

> prepared by the international organizations, reflecting the interests of their much larger membership.
>
> Finally, the Group of Five, with its link to the Summit, has an inevitable bias towards damage limitation and the short-term political interests of those currently in power. It is a coalition of incumbent governments, and nobody wants to rock the boat. Genuine reform of the institutional framework for international cooperation is never likely to be high on its agenda (Chakravarty *et al.*,1989, pp. 12-13).

The WIDER Study Group proceeded on the basis of this analysis to argue the case for a coalition involving the developing countries, the smaller industrial countries, and the reforming economies of Eastern Europe. Such a coalition could be styled the "Group of the Non-Five" (non-G-5), and the argument was presented in the following terms:

> If this analysis [above] is accepted, it follows that needed changes are most likely to come about as the result of pressure from *outside* the charmed circle of the Group of Five. This, we suggest, could best be provided by the countries from outside this group coming together to form a 'Group of the Non-Five'. Membership would be open to all countries that are currently members of the IMF or GATT, except for the G-5 countries. It would, in other words, be open to all countries which by reason of their smaller size or lack of economic development have a strong self-interest in more effective *collective* management of the world economy. The new Group would seek to demonstrate, through its own structure and methods of work, that large membership is not incompatible with efficient 'small group' decision-making. To do this it would seek to delegate decision making authority to a small representative group drawn from its membership which would constitute the Governing Board of the Group of the Non-Five. In order to be of manageable size this Governing Board ought not, in our view, to exceed ten, and preferably be limited to only seven members, with the Soviet Union as an additional member at such time as she joins one or another of the multilateral institutions.
>
> We envisage that the Group of the Non-Five should meet on an annual basis with the five principal Summit countries (the participation of Canada and Italy in both the Group of the Non-Five and the Summit can only help the process of two-way communication). At these meetings the Group of the Non-Five would be represented by its Governing Board and it is our hope that these joint annual meetings could in time develop into and be known as an Interim World Economic Council. Such a mechanism would amount to an institutionalization of a World Summit where the selection of countries taking part would be determined on the basis of objective criteria reflecting their respective shares in world GNP, trade and population. However, in the initial exploratory stages of launching the process the Governing Board may wish to nominate an even smaller number of representative countries, say two or three, to initiate contacts with the Summit Five and set up joint meetings which could be known as 'Working Summits', pending the evolution of the Interim Council (Chakravarty *et al.*, 1989, pp. 13-14).

This design of the WIDER Study Group had as its first objective that of establishing a forum of limited size which would be conducive to the "hard-headed negotiations" that had hitherto eluded the Group of Twenty-Four. The expectation was that Canada and Italy, with participation both in the G-7 summit and with the Group of Non-Five, could act as honest brokers between the two groups. The maximum size of the joint forum, to be eventually styled the Interim World Economic Council, that would emerge from this design would be 16, comprising the G-5 on the one hand, the governing board of the non-G-5 on the other, which was not to exceed 10 in number, and an additional member to represent Eastern Europe and the former Soviet Union. This limitation was based on an assessment of the experience of decision making with somewhat larger numbers in the Interim and the Development Committees and indeed, in the Boards of the Fund and the Bank.

The second objective of the new forum would be to base negotiations on a reform agenda that the Group of Non-Five would seek to construct. As the WIDER Study Group observed:

> A central aim of our proposal is to provide a *political* counterpart to the G-5 so as to promote the development of a more representative framework for governance of the world economy. The Group of the Non-Five would address the entire range of issues pertaining to the management of the world economy and the activities of all the relevant international organizations and seek to develop coherent policy positions on these matters. If, through its Governing Board, the Group of the Non-Five were to speak with a single visible voice in the Working Summits and eventually in the Interim Council on these issues it would become a force to be reckoned with, whose existence would be very difficult for the Group of Five to ignore. It could indeed provide a *political* constituency that could respond to and even elicit initiatives from individual G-5

members, for example, a Japanese initiative on the debt problem that might otherwise be muted within the G-5. If it succeeded in developing common positions on leading policy issues, the group of the Non-Five would quickly emerge as a pacemaker for constructive change in international economic policy. For the aim is not to create a new divide between 'them' and 'us' but rather to institute pressures to narrow and eventually bridge the gap. The ultimate aim of the Group of the Non-Five would be to proceed from the Working Summit and Interim stages, where joint meetings are held with the key five Summit countries, to a fully-fledged World Economic Council with an even more manageable size of eight or eleven, as outlined in more detail below...

More specifically, the objectives of the Group of the Non-Five in seeking meetings with the Summit countries would include the following:

(1) To resist, by all possible means, further erosion of the multilateral institutions and to use the considerable influence that the Group would have within these organizations to try to ensure that relations between them and the Group of Five were not just a one-way street, as is to a large extent the case today.

(2) To loudly and persistently lobby for the creation of an Interim World Economic Council in which the Group of the Non-Five would meet with the G-5 Summit countries. The new Group would announce from the outset that, if invited, it would be prepared to designate one or more of its members to participate in the Group of Five and Summit meetings in order to prepare for the establishment of such a Council.

(3) To develop joint positions on all the main issues pertaining to management of the world economy - exchange rates, interest rates, finance, debt, trade, etc. - which can then be placed before the Interim World Economic Council and the multilateral institutions.

(4) To demonstrate, by its own mode of operation, the possibility of developing an efficient (i.e. small) but representative vehicle for discussion and negotiation on the major issues of international economic cooperation.

(5) To develop proposals for a major reform of the existing international institutional framework. Proposals for monetary reform would surely command a very high priority in this context. What is needed is a new international monetary system designed and developed in order to avoid unduly large swings of exchange rates over the medium-run which distort international resource allocation and strengthen protectionism in the countries with over-valued currencies.

Ultimately the objective should be to develop a consensus between the developing countries and the smaller developed countries on a number of important issues; this consensus would be significantly different from the policies which the G-5 is pursuing or proposing. This is clearly a wide-ranging agenda which will take time to accomplish. We are conscious of the fact that many governments may have difficulty in starting to work immediately on such a formal organization. Recognizing this, progress might be made initially through an informal representative group whose composition would, in effect, correspond roughly with that of a formal Governing Body of the Non-Five (Chakravarty, *et. al.*, 1989, pp. 16-18).

The third objective of the new forum was to base the composition of the governing board of the Group of Non-Five on the constituency system developed within the Bretton Woods institutions. For this purpose, objective criteria were developed that would reflect the economic and political weight of countries in the world, namely GDP, trade and population, and constituencies grouped according to geographic region. Accordingly, each country acquired voting rights on a basis of a formula developed by Stephen Marris, which assigned a weight of 45 per cent to a country's share in world GNP expressed in terms of purchasing parities, 45 per cent to its share in world trade, and 10 per cent to its share in world population. Overall, the formula - termed formula A - confirms that the present distribution of voting power in the IMF, where developed countries have a total voting share of 60 per cent to the developing countries' 40 per cent, is a reasonably accurate reflection of today's economic and political realities; for when the formula is applied to the current IMF membership, it results in precisely the same 60-40 ratio.

Table 1 sets out alternative configurations of governing board representation, voting rights according to the Marris formula, and the numbers of countries involved. A ten-member governing board, for example, would allow for three members from Europe, three from Asia (including Oceania), two from the Western hemisphere, including Canada, and one each from Africa and the Middle East. In Europe, there could be two European Union constituencies, and another primarily from Eastern European and neutral countries, such as those of the Nordic group. In Asia and Oceania, there might be two constituencies formed under the leadership of India and

Table 1

COMPOSITION OF THE NON-G-5 GOVERNING BOARD, REGIONAL GROUPINGS

Region	*Voting rights (Formula A)*	*Number of countries*	*Number of seats on the governing board*	
Europe	33.4	23	2(2.34)	3(3.34)
Asia and Oceania	32.0	30	2(2.24)	3(3.20)
Western hemisphere	18.0	34	1(1.26)	2(1.80)
Africa	8.5	50	1(0.60)	1(0.85)
Middle East	8.1	15	1(0.57)	1(0.81)
Total	100.0	152	7	10

Note: Figures in parentheses are the unrounded number of seats.

China, and a third Pacific rim constituency, including Australia and New Zealand. In the Western hemisphere, Canada might join in a constituency including Central America and the Caribbean, as is indeed partly the case today in the IMF, with a second South American constituency. There would be provision for Russia to join as an observer from the outset, with full membership resulting from a further decision to join either GATT (WTO) or any of the Bretton Woods institutions. An even smaller governing board of seven members would also be feasible. In this configuration, Europe and Asia would each have two constituencies, with one each for the Western hemisphere, Africa and the Middle East.

The final stage in the process of boiling down participants to an even more manageable size, would involve the transition from joint meetings between the G-5 and the non-G-5 to a World Economic Council comprising no more than eight to 11 members, representing all countries in the world economy, with the former Soviet Union and Eastern Europe being assigned one seat on the governing board. Once such a World Economic Council is created, then the Group of Non-Five would achieve its ultimate aim of making itself redundant and would be wound up. The composition of the World Economic Council is given in table 2 below.

An alternative approach to coalition building and decision making on global economic management would be centred in the United Nations, and would seek to expand the membership of the Security Council and set up a parallel body styled the Development Security Council. The formula developed by UNDP (1992, p. 82) would seek to add to today's five permanent members of the Security Council, namely, China, France, Russia, the United Kingdom and the United States, the two most powerful developed countries, Germany and Japan. They would be joined by the most populous country in each developing region: India, Brazil, Nigeria and Egypt, making 11 permanent members in all. This permanent membership would be matched by another 11 members chosen on a basis of rotational election to represent various regional economic groupings, resulting in a total membership of 22.

The differences between this formula and that of the WIDER Study Group are worth noting. In the first place, a decision making body as large as 22 may provide the same kind of obstacles to "hard-headed negotiations" that have characterized the organs of the Bretton Woods system, namely, the Interim and the Development Committees and the Executive Boards of the Bank and the Fund, which are all of about the same size. The merit of the WIDER Study Group formula is that the initial joint meetings between the G-5 and the non-G-5 have an outer limit set to membership of no more than 16. Second, the Development Security Council formula avoids, as is United Nations practice, any mention of voting rights and constituencies based upon weighted voting, whereas the WIDER design builds on prevailing Bretton Woods practice with constituencies and weighted voting.

Third, in organizational terms, it would be open for the Development Security Council to function exactly in the same mode of coalition formation as in the case of the WIDER

Table 2

COMPOSITION OF A WORLD ECONOMIC COUNCIL, REGIONAL GROUPINGS (INCLUDING THE FORMER SOVIET UNION)

Region	Voting rights (Formula A)	Number of countries	Number of seats on the governing board	
Western Europe	27.3	21	2(2.18)	3(3.00)
Asia and Oceania	25.6	32	2(2.05)	3(2.82)
Western hemisphere	25.2	35	2(2.02)	3(2.77)
Former Sovient Union and Eastern Europe	12.4	8	1(0.99)	1(1.36)
Africa and the Middle East	9.5	65	1(0.76)	1(1.05)
Total	100.0	161	8	11

Source: Chakravarty, 1989, p. 30, table 3.
Note: Figures in parentheses are the unrounded number of seats.

design. In other words, the 17 members who would comprise the non-G-5 in the Development Security Council design could seek to caucus separately among themselves and hammer out a common negotiating agenda. This non-G-5 could then seek to limit its size further by boiling itself down to a still smaller representative group of no more than 10 (with Russia, of course, as the 11th member), which would seek to have joint meetings with the G-5 within a working group or sub-committee of the Development Security Council.

One formula worth exploring would be to expand the nucleus of the permanent developing country membership, numbering five (including China), to a total of 10 to represent other developing countries and the smaller industrial countries in any such working group. What this means is that the 11 non-permanent members of the Development Security Council would have to devise a mechanism for no more than five of their number to participate in the working group. One possibility here would be to have, in the interests of coalition building, two representatives from the small industrial countries, e.g. the Netherlands and a Nordic representative, with three developing countries to represent each of the regions: Africa, Asia and Latin America. This formula would in effect convert the working group into becoming the effective decision-making organ of the Development Security Council, and it has the advantage of being no larger than the membership envisaged in the WIDER proposal for the Interim World Economic Council.

B. Japan and the developing countries: the basis for a convergence of interests

The previous section has summarized the case for bringing international economic decision making back into the duly constituted multilateral framework based upon objective analyses by international secretariats, as contrasted with today's situation where G-5/G-7 decisions are dutifully rubber stamped multilaterally. The existence of a political constituency outside the G-5/G-7, which would seek to develop joint positions on all the main issues pertaining to management of the world economy, can be expected to have the effect of encouraging initiatives by individual G-5/G-7 members that would otherwise be muted in the process of reaching a consensus within the G-5. A particular recent illustration of such an initiative which might have born fruit concerns the well known Japanese initiative on an approach to the international debt problem, known then as the Miyazawa Plan, named after the Japanese Prime Minister at the time. Its central idea was for a facility to buy back developing country debt at the discounts prevailing in international markets, in exchange for a package of economic reform that the debtor country would undertake to implement. This plan was presented to the Toronto Summit, but

failed to command support at the time for a variety of short-term political considerations, shaped by the timing of key elections in the principal summit countries. The plan re-emerged at a subsequent summit and at a more politically opportune moment for the G-5, as the Brady Plan, named after the United States Treasury Secretary at the time. It is arguable that, had a joint non-G-5 position of a similar kind on the debt problem been developed well before the Toronto Summit, Japan might have been emboldened to stick to her initiative on the debt problem, so that the Brady Plan might, in effect, have been implemented several years earlier.

More generally, Japan has in recent years been espousing in international fora a reasoned critique of the prevailing conventional wisdom on development that is being espoused by the Bretton Woods institutions. This criticism, based upon the development strategies pioneered by Japan that have also underpinned the "East Asian Miracle" economies, is not dissimilar to the criticism of conventional Fund/Bank policies being mounted by the developing countries. Since coalition building relevant to reform of the Bretton Woods system presupposes a shared perception of what is an appropriate development strategy, it is relevant to discuss the nature of this criticism of established development orthodoxy.

Today's development orthodoxy and its associated prescription for appropriate macroeconomic policies for developing countries, are contained in the "market-friendly" policy framework articulated most clearly by the World Bank. What is meant by "market-friendly" policies is a framework in which governments *support* rather than *supplant* markets; which, in other words, is friendly to, rather than hostile to, markets. This has been well summarized by World Bank economists as follows:

> Governments have done too much of the things that they cannot do well - regulating markets and producing goods and too little of the things they must do well - maintaining macroeconomic stability and making necessary public investments. Governments need to do less and do it better (World Bank, 1992).

In other words, in the "market-friendly" policy framework, government intervention is to be confined, by and large, to the areas where markets typically fail, i.e. in human development (education, health and social welfare), in essential public infrastructure, and recently after the Earth Summit in Rio, environmental protection. This would leave the bulk of the task of resource allocation to the private sector responding to market forces.

Now of itself this framework is not necessarily a bad thing, and under certain circumstances, it can produce spectacular growth results, as happened in Sri Lanka, for example in the period immediately after 1977. Its major rationale then was that it was leaning against the prevailing *dirigiste* wind that had been blowing for some three decades, as is indeed the case with India today. The problem with "market-friendly" policies - and I am now speaking quite generally and not of South Asia - is not so much with the underlying conceptual framework, as with the manner of its implementation. The vehicle for implementation has been described as the Washington consensus on stabilization and adjustment, a consensus common not only to the Bretton Woods institutions, the IMF and the World Bank, but to the various prestigious "think-tanks" strung along the Potomac river in Washington, hence the name. The Washington consensus involves five basic principles:

(1) Budget balancing: this has two meanings. The narrow meaning is that a country should eliminate deficit financing, i.e. the printing of money through borrowing from the central bank. The wider meaning involves the elimination in addition of non-inflationary borrowing by government from the domestic capital market. The argument here is that such borrowing "crowds out" the private sector from having recourse as required to domestic capital markets.

(2) Relative prices correction: this involves getting major prices right, such as the exchange rate, typically a devaluation, and interest rates, typically an increase.

(3) Trade and foreign investments liberalization: this involves the abolition of import controls and progressive tariff reductions, alongside an open door policy to foreign investment.

(4) Privatization: this involves the elimination of state ownership of productive enterprises.

(5) Domestic market deregulation: this involves the freeing of financial markets and scrapping of controls on foreign exchange.

Indeed, "market-friendly" policies may be defined as equivalent to implementing the Washington consensus, supplemented by government intervention in the areas of market failure already enumerated. This framework encounters two problems. In the first place

budget balancing within the Washington consensus can conflict with essential expenditure in areas where markets fail: on human development and public infrastructure etc., unless these activities are explicitly supported by foreign financing on an adequate scale. Indeed, it can be argued that foreign financing supplemented by non-inflationary domestic market borrowing in support of these activities, by providing vital complementary ingredients for private investment, "crowds in" rather than "crowds out" the private sector. This problem is examined in section C below.

The second problem is that it appears to conflict in crucial respects with the implementation of the alternative policy framework that has underpinned the spectacular success of the East Asian newly industrialising countries (NICs), following the pioneering example of Japan. I am referring, of course, to the Republic of Korea, Taiwan Province of China, Hong Kong and Singapore, whose example is in turn being followed by a second generation of aspirant NICs: Indonesia, Malaysia and Thailand. What is distinctive about the policies of these economies is summarized below under four heads. Under each head what may be termed the Japanese development model differs from "market-friendly" policies, in some cases markedly, in others in more nuanced fashion; and the discussion indicates the scope for coalition-building with Japan based on a common approach to development.

1. Industrial strategy and support

The Japanese model differs from the "market-friendly" model in that government intervention was not limited to human development and essential public infrastructure. Although these interventions are regarded as indispensable in the Japanese model, what is distinctive about East Asian experience was that governments also intervened to "pick winners", instead of leaving industrial choice to the workings of the market alone. Their strategy has been summarized by a former Vice President of the Asian Development Bank (AsDB) as follows:[1]

> Neither Asia's NICs nor Japan entrusted to the market, or to foreign investors, responsibility for deciding which of their industries would prosper and which would fail. On the contrary, they formulated industrial strategies based on forecasts of market developments and assessments of which of their 'neo-infant industries' could be expected to carve out a competitive niche in world markets and which could not. For the first group, they provided protection from import competition as well as export incentives, tax relief and other financial help to bolster their growth and competitiveness (Katz, 1991).

Market pressures were used to ensure that infants initially protected would become internationally competitive over time, so that subsidies initially given to them were tapered off eventually. Simultaneously, governments intervened to help firms in declining industries to diversify and retrain workers. The merit of the East Asian approach is that industries which might succeed over the medium term in Latin America or in Eastern Europe if handled East Asian style, might not survive the competition resulting from the rapid and uncontrolled liberalization which is an integral part of the Washington consensus. More recently, a quasi-official challenge along these same lines to Washington consensus policies has been mounted by Japan's aid agency, the Overseas Economic Cooperation Fund (OECF). In an important paper (OECF, 1991) this agency makes several suggestions pointing to a longer-term approach to development if Washington consensus policies are to move countries towards sustained growth. In the first place, it questions whether the impetus for sustained growth can be created by structural adjustment, if this merely takes the form of introducing a market mechanism and eliminating restrictions on the private sector. It argues for additional measures aiming directly at promoting investment, and patterned after Japan's fiscal and monetary policies in the postwar era, which were centred on preferential tax treatment and lending by development finance institutions. It also mentions the encouragement given by these policies to building up small-scale industries that would supply components to large-scale industry. Their effect was to encourage self-employment, and reduce unemployment to very low levels.

Secondly, the paper challenges the third principle of the Washington consensus, which prescribes rapid and indiscriminate trade liberalization. It argues that effective development and industrialization involve deliberate state intervention, and cannot be left automatically to the private sector, and advocates the temporary protection of selected domestic industries for relatively long periods of time in order to allow a viable industrial export sector to develop. The paper acknowledges the need to prevent the harmful effects of protection, and

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1 The subsequent account of East Asian experience draws on an article by Katz (1991).

proposes as a preventive measure a "policy dialogue on industrial development" between donors and each developing country in order to identify promising products.

2. Exchange rate policy

Japan and East Asia kept exchange rates deliberately undervalued to encourage exports and discourage imports. They succumbed reluctantly to pressures to revalue only after capturing overseas markets and building up often large reserves. In contrast, Washington consensus policies, by prescribing market clearing rates from the outset, as in Eastern Europe, may fall between two stools. On the one hand they run the risk of not succeeding in generating the necessary export inducements. On the other, they court the risk of excessive devaluation, resulting in excessive import costs and an exchange rate induced inflationary spiral.

3. Foreign investment

The NICs followed Japan in being somewhat lukewarm in their approach to foreign investment. They preferred to acquire technology through licences, franchising and market sharing arrangements, and skills through training of personnel abroad. This selective approach contrasts with the indiscriminate approach to liberalizing foreign investment that is built into the Washington consensus. In today's international climate, welcoming foreign direct investment may be the only practical option available to developing countries aspiring to be NICs. But what East Asian experience suggests is the need to attract private foreign finance through encouraging "portfolio" investment as well, in addition to promoting direct investment alone. A WIDER Study Group has suggested that "the net inflow of portfolio investment into developing countries could expand from an annual level of around $1 billion a year in the second half of the 1980s to a potential level of around $5 to $10 billion a year in the 1990s" (Berrill *et al.*, 1990, p. 3).

4. Price liberalization and subsidies

While as a rule prices in the Japanese model reflected market forces, key prices were adjusted to conform to social goals, i.e. to ensure high savings and investment rates, to give selective inducements to exports by means of subsidized rates of interest, and to bring about self-sufficiency in food. For example, in Japan there is no market price for imported rice because of protection in the interests of self-sufficiency and of maintaining the social fabric of peasant producers intact, and the banning in consequence of rice imports.

To summarize the Japanese and East Asian experience, what is distinctive about the model is its use of the market in support of defined social priorities, as contrasted with an abdication to market forces which accepts whatever short- and long-run consequences are incurred as a result. The merit of the approach is that the experience of Japan and the NICs has succeeded in bringing about rapid growth and development without incurring unacceptably high social costs, so that at all times popular support has been enlisted in favour of the reform process. The concluding paragraph of OECF (1991), captioned "Beyond the Decade of Efficiency", summarizes Japan's viewpoint on this matter:

> Although efficiency and fairness are the major objectives to be pursued in economic policy, there is sometimes a trade-off between the two. In the 1980s, economic theory as well as economic policy were heavily oriented toward the pursuit of efficiency. In this sense, it was a unique period. However, this period has come to an end. What is now needed is a policy well balanced between efficiency and fairness in order to improve the welfare of the entire society. The World Bank's approach to structural adjustment may have to be changed reflecting the change of streams.

Masaki Shiratori, a former Executive Director of the World Bank and Vice-President of OECF, has pointed out that while in the World Bank Research Department's formulation of "market-friendly" policies there was acceptance of the government's role in areas of market failure, Japanese experience "suggests a bit stronger role for government" than envisaged by the Bank's Research Department, including selectively "picking winners" and subsidizing interest rates. He concluded, however, from his assessment of the established practice of the operational departments of the Bank, that,

> ... in reality, even this 'market-friendly approach' seems to have been not fully adopted and developing countries have been often urged to adopt policies based on the blind belief in the market mechanism instead. It is argued that the government cannot be relied upon because of weak structures of the civil service and resultant corruptions in many developing countries, thus making the market mechanism the better alternative. Thus, var-

> ious regulations should be abolished, transactions liberalized, and state-owned enterprises privatized.
>
> More often than not, the market mechanism fails to function properly in developing countries, and in many cases markets simply do not exist. The single-minded application of marketism is unrealistic under such circumstances (Shiratori, 1993).

According to Shiratori, Japanese experience suggests that the role of government should include the following:

- setting medium-term goals that could serve as guidance for private economic agents;
- appropriate economic policy management;
- human resources development through education and training, and the promotion of science and technology; and
- establishment of a financial system that will encourage national savings and channel them into productive investments.

If the substantive consensus evolved in a dialogue between Japan and developing countries is that it is the East Asian path of development which is preferable for developing countries to follow, then this consensus can form the basis for appropriate reforms in the Bretton Woods system and alter the content of the policy advice coming to developing countries from the Bretton Woods institutions. This would enable development finance from Japan and other East Asian surplus countries to be deployed in support of such a strategy on an appropriately longer-term basis. The nature of such a strategy is explored in section C.

An important issue of global macroeconomic policy coordination arises in relation to any such stepped-up aid effort by surplus countries which is also relevant to any process of coalition building between Japan and the developing countries. The conventional focus of policy is on domestic expansion in surplus economies in the interests of moderating payments imbalances in the world economy. Yet successive bouts of domestic expansion in Japan have had little impact on its current account surplus, and the situation now threatens to cause trade friction between the United States and Japan.

Very little attention has been given to the alternative of recycling surpluses to developing countries in support of their reform efforts, both as aid and as foreign investment, on the premise that the import demand resulting from developing country growth will moderate global trade imbalances. An econometric study conducted for WIDER by Jeffrey Sachs of Harvard University has established that, dollar for dollar, recycling the Japanese surplus to the developing countries would be five times as effective in improving the United States trade balance, as compared with domestic expansion in Japan, because of the difference in import propensities. The specific simulation contrasted the $25 billion recycling programme envisaged in the Okita Plan for dealing with the Japanese surplus,[2] with an equivalent, i.e. $25 billion programme of domestic expansion in Japan. While recycling to the developing countries improved the United States trade balance by $10 billion, the equivalent domestic expansion programme improved the United States trade balance by only $2 billion, or by one fifth as much. This provides a powerful argument for mobilizing additional aid by linking support for a development strategy in developing countries based on the Japanese/East Asian model with improved global macroeconomic policy coordination and the moderation of global payments imbalances.

C. A substantive reform agenda for coalition formation

This section illustrates the potential for obtaining support from Japan and the smaller industrial countries, possibly led by the Netherlands and the Nordic group of countries, in pursuance of a reform agenda which can best be described as implementing a strategy for sustainable human development. The starting point for such a strategy is a recognition of the internal inconsistency within the "market-friendly" policy framework being advocated by the World Bank. Specifically, as mentioned, budget balancing within the Washington consensus (taking into account both the narrow and wide meaning of the terms) can conflict with essential expenditure in areas where markets fail, on human development and public infrastructure etc., as prescribed in the "market-friendly" approach, unless these activities are explicitly supported by foreign financing on an adequate scale. As an illustration of

2 WIDER (1986 and 1987). Both Study Groups comprised Saburo Okita, Chairman, Lal Jayawardena and Arjun Sengupta.

the potential for gaining support for a sustainable human development strategy from the smaller industrial countries, a recent initiative taken by the Netherlands in convening a preparatory conference to plan ahead for the forthcoming United Nations Social Development Summit, indicates the available scope.

The background documentation for the conference drew attention to the policy inconsistency within the Bretton Woods system so far as it concerns human development and social security broadly defined. Radwan (1994) elaborated the ways in which improving the human capital base of the poor enhances their capabilities and development potential. The Netherlands policy document provided for the meeting entitled *A World of Difference* defined the new "conventional wisdom" namely, "the emphasis on the free operation of markets and the functions of prices" as "neo-realism", marking a swing in the pendulum of policy from a previous *dirigiste* extreme to one of *laissez-faire*. It argues:

> The new conventional wisdom to which this gave rise counterbalanced the excessive emphasis on the role of governments too ambitious in their desire to regulate the development process: over ambitious in their supposition that they could in fact regulate this process and in their claim to represent the whole of society. But the lack of an adequate counterbalance also resulted in neo-realism itself fossilising into a new orthodoxy, with all the partiality that entails. Adjustment, originally an appropriate complement to the old objective of growth with distribution, stood in the way of progress, if only because it placed excessive emphasis on the short term. Overcoming this barrier by striking *a new balance between the short and the long term, between the private and the public sector, between growth and distribution, is one of the most important tasks at the beginning of the 1990s* (Netherlands, 1991; emphasis added).

The new balance that needs to be struck during the 1990s is thus an area which can elicit the support of both the smaller industrial countries and Japan; for the overall development strategy both of Japan and the East Asian NICs in ensuring rapid development has been remarkably successful in both eradicating poverty and enhancing social security. Rapid development, by analogy with Lenin's recipe for socialism - electrification plus soviets - can be somewhat provocatively defined as equalling skills plus infrastructure. Now both these are areas where markets typically fail, and they therefore require public investment, as was indeed the case in Japan and East Asia. While the "market-friendly" framework, at the conceptual level, provides for the necessary public intervention, in practice the necessary expenditures have often had to be sacrificed in the interests of budget balancing, in the absence of supporting foreign finance.

In the 1980s, for example, conventional adjustment programmes called not for a single bout of budget balancing, but for repeated bouts in the face of a continually deteriorating external environment. The typical sequence facing a developing country experiencing an external shock, such as a fall in the price of its staple export commodity, e.g. coffee or cocoa, was, first, a sharp reduction in its export revenues; next, a vain attempt to maintain budgetary expenditures which are inflexible in the short run, by printing money; third, as reserves ran out, a tightening of import controls with its attendant distortions, which if prolonged would lead to rapid inflation, until sooner or later the country became compelled to negotiate a stabilization and adjustment programme with the Bretton Woods institutions. Given the stringencies affecting external resources availability, the readiest way of restoring fiscal balance in such a programme was to sacrifice human development expenditure, and the adverse consequences of the policy have been explored by studies in UNCTAD, UNDP, UNICEF and UNU/WIDER. WIDER's country study of Tanzania provides a good example of the difficulty. Under its adjustment programme "expansion of education, health, and water facilities stopped despite increasing needs, as development expenditure was drastically cut" (Ndulu, 1987). In general, sharp cuts in real public and private consumption and social infrastructure resulted.

Michael Bruno, former Governor of the Bank of Israel, has subsequently also made the point that public infrastructure investment is similarly vulnerable:

> In the absence of a tax alternative, the pressure to balance the budget usually leads to expenditure cuts where the political opposition is least but the long-term economic cost is highest, namely investment in infrastructure (roads, communications). This is the one area in which government intervention is usually essential and the positive externalities for the long-term growth of the private enterprise sector may be highest. There may be differences in the urgency of the problem in different countries, but there is a minimum requirement in each of the countries (Bruno, 1992).

It is not without significance from the standpoint of a future reform agenda, promoted by a coalition of the developing countries with Japan and the smaller industrial

countries, that Bruno has recently been appointed as the Chief Economist of the World Bank, and Vice President in charge of its Research Department. For one result of the critique from the rest of the United Nations system so far has been the recognition of the need within the Bretton Woods institutions to address the social dimensions of adjustment (though not yet of the sacrifice of essential infrastructure); but this has so far been in the nature of an additional item to be catered for to the extent permitted by available resources, rather than an integral part of the design of an adjustment programme, which coalition building of the kind envisaged in this paper might well succeed in achieving.

In addressing the human development and essential infrastructure gap, the dilemma facing the donor community needs to be squarely faced. Once a country gets into economic difficulty, as a result of an external shock, the turn around would require major decisions on key parameters, such as the exchange rate and the interest rate, coupled with a determination to restore fiscal balance. In the absence of adequate corrective actions in these areas, external support can be viewed by donors as pouring money into a "black hole" without result. It is this fear which explains the reluctance of the G-7 countries to support the former Soviet Union, for example, in the absence, in their view, of a credible attack on basic macroeconomic problems.

1. *A sustainable human development compact*

On the other hand, once a developing country has got into difficulty as a result of an unexpected external shock, and has decided firmly to put its economic house in order by taking the basic macroeconomic decisions needed to chart an irreversible course for economic recovery and growth, there is a *prima facie* case for addressing the country's needs for human development and essential infrastructure as a matter of urgency. The solution that needs to be put in place for dealing with this problem can take the form of a sustainable human development compact with mutual obligations which can be put forward internationally by a coalition of the non-G-5 and Japan. It would require budget balancing to take place gradually, and the donor community to provide, in recognition of progress in other relevant areas of the Washington consensus, e.g. getting key prices right, adequate foreign financing support for human development, essential public infrastructure and environmental protection. Against the background of the cutbacks of the 1980s, the compact should look to increased domestic savings only *pari passu* with the increased production resulting from reform, and not insist on politically impossible cuts in consumption, whether public or private, at the outset of the reform.

In addition, in any human development design intended to safeguard social security, foreign savings support should also be extended to meeting some minimum set of consumption "entitlements" necessary for sustaining and expanding basic living standards, or at least the basic minimum necessary to enable people to function (Drèze and Sen, 1989; Ahmad 1991). The "entitlement" framework of thinking has recently been invoked also in the context of East European economic reform in support of,

> ... establish(ing) the entitlements of all members of society to a *minimal standard of living* (defined in terms of Western European standards of essential consumption and social services) derived from their status as citizens, to be derived from both their own 'resources' (particularly adequately waged employment) and publicaction (Fitzgerald, 1991, p. 15).

The implications of this argument, both for the time-frame of transition to a market economy and for *foreign savings support* of minimum consumption entitlements, are no less relevant for developing countries. Fitzgerald further argues:

> The belief that 'reforms' based on privatization, low wages and budget cuts alone could lead to a rapid transition from industrially backward socialism to industrially advanced capitalism in a few years was always an illusion. *The enormous gap between productivity levels in Western and Eastern Europe locates the latter in a state of relative underdevelopment and requires a long period of directed industrialization to catch up - not central planning of course, but rather the sort of strategy pursued by Japan, South Korea and Brazil.* Although EEEs (East European Economies) have a much more educated labour force than the MICs (Middle-Income Countries), and thus a greater capacity to absorb technology, massive investment is necessary to embody this technology - in a situation where the claims of the work force on resources for both private and public consumption levels comparable with Western Europe are equally pressing and cannot be simply dismissed as 'populism'.
>
> The resolution of the problem is not only crucial for economic policy but also for the legitimation of the post-Communist state and thus the continuation of the reform process

> itself. Appeals to 'realism', 'belt tightening' 'national sacrifice' and so on do not really face the central issue, which is need for an explicit social contract between management, labour and the state (see Janos Kornai (1990), *The Road to a Free Economy: Shifting from a Socialist System*, W.W. Norton & Co., New York). *The establishment of clear entitlements that this implies, however, may well imply the social planning of basic needs provision and will certainly require considerable budgetary support from Western Europe during the transition period - and thus implies the recognition of a wider concept of European citizenship itself* (emphases added).

A fortiori, foreign savings support for minimum consumption "entitlements" would be particularly important for both African and Latin American countries which encounter serious difficulties in mobilizing domestic savings, against the background of the cut-backs in consumption sustained in the 1980s. At a minimum, this might take the form of foreign savings support for a social safety net to finance the transitional costs of adjustment, as for example in Poland, where a World Bank structural adjustment loan funded unemployment benefit payments. Alternatively, it might be possible for a development compact to provide foreign savings support up to a specified maximum proportion of a country's GDP for a social security programme of the country's devising.

The need for a solution involving a sustainable human development compact has been brought into sharp relief by the recent disastrous reform experience of Russia, where reformers suffered at the polls. Jeffrey Sachs, in resigning as advisor to the Russian Government, has castigated the West, and specifically the IMF, for not giving sufficient credit to initiatives taken by the reformers by providing adequate supporting foreign finance. As a result, only a fraction of the foreign finance promised in 1993 - $2 billion out of a total of $17 billion - was delivered, and Russia was pressured by the IMF into making politically impossible cuts in her budget deficit without exploring other non-inflationary financial methods, such as domestic borrowing, as an alternative to printing money. As Sachs (1994) puts it:

> The IMF's relentless advice was to cut the deficit not to find acceptable and non-inflationary ways to finance part of it. The World Bank has failed in its most important task: to help finance badly needed social services.

Sachs' explanation for the IMF's failure is significant for our present discussion on coalition building in support of reform and merits extensive quotation:

> Why was the IMF so inept? For a simple reason. For 50 years, it has been nearly as secretive and monopolistic as the Central Committee of the Communist Party. All IMF loan documents concerning Russia are secret. The only information the IMF publishes is general economic data, not specific policy advice. The IMF is cut off from independent professional scrutiny and from competition. It alone determines whether Western aid will flow. Like any longstanding monopoly it has grown arrogant, self-protective and sloppy.
>
> And yet whenever anything goes wrong with an IMF program, the United States Treasury and the other Group of 7 governments draw the wagons around the IMF. The Western governments have to understand that it is one thing to defend the basic and sound principles espoused by the IMF - budget discipline, responsible monetary policy, open markets - and another to cover up the shortcomings of the organization's technical work and its reluctance to make loans in urgent circumstances (Sachs, 1994).

To summarize, the recent experience of Russia reinforces the case for a coalition between the non-G-5 and Japan in putting forward the solution that seems appropriate to developing countries, namely, that the reciprocal obligations between a country and its donors should be embodied in a medium-term sustainable human development compact, whereby the donors undertake to protect the essential expenditures on human development and social security etc., in exchange for the country making adequate progress in other areas of the Washington consensus, e.g. getting a key price, such as the exchange rate, right. This suggestion was first elaborated in my Dr. N.M. Perera Memorial Lecture delivered in Colombo in August 1991 (Jayawardena, 1991). It built on the development contract framework articulated by Thorvald Stoltenberg, Norwegian Foreign Minister in 1989 (Stoltenberg, 1989, pp. 241-242; Jayawardena, 1993). The idea was adapted with acknowledgement by the secretariat of the United Nations Conference on Environment and Development (UNCED), and presented to the Rio Earth Summit as its principal proposal on financing, under the caption "A Partnership in Additionality: Contracts for Accelerated and Sustainable Development". The idea as presented by the UNCED secretariat is that:

> It might facilitate the provision of aid if developing countries were to put forward ambitious, accelerated and 'sustainable

> development' programmes, and if willing donors responded with additional funding.
>
> A 'partnership in additionality' would be based on a developing country's clear articulation of policies and strategies and a programme of action for their implementation. The strategies would be designed to enable full use of economic opportunities in a drive for fast growth in production levels, while at the same time *re-ordering internal priorities toward a broad-based attack on poverty, concentrating, for example, on basic education, and rural infrastructure.* Such strategies would be the basis for a commitment to increased funding from international and bilateral donor sources. A sustained commitment would be needed by both developing countries and by the donors. It would be essential for such programmes also to enjoy broad popular support since the donor-recipient relationship would be unlikely to endure any charge of unwanted conditionality.
>
> Such a process could be co-ordinated through existing consultative group and roundtable processes. However, in view of the broad nature of the funding required, a special process could be considered where periodically the 'con- tracting parties' could meet to discuss progress and agree on the solution of any emerging problems and on future plans (United Nations, 1991, pp. 18-19; emphasis added).

In the final decision of the Earth Summit, a somewhat weak formulation of this compact was adopted in chapter 33 of Agenda 21, "Financial Resources and Mechanisms":

> For an evolving partnership among all countries of the world, including, in particular, between developed and developing countries, sustainable development strategies and enhanced and predictable levels of funding in support of longer term objectives are required. For that purpose, developing countries should articulate their own priority actions and needs for support and developed countries should commit themselves to addressing these priorities. In this respect, consultative groups and roundtables and other nationally based mechanisms can play a facilitative role.

What is crucial to the notion of a compact between developing countries and their donors implicit in this Earth Summit decision, is that a country's development strategy is cast over a sufficiently long period of time. There is an opportunity for doing this by extending the three-year time horizon of the policy framework paper that a country has to prepare as part of any IMF package, to a minimum of five years, and fleshing it out to encompass expenditure on its sustainable human development and infrastructure goals. The donor community would be required to protect the country's import capacity for the duration of the compact by providing the necessary assurance of long-term aid support, and of "supplementary" financing in support of the underlying export and/or terms of trade expectations. This process can make use of the country strategy notes being prepared under United Nations auspices in some 40 countries. There is an opportunity available at the forthcoming Social Development Summit of the United Nations for ideas along these lines to gain political endorsement as a result of an initiative which lies with the non-G-5 and Japan to take, and to strengthen the UNCED decision on the compact to bring it into line with the UNCED secretariat's emphasis on poverty eradication.

2. *20-20 vision*

Subsequently, a parallel initiative has been developed by UNICEF, based upon UNDP work (UNDP, 1991, p. 41, and 1992, p. 9, table 3.1), which isolates a subset of priority areas of human development that are in the nature of basic human rights and minimum social security requirements, and which should never be sacrificed on the altar of an adjustment programme. This can readily be incorporated in such a country level compact, once the concept gains the necessary political endorsement, again possibly at the forthcoming United Nations Summit on Social Development with, as mentioned, the initiative lying with a coalition between the non-G-5 and Japan.

What UNICEF envisages is a global compact termed "20-20 vision". What this means at the aggregative level is that donors (both bilateral and multilateral) undertake to provide 20 per cent of their aid for priority human development needs, as the *quid pro quo* for developing countries deciding to allocate 20 per cent of their budgetary expenditure towards these same purposes. This contrasts with the current global averages, whereby under 10 per cent of aid, and barely 10 per cent of developing countries' budgetary expenditure go towards meeting priority human development needs. For "20-20 vision" purposes, priority human development expenditure can be defined as a sub-set of allocations for the social sector, and would comprise the following activities:

- primary health care (including basic curative care and family planning);

- basic education (including pre-school, primary, literacy, and life skills);
- low-cost rural, and peri-urban water supply and sanitation; and
- nutrition support (including community based approaches, and the provision of micro-nutrients).

"20-20 vision" as defined above is in the nature of a global compact between donors and recipients. What would be required to incorporate it into a compact at the individual developing country level of the kind envisaged by the Earth Summit, would be to link foreign savings support for basic human development priorities (with 20 per cent of all aid to that country and 20 per cent of its budget being devoted to these priorities), with irreversible movement in the direction of economic reform. The simplest formula that can be specified as regards a country's commitment to economic reform is that it is engaged in an economic reform programme acceptable to the Bretton Woods institutions, or is in otherwise good standing with one or other of these institutions. This could be supplemented by making endorsement by the United Nations bodies most concerned with sustainable human development, namely UNICEF and UNDP, of a country's reform programme as an additional requirement.

The targets in "20-20 vision" were based upon the principle of both donors and recipients catching up, so to speak, with the leaders. A UNDP analysis of the data for some 25 developing countries covering 74 per cent of the developing world for the year 1988, revealed that only four countries were allocating more than 20 per cent of their budgets for human development priorities: Malaysia, Morocco, the Republic of Korea and Zimbabwe. A parallel analysis of bilateral donors revealed that only Norway was apportioning 20 per cent of its aid for these same human priorities, while all multilateral donors with the exception of UNICEF fell short of the 20 per cent target.

3. Human development and disarmament

An alternative approach to insulating at least the priority areas of human development from the budget balancing pressures of conventional adjustment programmes, is to link additional foreign aid with reduced military expenditures in a recipient developing country. The most straightforward link would be that of matching every dollar saved on military expenditure with a dollar of additional aid, which could also be earmarked for human development purposes. It is easy to give such a design a regional focus having regard to the position of Japan as the largest donor country today in the South Asian region. One approach, now being canvassed by UNDP, is for each country to prepare its own sustainable human development plan for the year 2000. The financing for this would come in part from a phased reduction in the region's defence budget, which might release funds totalling around $10 billion by the year 2000. This figure represents today's annual military expenditure by India and Pakistan alone, with Sri Lanka accounting for an additional $500 billion. Military expenditures are substantial in relation to GDP, accounting for 6.6 per cent in the case of Pakistan, 5 per cent in the case of Sri Lanka and 3.3 per cent in the case of India. A regional initiative for disarmament in which Japan plays a leading role can catalyse levels of disarmament and internal conflict resolution, which an individual country focused approach may not be able to do. The catalyst and indeed the carrot in any such operation would be the offer by the donor community, with in this case Japan taking the lead, to match dollar for dollar, the reductions in defence expenditure. On the magnitudes outlined above, South Asia alone would be able to earmark over $20 billion for human development by the year 2000, thus entirely transforming the rate at which human development poverty eradication can occur and enhancing social security within the region.

A similar programme could be implemented for Africa, with the Netherlands and the Nordic countries taking the lead. Indeed the Netherlands African programme initiative admirably qualifies it for continuing with that initiative in respect of sustainable human development for Africa; and such a Netherlands initiative can readily be coordinated with Japan. A non-G-5 coalition with Japan can, in sum, promulgate a common approach both in South Asia and Africa, linking reduced military expenditure to human development.

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17

BACK TO THE FUTURE: SMALL DEVELOPING COUNTRIES IN THE INTERNATIONAL MONETARY SYSTEM

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A. Introduction

This 50th anniversary of the Bretton Woods Conference, which was held in New Hampshire, United States in July 1944, will certainly add to the already voluminous literature on international monetary reform and bring forth both historical and analytical work. There have been several retrospective pieces of work on Bretton Woods, the most recent being perhaps the volume edited by Bordo and Eichengreen (1993). It is in a sense odd to commemorate the anniversary of a system which arguably collapsed in 1971, and which actually operated for a relatively short period from 1958, when the West European countries made their currencies convertible, to August 1971, when President Nixon closed the gold window (Bordo and Eichengreen, 1993).

From the perspective of most developing countries, any Bretton Woods retrospective would bring neither joy nor optimism. Although there were 27 developing countries counted among the 44 countries attending the Bretton Woods Conference, that meeting was essentially a negotiated settlement between the United Kingdom and the United States which took into account the interests and perspectives of those countries on what the postwar international trading and monetary system should look like, but did not address in any meaningful way the interests and problems of the developing world.[1]

Although the developing countries were allowed to play a small part in the creation of SDRs in the late 1960s, their more meaningful efforts to try to impact the reconstitution of the international monetary and financial system came only in the early 1970s after the Bretton Woods system had collapsed. Acting under the auspices of the G-77, developing countries created the G-24 in 1972 and took an active role in the work of the Committee of Twenty, which was established by the Board of Governors of the IMF in July 1972 (Zalduendo, 1986).[2] Developing countries began to press at that time for a "New International Economic Order". The credibility of their demands was enhanced by the emergence of OPEC which, at one and the same time pointed to the value of collective action, and illustrated what genuine economic and financial power could achieve (Bhagwati, 1977; Helleiner, 1976; Ferguson, 1988). Since the mid-1970s, the G-24 countries have been calling for an international monetary conference that would address meaningfully the problems and interests of the developing countries.

This paper asks the question: If a "Bretton Woods" Conference were to be held today, what would be the issues that developing countries, and more particularly small States, would bring to the table, if they elected to attend at all, and what would be the likelihood of success of such an agenda. The paper is an exercise in the political economy of interna-

[1] The developing countries represented were Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, the Dominican Republic, Ecuador, Egypt, El Salvador, Ethiopia, Guatemala, Haiti, Honduras, India, Iran, Iraq, Libya, Mexico, Nicaragua, Panama, Paraguay, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia (Ferguson, 1988, p. 47, footnote 10). Although the Soviet Union was signatory to the Final Act of the Bretton Woods Conference it failed to ratify the Agreement: see comments by Bernstein in Bordo and Eichengreen (1993, pp. 193-196). Arguably, the Bretton Woods conference could not take the interests of the developing countries into account since these interests only began to be formulated and articulated in the 1950s.

[2] It should be noted that another group, the G-10, consisting of 10 industrialized countries, was formed as early as 1962 when the General Agreement to Borrow (GAB) was organized.

tional economic relations. It reviews past experiences as these have shaped the current situation and the prospects of the developing countries vis-à-vis the industrialized countries. Our review of past experience is, however, eclectic. First, we identify four underlying themes which seem to bear on the formulation of an agenda for developing countries. These are (a) the increasing heterogeneity of the developing countries; (b) the neo-liberal paradigm of growth and development; (c) the "end of history" and (d) the globalization of trade, finance and industry driven by communications and information technologies. Second, we examine the G-24 agenda against the background of these themes to assess the power and relevance of that agenda. Third, we focus specifically on the problems of small States. The paper concludes with suggestions for elements of an agenda for a new "Bretton Woods" conference and comments on the likelihood of success of such an agenda.

B. Contemporary themes in an agenda for international monetary reform

1. The increasing heterogeneity of developing countries

At the time of the Bretton Woods Conference and up to the early 1970s, the literature rarely distinguished among developing countries. The dominant cleavage in the world economy was seen to be the industrialized countries of the West; the centrally-planned economies of the East; and the "rest", which were variously termed "developing", "less developed" or "underdeveloped" countries, and which, on the basis of this tripartite division of the world, came to be known as the "Third World". The failure to differentiate among the developing countries certainly did not promote a sound understanding of their development problems, especially the dynamics of political independence for the former colonial territories.

By the early 1960s, the imperative of making distinctions among developing countries was apparent to students of the development problem (Demas, 1965). The emergence of OPEC forced a distinction to be made between this potentially rich group of developing countries and the non-oil developing countries, a distinction which has obtained official sanction within agencies such as the IMF. More recently, the emergence of fast-growing, export-oriented economies in Asia, and the severe problems of poverty in sub-Saharan Africa, have caused a distinction to be made between these newly industrialized economies (NIEs), the sub-Saharan countries, and other developing countries. The latter are, in turn, divided variously into the highly-indebted countries, "middle income" developing countries, and small, island economies.[3] The recent removal of the Iron Curtain has led to the identification of the so-called "economies in transition".

These distinctions are important since the manner of insertion of these types of developing countries into the international economic and monetary system does vary, and they often have separate and distinct interests and concerns about the structure and evolution of the international monetary and financial system, as well as the international trading system. Krueger notes that:

> By the year 1990, differential rates of economic growth and other factors implied that any analysis of the role of developing countries in the international economy required systematic recognition of their differences ... There are real questions as to whether the designation 'developing country' any longer makes sense (Krueger, 1992, p. 465; Kennedy, 1993, p. 194).

For the poorest countries, the enduring concern remains the inadequacy of the transfer of real resources. The highly-indebted countries have concerns related to market access for their exports and the structure and availability of finance for projects and balance-of-payments support. The NIEs' major concerns are not with the operation of the international monetary and financial system, but with the maintenance of market access and the requirement of industrialized countries that they open up their own markets. Small States, particularly island economies, have concerns related to their vulnerability to natural disasters, swings in the terms of trade, and maintenance of the stock of human capital needed for development.[4] Given the differentiation of developing countries, one could not expect that Singapore or Taiwan Province of China would have many

[3] The G-24 itself began to acknowledge the special status of small, island and landlocked countries in its "Outline of a Program of Action on International Monetary Reform", Belgrade, 1979. Outside official circles, the Crown Agents have hosted a "Small States" forum on the occasion of the annual Fund-Bank meetings, and the Commonwealth Secretariat has also recently given some attention to the issues and problems of small States.

[4] See the Summary Proceedings of IMF Annual Meetings, various issues.

interests in common with Nigeria or Chad, nor indeed is there likely to be much common ground between Brazil and Barbados.

2. *The dominance of the neo-liberal paradigm*

Over the last 20 years, the industrialized countries and their surrogate international financial institutions have come to embrace what may be termed the neo-liberal paradigm. The essential elements of the paradigm are: (a) a powerful belief that free markets are usually the best allocators of resources, and even where they are not working optimally, they are still superior to any other mechanism that can be devised; (b) a strongly held view that governments should neither get directly involved in productive activities, nor seek to encourage, foster or target any particular industry or activity for development; (c) a view that the international trading and investment environments should be free of restrictions imposed unilaterally by individual nation States, or groups of nation States; (d) a view that growth and development are best secured by export-led production; (e) a view that Western-style democracy, in form if not in substance, is the best, though not the only way of organizing political activities in the service of economic development.

The elements of the paradigm, and the degree of tenacity with which each element is held, have evolved over time, and indeed seem to have been strengthened during the Thatcher and Reagan years. The Commonwealth Secretariat group, reporting in 1983 and commenting on this question of the role of governments, stated:

> With the relative decline in the role of the unfettered private market place, in industry, trade and in domestic monetary affairs, more and more domestic governmental policies were likely to generate implications for others outside national orders. Recent efforts in a number of countries to reduce the share of the public sector and to encourage market forces nationally if not internationally, have not yet significantly changed the total picture (Commonwealth Secretariat, 1983, pp. 11-12).

It is unlikely that the group would arrive at the same conclusion today.

The neo-liberal paradigm has had several important consequences for policy formation and implementation. It has led to the disparagement and decline of economic planning which preoccupied many developing countries in the 1960s and 1970s. It has promoted policies of privatization, reduction of protection by replacing quantitative restrictions with low or zero tariffs, and shifting from import substitution to export promotion. In more recent years, the free market element has been extended to the market for foreign exchange in developing countries as exchange controls are removed and exchange rates allowed to float freely (Quirk *et al.*, 1987). The neo-liberal paradigm is also prepared to accept certain uncomfortable consequences of its uncompromising acceptance of free markets. Certain markets, such as those for foreign exchange and certain financial instruments, tend to be subject to wide and sudden fluctuations, often unrelated to market fundamentals. Lal's views are perhaps typical of the position:

> It should be noted ... that a government which chooses a freely floating exchange rate and free capital mobility provides its citizens with the largest access to what are in effect insurance markets. Taking advantage of this access, private and public sectors can make consumption and production decisions according to their degree of risk aversion, given the degree of uncertainty associated with variable prices ... Complete price stability, or even increased price stability, is not necessarily welfare optimal (Lal, 1980, p. 34).

The business cycle has also been accepted as a normal aspect of the operation of a market economy and it is generally held that governments can and should do little to mitigate or offset its effects. Equally, the neo-liberal paradigm is unmoved by the idea of a secular decline in the terms of trade of developing countries to the extent that this decline reflects the operation of market forces.

Yet another important implication of this paradigm is that in terms of policy toward developing countries, the industrial countries and international financial institutions take the view that "one size fits all", i.e. the policy prescriptions which flow from the model are equally valid for all countries in any circumstances, regardless of the "initial conditions" of the economy. A corollary implication is that the treatment of all countries should be uniform and that relationships should normally be characterized by reciprocity.

3. *The "end of history"*[5]

In the postwar period, and more particularly over the last 25 years, as the power and influence of the Western countries expanded,

powerful forces have been unleashed, working through the media of television, the press, literature and the arts, which have been leading to a certain cultural homogenization. The international financial institutions have also been active proselytizers. In an earlier time, it would have been termed "cultural imperialism", but part of the process of homogenization has been the seemingly rapid acceptance of the ideology of "liberalism" as the preferred organizing principle for economics and politics. It is no longer fashionable even in Third World circles to talk about imperialism, or about the alleged pernicious effects of transnational corporations (TNCs). Socialism is no longer regarded as a viable option, nor are the former Soviet Union, China or Cuba viewed as models for economic reorganization.

Throughout the Third World, countries are increasingly run by business and political elites which have been educated in the best schools in the West. They see the world through similar lenses, and analyse the forces impacting their businesses and polities with more or less the same apparatus of thought. Their awareness of the social realities of their countries may lead to modifications, in some instances in the direction of authoritarianism, in others to a preparedness to seek to modify market outcomes. However, the fundamental correctness of the Western democratic ideal and the superiority of Western capitalist market economics is not brought into question.[6] Having said this, possible challenges to this Hegelian, teleological view of history might be emerging from the articulation of "Asian" capitalism, and from the re-thinking of democratic political processes caused by ethnic assertiveness in places as far apart as the former Soviet Union, former Yugoslavia and the emerging post-apartheid South Africa.

Without any ideological counterweight to the neo-liberal model, the developing countries have lost a fulcrum through which leverage used to be exercised during the Cold War in order to achieve their objectives. Indeed there has been a concern that Western support of the liberalization process in Eastern Europe and the former Soviet Union could be at the expense of the Third World developing countries, as the transfer of resources is redirected to these politically more sensitive areas (Collins, 1992).

4. *Globalization of trade, finance and industry*

During the 1970s, a great deal of discussion in development economics and international trade theory surrounded the role, the power and effects of TNCs. Scores of dissertations were written on the subject. Today, TNCs warrant only passing mention. Part of the reason for this is that in today's world, virtually any corporation in industrialized and in many developing countries can exercise global outreach. Developments in telecommunications and information technology are increasingly making real the concept of a global village. Capital is now more mobile internationally than at any other time in history. The providers of funds have access to information on the credits which they are considering financing, whether these are sovereign or corporate, and the financial markets have developed a sophisticated capability to assess and price these credit risks. The private capital markets, while still subject to herd-like behaviour, reflecting asymmetric information among participants, are arguably much more sophisticated than in the 1970s, when weak internal controls and poor information led to overlending to the now heavily indebted developing countries. There has been a significant improvement in the due diligence of the private capital markets, partly through improvements in their own research and intelligence capabilities, partly through the work of credit-rating agencies, and partly because of the response to more demanding regulation and supervision.

One of the central issues in international economic relations today is the protection of intellectual property. This flows from the fact that competitiveness is primarily a function of access to proprietary, value-adding information, which is expensive or difficult to produce, but extremely cheap to replicate and disseminate (Reich, 1992; Porter, 1990). Those developing countries which still seek a competitive advantage in raw material production, or even in labour-intensive manufactures, are finding the terms of trade moving persistently against them. An important element which has emerged in international economic relations over the last decade is the environment, based on a growing appreciation of the fact that the world is indeed a global village in respect of the utilization and disposal of resources.

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5 The notion of the "end of history" comes from Fukuyama (1992). While I do not share Fukuyama's "optimism" that liberal democracy constitutes the pinacle of human political organization, I do support his contention that the ideology of liberalism is dominant today.

6 The G-24 agenda is based on an "immanent" critique of the neo-liberal paradigm, not on a "substantive" critique, in which the fundamental premises are challenged, as for example in the Marxist-Leninist critique.

While globalization is indeed the dominant trend in respect of trade, finance and industry, the distribution of economic power within the world economy continues to shift. The United States no longer dominates world trade and payments. Germany, and more particularly the European Union, as well as Japan, have emerged as players of considerable weight. Two regional blocs face off across the Atlantic. While a Pacific bloc is not yet on the cards, it is probably only a matter of time. The current disarray in Eastern Europe and the former Soviet Union masks the likely emergence of this group of countries as a fourth bloc. The degree of integration and interdependence of the world economy has increased considerably over the last two decades. Developing countries now have to address a multi-polar world, and can hold a variety of currencies as reserves.

C. *The G-24 agenda*

The developing countries, or at any rate those acting through the G-24, have consistently articulated an agenda somewhat different from the agenda that flows from the neo-liberal paradigm (Group of Twenty-Four, 1979; 1984; 1985; 1986). The G-24 agenda comprises four main issues: (a) the "problem" of international liquidity; (b) the adjustment process and exchange rate stability; (c) the transfer of real resources; and (d) the lack of influence of the developing countries in decision-making on the international monetary system.

In respect of international liquidity, the G-24 has argued that liquidity has been inadequate to finance the growing volume of world trade, and that there has been a need to increase Fund quotas substantially, to increase the issue of SDRs and to link SDR creation with the transfer of resources to developing countries. Although the staff of the Fund have shown sympathy, if not support on this issue, the G-24 has been unable to marshal the evidence that would convince the G-10 countries that there is indeed a liquidity problem or that additional SDRs should be created (Lal, 1980, pp. 29-30).

The evidence would suggest that there has been in fact no real liquidity problem at the global level. The ratio of non-gold reserves to imports has increased over the last 30 years, averaging 8.7 per cent over 1963-1970, 12.5 per cent over 1971-1981, and 12.9 per cent over 1982-1992. At the time SDRs were created, on the argument that international liquidity was probably insufficient to support fast-growing trade, the ratio of non-gold reserves to imports was about 8.7 per cent. The reserves-to-imports ratio is even higher for developing countries than for the industrial countries, though, not unexpectedly, there has been greater variability. This measure arguably understates available international liquidity since private markets have increasingly financed commercial transactions, even for developing countries, although the poorest countries continue to have limited access to private markets. The distribution of reserves between industrialized and developing countries, however, remains a source of concern to the G-24 countries, and has underlain their repeated calls for a new allocation of SDRs.

In respect of the adjustment process and the stability of exchange rates, the G-24 countries have focused on the lack of symmetry in the adjustment process between surplus and deficit countries, whereby surplus countries do not appear to accept any obligation to adjust by appreciating their currencies or by expanding domestic demand, while in contrast, developing countries in chronic, often structural, deficit are required to undertake painful devaluations, along with severe contraction of domestic demand, often with onerous conditionalities, in return for limited financing from the Fund. The G-24 also point to the failure of multilateral surveillance and the weak or non-existent leverage the Bretton Woods institutions have over the major industrial countries. Here too, although the G-24 countries are factually and morally correct on this issue, the G-10 countries have remained unmoved.

The position of the G-10 countries is not due to perversity on their part, but to their own inability to resolve this problem of symmetry of adjustment even among themselves. Surplus countries, industrialized or developing, have no real incentive to adjust, because of an overriding concern to maintain the competitiveness of their exports. Moreover, it has proved relatively easy in a world of imperfect capital mobility to sterilize reserve inflows (Obstfeld, 1993; Aliber, 1993). The problem of adjustment has been compounded in the last decade by the ability of international capital markets to cause variations in exchange rates to become detached from current account developments for extended periods. This has led to administrative attempts to correct bilateral trade imbalances through provisions such as Super 301 of the United States Omnibus Trade and Competitiveness Act. These administrative devices are being used increasingly against developing countries to compel market access for the exports of the industrialized countries.

The transfer of real resources remains the most enduring and important issue on the G-24 agenda, although strictly speaking, it has little to do with the international monetary system. The argument is that the private capital markets cannot supply the developing countries, or at least the poorest, with the resources needed to finance their structural current account deficits. Therefore the international financial institutions, which have better information on these countries and can afford to take a longer view, should fill the breach. The G-24 countries point to the difficulties encountered by those countries which accessed the private markets in the late 1970s and early 1980s to finance the deficits induced by higher oil prices, and then encountered soaring interest rates and a sudden withdrawal of incremental capital by panic-stricken banks, which in turn precipitated the debt crisis.

The question of the influence of developing countries in decision-making on the international monetary system has been extensively analysed (Ferguson, 1988). The developing countries had no representation in the G-10 discussions during the 1960s. Cohen (1977) has argued that "LDC views and interests were not so much ignored as rejected as irrelevant," and that in respect of the creation of SDRs,

> It was only through the intervention of the IMF Managing Director in the negotiation process that provision was made for allocation of the new reserve asset to all Fund members (Cohen, 1977, p. 151).[7]

While Ferguson argues that the developing countries were able to influence certain decisions and processes, for example participation in the Committee of Twenty and the Interim Committee, and representation on the Fund Board, it must be noted that the critical decisions on the international monetary system were made either unilaterally - e.g. the closure of the gold window - or collectively by the G-10 countries, and such influence as the developing countries have had has been materially aided by the active support of the executive management of the Fund, who were themselves concerned about the possibility of the marginalization of the Fund in decision-making on international monetary matters.

The world view which seems to underlie the G-24 agenda is characterized by the following elements. First, there is the notion that market outcomes are not usually or necessarily beneficial to the developing countries, and therefore specific interventions are required in order to correct these perverse outcomes. For example, while the industrialized countries may be able to take cyclical recessions in their stride, the backwash effect of these on the developing countries may be particularly severe, since the proportionate impact on the exports of developing countries is larger. Second, there is the view that the developing countries collectively constitute a "special case", which requires certain concessions and derogations in whatever arrangements might be considered optimal for the industrialized countries. Third, there is the notion that the international economic system should be designed and operated on democratic principles which enshrine equality and equity in the determination of issues which affect all countries. This world view is somewhat at variance with the pure neo-liberal paradigm.

The industrialized countries would reject or modify these contentions. The more conservative thinkers in the neo-liberal camp point to the contemporary successes of the "Asian Tigers", Chile and Mexico to reinforce the argument that market-oriented policies enhance growth and development, and can be consistent with a reasonable distribution of income (Summers and Thomas, 1993). They would insist that the international community could accept only limited responsibility for the economic and social difficulties of developing countries, and that in most instances the greater part of the problem of these countries lies in their weak domestic policies and corruption and inefficiency in government.

D. Problems of small States

It is not often appreciated that most of the nations of the world are small. For the purposes at hand, a small country is defined as one with a population of less than 10 million, and which is a "price taker" in its trading relationships with the rest of the world and highly dependent on imports of goods and services, including technology. Typically, small countries exhibit a high ratio of exports to GDP and will have a limited resource endowment. They are often prone to natural disasters, such as hurricanes, earthquakes and flooding, which

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7 There is no gainsaying the significance of this occasional alliance between the developing countries and the Fund's management. As a bureaucracy, the Fund's management, staff and Executive Directors came to develop their own interest in the continuation of the organization and would have been concerned to ensure that the power and influence of the organization were not eroded or subverted. This problem was particularly acute in the post-1971 period when the very *raison d'être* of the Fund came into question.

have the effect of further increasing the variability of exports.[8] Small States can be counted among industrial countries (e.g. Iceland, Switzerland and Denmark), among NIEs (e.g. Singapore), among middle income countries (e.g. Trinidad and Tobago) and among the poorest and least developed (e.g. the Central African Republic).

The relative success of small States is not unrelated to their geographical location. The small States of Europe have clearly benefited from their proximity to larger States such as France, Germany and the United Kingdom. Singapore has benefited from its location as an entrepôt. By contrast, small island States in the Pacific, and, to a lesser extent, those of the Caribbean, are seriously affected by the long distances to neighbouring countries. Small States require proportionately more social overhead capital than larger States, which are able to benefit from economies of scale in the provision of ports and airports, roads, health care delivery, etc. Small States tend to have limited access to human capital, owing to their small population and consequent inability to attain critical mass in certain skills.

In respect of their relationship with the international financial system, small countries encounter a range of problems. The international capital markets providing debt-creating capital through syndicated loans and bonds are less attracted to small countries, since the effort required to understand the sovereign credit risk represented may be seen to be large in relation to the volume of financing to be provided. This usually means that when small countries do access the international capital markets, the terms - interest rate, maturity of the loans, collateral requirements - may be disadvantageous. Contemporary markets require that debt issues be sufficiently large and frequent for the paper to be easily traded. Infrequent and relatively small issuers find that they have to pay a premium for issuing paper which is not likely to be actively traded.

Small size poses similar problems in respect of relationships with the international financial institutions. On the supply side, the administrative effort required to prepare a project for development assistance in a small country is as great as that required for a much larger project in a large developing country. On the "demand" side, limited human resources often mean that implementation capacity is weak, and the projects actually require proportionately more man-hours to reach a stage where financing can obtain Board approval, and drawdowns effected. The staff of the international financial institutions, like employees in any organization, prefer to work on problems that are challenging. The problems presented by small countries are not seen as challenging and do not assure staff of recognition and advancement for addressing those problems.[9]

Because of their often more limited resource endowments, small countries are usually more accommodating to foreign direct investment. While direct investment can bring substantial benefits, as evidenced by the experiences of countries like Singapore, Mauritius and Taiwan Province of China, it does require closer management and monitoring to ensure that the benefits outweigh the costs and are sustained. Thus, small countries need to develop a fairly sophisticated knowledge of TNCs, and a capacity to "intervene" based on that knowledge.

The problems of small States have been articulated at the Annual Meetings of the Fund and Bank every year by the representatives of the Caribbean and Pacific countries. They have lamented the inadequate attention given to the peculiar problems of small States and have called for a special dispensation. The statement of the representative for Kiribati at the Berlin meetings in 1988 is perhaps typical of the concerns raised, though atypical in its frankness. He stated *inter alia*:

> It is difficult for us to share the complacency that colored many of the statements made earlier ... [which] seem aimed at the stock markets and foreign exchange markets ... We are unimpressed by self-congratulation based on financial aggregates. We are more concerned with the realities of trade, investment, jobs, health and national self-respect. We see increasing protectionism in the same countries that urge us to increase our exports, deregulate our economies, and roll out the welcome mat to foreign investors. We see a continued decline in the readiness of rich countries to transfer even a small part of their accumulated wealth to the poorer countries ... They are full of theories of the market place that cannot work except where buyers and sellers have equal access to information, credit and political power.[10]

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8 See the contributions of representatives of small States of the Caribbean and Pacific to the proceedings of the Fund-Bank Meetings.

9 Recently, the small countries of the Eastern Caribbean within the Fund were "shared out" among groupings of larger countries, partly because, we are given to understand, staff did not wish to get stuck in dealing with only small countries.

Many analysts of the problems of small States would lend support to the views expressed above. However, not all small States seem to value the public forum provided by the Annual Meetings of the Fund and Bank to press the special case of small States. In perusing the proceedings of these meetings over the last two decades in order to obtain a perspective on how the problems of small States have been articulated, this author was unable to find a single instance when a representative of the Government of Singapore addressed these meetings. It would also appear that, although Singapore is very conscious of its small size and vulnerabilities, it goes about addressing this problem in a different and clearly more effective manner than other small developing countries. Singapore is said to make very good use of the resources and capabilities of the Fund in respect of policy issues, but its relationship with the Fund seems to be carefully measured for effectiveness. The small Nordic countries, although enjoying high levels of development, are concerned about the impact of poor policy coordination among the larger industrial countries, and are on record as supporting an increase in allocations of SDRs.

E. Bretton Woods 2004: a new monetary constitution?

1. Rules versus discretion

The Bretton Woods Agreement has been described as "... an unprecedented experiment in international rule making and institution building" (Ikenberry, 1993, p. 155). That agreement had sought to establish (a) an adjustable peg system; (b) a supplementary source of international liquidity; (c) a "code of action" in respect of multilateral payments and currency convertibility; and (d) the creation of a forum for international consultation and cooperation on monetary matters (Cohen, 1977, pp. 91-93). In 1994, as we look into the future, especially with the problems of small developing countries in mind, we ask what might be the elements of a new monetary constitution as we move to the turn of the century.

The first question to be addressed is, whether there is a need for a constitution at all. Is there a need for rules of the game? Kit McMahon has put the issue cogently:

> An international monetary system must involve some kind of set of rules governing the monetary relationships between (sic) nations: in particular, the determination of exchange rates and the nature, convertibility, and acceptability of international assets. The rules may be of many kinds, they may be tight or loose, simple or complex, but they must exist in a form that can be clearly expressed and they must be accepted by all the nations participating in the system ... Observance of any set of rules will at times constrain, and explicitly constrain, individual national policies (McMahon, 1988, pp. 5-6).

If one weighs the evidence of the experience of the last two decades against the experience of the Bretton Woods years, there does not seem to be a strong case for a new international monetary constitution. One could take the view of Robert Aliber:

> A major purpose of the Bretton Woods rules was to avoid a repetition of what was viewed as the chaos of the interwar period ... The negotiators at Bretton Woods were much more concerned with the development of the set of rules that would be effective during an extended postwar transitional period and far less concerned about the rules for the post-transition period. If we look at the results - the growth in world income and trade in the twenty-five years from 1945 through 1970, the integration of Germany and Japan into the world economy - Bretton Woods proved to be a brilliant arrangement (Aliber, 1993, pp. 263-264).

On this view, it was an arrangement which by 1971 had done its job, but had outlived its usefulness, and has been replaced by a "system" without rules (in McMahon's sense) and with considerable discretion for its managers.

The transition to the contemporary neo-liberal view that the existing system is workable, if not optimal, was by no means easy. The international economy had to deal with the successive oil price shocks, a slowdown in world trade and an increase in protectionism mainly through non-tariff barriers, exchange rate volatility, and the debt crisis which at one time threatened the international banking system. There was a prolonged recession in the industrial countries accompanied by inflation and high interest rates. In the late 1970s and

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[10] Summary Proceedings, Annual Meeting, 1988, p. 191-192. It is almost certain that the representative of Kiribati would have been speaking to a near empty hall. At the Annual Meetings, the staff of the Governors from the developing countries scramble to get a speaking position early in the proceedings and close to a major industrial country so that the Governors would have some sort of audience for their speeches.

early 1980s, there was a chorus of calls for reform of the international monetary system and a new Bretton Woods (Commonwealth Secretariat, 1983).

Yet the world economy has not collapsed and has apparently begun to function reasonably well without the adjustable peg system, and with no demonstrable need for additional liquidity. Exchange rate volatility may continue to be lamented, but market participants are apparently learning to adjust and to hedge.[11] Increasingly, developing countries are embracing the international capital markets and flexible exchange rate arrangements for themselves. The IMF does constitute a forum for discussion of the problems of the international monetary system, but in a routinized and ritualistic fashion, with the real forum remaining the meetings of the G-7/G-10 countries. The post-Jamaica "rules" have diminished the role of the IMF as one of the managers of the post-1971 system.

2. A search for organizing principles

Cohen (1977, p. 9) has argued that short of autarchy or an anarchic "free for all", there are four organizing principles for an international monetary system. These he saw as: (a) automaticity: a self-disciplining regime of rules and conventions binding on all participants; (b) supranationality: collective adherence to the decisions of an autonomous international organization; (c) hegemony: a regime organized around an acknowledged leader; and (d) negotiation: a regime of shared responsibility and decision-making. To these we might wish to add a fifth principle: (e) equity in the sharing of the benefits and opportunities of the world economy (Commonwealth Secretariat, 1983, p. 3). Bhagwati (1977) has also pointed out that developing countries are more likely to succeed where "mutual gain bargains" with the industrial countries can be struck. While we may not wish to embrace this as a sixth organizing principle, it is an important pragmatic consideration which is likely to influence the outcome of any negotiation on the international monetary system.

The breakdown of the Bretton Woods arrangements suggests that automaticity is unlikely to work in a heterogeneous world economy of sovereign nation States. Lal has argued forcefully:

> ... fixed exchange rates are not feasible in the real world, where monetary independence is identified with national sovereignty and there is some downward rigidity in money wages and prices of non-traded goods ... In the real world of irreducible uncertainty, ... free trade in goods and services (including capital flows) and freely floating exchange rates represent the optimal system for the world as it is (Lal, 1980, p. 2).

Lal goes further to argue that no rules for managing exchange rates can be laid down. Cohen arrives at essentially the same conclusion though by a different route. He opines:

> The defect of automaticity as an organizing principle is that it expects too much and delivers too little. Fully automatic monetary orders demand more from politically sovereign States than governments can realistically be expected to surrender ... They are politically naive and economically sub-optimal (Cohen, 1977, p. 196).

However, the principle might be made to work at regional level, where States are prepared to surrender some degree of political autonomy. The recent experiences in Europe suggest that a definite conclusion cannot yet be drawn on this matter, despite the progress made towards European Monetary Union.

The neo-liberal paradigm is prepared to substitute the principle of "competitiveness" for automaticity. Each State is expected to adjust as best as it can to a competitive global economy, which makes no distinctions among countries (the principle of uniformity of treatment) and in which reciprocity is expected of even the smallest country in the system. Supranationality is a principle which is unlikely to find favour with the industrial countries at a global level. It would require nation States to surrender control over policy instruments which they are unlikely to wish to do, except in the context of regional arrangements. Far from becoming a world central bank, the main activity of the IMF over the last two decades has been to act as a mechanism for enforcing adjustment in certain developing countries.

Hegemony is increasingly a remote candidate as a basis for organizing the world's monetary relations. The relative economic power of the United States has declined and there is now a multiple reserve currency system. This does suggest that negotiation is likely to be more significant today and in the future, and the Uruguay Round provides ample evidence

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[11] Arguably, the new hedging instruments are beginning to create problems of their own; markets now seem to overreact to "news". The recent change in the Federal Funds rate by 25 basis points (a move that was apparently widely anticipated in direction and magnitude, if not timing) has sent the markets into turmoil.

of this. In the scheme of things, however, the developing countries as a whole still would not attain genuine power sharing. While it is not difficult to envisage a role being carved out over the next few years for the participation of the NIEs in the G-10 forum, as the economic weight of these countries continues to increase, other developing countries will remain marginal in decision-making on international monetary matters.

The principle of equity relates specifically to the enduring issue of the transfer of resources to the poorest developing countries. As the Commonwealth Secretariat has put it:

> For widely accepted humane and political reasons, no less than for economic ones, the system has to continue to take account of their special needs (Commonwealth Secretariat, 1983).

It is not clear that the dominant conservative view in the industrial countries accepts that this is the case. Even as illegal immigration accelerates from China, Mexico and Central America, and Haiti into the United States, and from Eastern and Southern Europe and North Africa into Western Europe, the ruling conservative elites in the industrial countries seem to continue to focus their efforts on containment and suppression of these migratory flows rather than addressing the problem at source by committing themselves to a sustained transfer of sufficient resources to the poorest countries. Part of the reason for the reluctance to do so is the problem of governance in many of these countries, where conditions of poverty help to create and sustain in power anti-democratic forces within corrupt regimes. These regimes do nothing to alleviate the problem of poverty, and the vicious circle is complete.

3. An agenda for small States

The elements of an agenda for small developing countries would probably comprise the following set of issues. First, there is likely to be a concern to institute a regime which in some way ensures stable exchange rates. This concern would apply more to those small countries with a diversified trading pattern which establish an effective exchange rate target. States with a dominant trading partner would do well to recognize that they are part of an optimum currency area and simply peg their currencies to that of the dominant trading partner (Worrell, 1994; Diaz-Alejandro, 1976). Second, there would be a concern to establish a supranational organization with the capacity to address the special financing needs of small States.[12] This organization would be able to design special balance-of-payments support following a natural disaster, and either provide development financing on appropriate terms, or assist the small countries in approaching the private international capital markets, perhaps by underwriting or providing security for their issues. This is not likely to be an onerous obligation since the volume of issues by small countries will be relatively modest, and they can be "graduated" from such assistance once the private markets become familiar with the credit risk involved. Special support for the financing of lumpy social overhead capital projects could be arranged by this organization. Though not a monetary question, a third issue which would be of concern to small countries would be market access.

While small developing countries would have a great stake in a new monetary constitution which addresses their special problems, they are unlikely to achieve their objective. The current dominant neo-liberal model does not favour special cases, since, in the limit, each country constitutes a special case. Rather, in order to lower the costs of transactions, it favours uniformity of treatment and reciprocity. In this regard it makes good sense, wherever possible, for small countries to associate themselves to make collective approaches in negotiation with the industrial countries, which would prefer such an approach in any event.[13] Broader coalitions with other groups of developing countries may be more difficult to achieve, since these countries will have different priorities.

The dominant paradigm also does not favour a set of rules governing exchange rate adjustment, except in the context of regional arrangements, even though, as we have noted, the problem of adjustment remains intractable. While a supranational organization is unlikely to eventuate, a combined IMF-World Bank,

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[12] We are suggesting that there should be one organization, not two as obtain at present. The experience seems to indicate that since the IMF now deals essentially with developing countries in respect of stabilization programmes and the World Bank addresses development finance for the same set of countries, and since balance-of-payments support in the context of these countries approximates development finance, there seem to be good grounds for merging the two institutions at this stage.

[13] For example, as the small countries of the English-speaking Caribbean look to some arrangement to link with NAFTA, the United States has indicated its preference to negotiate accession with the CARICOM countries as a group rather than negotiate separately with 13 small States which otherwise hardly merit attention.

which is permitted to establish special regimes for small and least developed countries, might find favour, since it would allow the institutionalization of the principle of equity, which often requires special treatment to be meted out. In order to induce the industrialized countries to reform the Bretton Woods institutions in this way, the reformed organization would need to focus some of its attention on "mutual gain" areas, such as environmental pollution, drug trafficking from or through developing countries, and migration.

Our review and assessment of the situation and prospects for small developing countries in the international monetary system are not encouraging if we focus exclusively on the perspective of the neo-liberal paradigm. Yet, if one is to reflect on the examples of successful small countries such as Switzerland, Singapore, Iceland, and others, it is equally clear that there is a path to success for small countries, even in a difficult global economy. Unfortunately, there has been no study of the policies and experiences of these successful small countries - their foreign policies and relations with the international institutions and capital markets - in order to draw lessons for other small countries. However, the experience of the successful countries suggests that it is possible for small economies to work within the neo-liberal paradigm and indeed to work the system in their interests.

F. Conclusions

Several important conclusions flow from the analysis. First, there is currently little incentive on the part of industrial countries to initiate a dialogue in international monetary reform, since the neo-liberal view holds that the existing system is optimal, by virtue of the fact that, by and large, it constitutes free markets in operation. Second, the developing countries as a group now have little leverage in pursuing the goal of international monetary reform, partly because of the power of the paradigm, and partly because of their own increasing heterogeneity, which makes interest coalitions more difficult and less likely. However, the NIEs are emerging as an important force in world trade and the holding of reserves, and they will increasingly be able to exercise influence, though more than likely this will occur through the G-10, rather than the G-24. Third, private capital markets seem to be working better in the service of developing countries, further attenuating the arguments for an increase in international liquidity, though they cannot satisfy the special requirements of the least developed and certain small countries for development finance. In this regard, there is a good case for merging the World Bank and the IMF into a single agency to address situations where private capital markets do not work well. Fourth, small States would do best to act jointly in the pursuit of their interests where this is possible, and in any event they would do well to study the model for success presented by small countries such as Switzerland, Singapore and Iceland.

Like any other paradigm, the existing neo-liberal paradigm has weaknesses and blind spots. Even as it becomes conventional wisdom, the model is being challenged externally by experience and internally by its inherent contradictions. One major problem is its inability to deal effectively with the issue of equity, or the economic expression of this principle: the distribution of income and wealth. The inner logic of the model requires that it ignore the problem of the distribution of income and accept a certain level of unemployment as "natural"; yet these issues are basic to socio-political stability and hence ultimately, the success with which markets can actually operate. The problem is difficult enough to handle within nation States with legitimate and active governments. At the level of the world economy, the problem is manifest in the widening gap between the rich and the poor countries, but without the possibility of intervention and amelioration by a supranational authority. This constitutes the Achilles heel of the model, though how the paradigm will be superseded, and when, remains moot.

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Comments

Norman Girvan

Terrence Farrell's paper is essentially pessimistic on the possibilities for reform of the international monetary system in general and of the Bretton Woods institutions in particular. So is the paper by Joseph Abbey on which I comment elsewhere. The dominance of neo-liberalism and the "end of history" mean that developing countries, especially small ones, are powerless to influence existing structures and conditionalities. They will have to settle for the more modest goals of accessing additional development finance: perhaps by means of a new development finance institution (Farrell), or by working for a dual indirect link between liquidity and development finance (Abbey).

How depressing ! On this occasion, are we not allowed to speculate on the kind of fundamental institutional changes needed to bring about a more rationally ordered world of money and finance? Is the establishment of a global institution empowered to regulate the expansion of international liquidity, with responsibilities similar to those of national central banks, to await a global financial catastrophe similar to the national financial crises which brought the latter into being? Is the transformation of the Bretton Woods institutions into the financial "enforcers" of the West in dealing with the developing world and the "economies in transition" really a stable situation in economic and political terms, as Farrell seems to imply?

One of the most important pieces of information in Farrell's paper is hidden in a footnote. He reports that IMF staff have insisted on "sharing out" the work on the small countries of the Eastern Caribbean amongst groupings of larger countries because they did not wish to be "stuck in dealing with only small countries". This is the very opposite of what is required: we need staff who specialize in dealing with the peculiar problems of small economies and even more particularly with specific countries or groups of countries.

Moreover, a process of detailed research and consultation requires special kinds of skills. Staff members need to be able to collect qualitative as well as quantitative data from a variety of sources, to analyse various types of information of uneven quality and reliability, and especially to be able to interpret the results of analysis outside of the established paradigm that "the market knows best".

Equally important are skills in communication, dialogue, consultation and consensus-building, and cultural and social sensitivity. No staff member with the responsibility to co-ordinate the preparation of a policy package for a particular country should hold this appointment solely on the strength of technical qualifications. Qualifications should include a thorough knowledge of the history, culture, politics, language, and social structure of the country. This implies major changes in the approach to staff recruitment, training and promotion, as well as substantial devolution of responsibility and initiative in the preparation of country programmes to regional and country offices.

Finally, changes in the structure of representation and administration in the Bretton Woods institutions will need to be contemplated. For example, what is the logic behind the attachment of small countries to larger countries in Fund/Bank constituencies? Would it not be more logical to organize constituencies according to common interests derived from similarities of size and economic structure, and to reflect these groupings in the structure of regional offices? By this criterion for example, the countries of Caricom and the Central American Common Market might be better served by having their own constituency and office either separately or jointly.

Appendix

WORDS BY MR. CÉSAR GAVIRIA TRUJILLO, PRESIDENT OF THE REPUBLIC OF COLOMBIA, DURING THE INAUGURATION OF THE CONFERENCE ON THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM ON THE OCCASION OF THE FIFTIETH ANNIVERSARY OF THE BRETTON WOODS CONFERENCE

Cartagena, 18 April 1994

I wanted to be here in Cartagena to honour the kind invitation extended by the organizers of this event in which outstanding technicians and specialists will be able to take a step back and reflect on issues of interest to all developing countries. This is why it is especially pleasant for Colombia to host this technical assembly with which the Group of 24 joins the celebration of the 50th anniversary of the Bretton Woods Conference.

The people gathered here today will work during the next three days on a subject which is of continuing relevance and which should be a matter for constant study. I refer to the outlook for the international monetary and financial system, seen from the perspective of the developing countries and that of the international organisms that make up the system itself.

This conference is taking place when the world is just becoming aware of the magnitude and depth of the political, social and economic changes that are shaking Eastern Europe, the American continent and Pacific Asia.

Beyond the obvious historical differences and despite the time that has gone by and the changes that have taken place all over the planet and in every area since 1944, it is possible to draw a parallel, underscoring the similarities among some of the circumstances that led to the birth of the International Monetary Fund and the World Bank in 1944 and the current threshhold of the 21st century.

When the end of the Second World War was near it became clear that the nations of Western Europe, the United States and the Asian countries simply could not take up once more the roles they had traditionally played in political and economic matters. The exhaustion of the European economies after the war effort, the final breakdown of the colonialist systems, the rise of new participants in the concert of nations, the revindication of the fundamental rights of enormous groups of people, demanded the creation of a new international political and economic order to reflect these new realities.

In 1994 the world has also seen a significant redefinition of the roles played by almost all nations. The sudden transformation of the Eastern European economies has had unsuspected consequences and, although it represents a window of hope and opportunity for many regions, it has also brought pain and misery to countless people who find themselves deep in poverty or the horrors of war. Most Latin American economies, clearly recovering from the debt crisis, are insistently demanding from the developed countries a response to their efforts to liberalize and modernize their economies. A good number of South-East Asian countries have harvested the material fruits of a development unprecedented in the history of mankind, and are getting ready to join the ranks of the industrialized nations. In Africa, on the other hand, the general situation reaches dramatic levels, in which large sectors of the population can hardly survive under the weight of endemic backwardness in every area.

There is, however, a basis for comparison between the two periods which, in itself, is proof of the validity of the road taken at Bretton Woods. This is the role played by the institutions created 50 years ago in promoting development and trade, and correcting the imbalances which countries can incur due to various circumstances.

Indeed, for the statesmen and scientists who gathered in New Hampshire in 1944, coordinating the actions of nations towards a

common goal was no more than an objective whose viability had been cruelly belied by the ineffectiveness of the League of Nations. Aware that chauvinistic, autarchic and protectionist economic policies had been a major cause of the recent economic crisis, they designed a new scheme to join forces, with common rules and within the framework of international organizations, in order to advance the postwar world economy.

Today, after 50 years of activities by the IMF and the World Bank, we know that economic cooperation is not a utopia and that, in spite of the difficulties, the road travelled has been a fundamental element of world progress.

The IMF mandate to facilitate the expansion of international trade, foster current exchange stability of member countries and ameliorate the imbalances in their balance of payments, has resulted in the Fund becoming an important player in the development processes of very different regions. The Fund's participation in ambitious adjustment programmes, which frequently had manifestly negative connotations, is seen today in a more constructive manner, to the extent that, in most cases, the countries have managed to recover the trust of international and domestic markets, and been enabled to travel again along the road to trade and growth. As in every process, there have been mistakes born of excessive rigidity or lack of understanding of changing circumstances. But we must note the willingness of the Fund to adapt to new realities for the welfare of the nations; and also the Fund's contributions to administrative discipline and consistency of economic policies.

The resources and technical assistance for development that have come from the World Bank and other multilateral organizations have made a very significant contribution to the growth of key sectors in the economies of developing countries. For a long time its credits were the major alternative for the provision of medium- and long-term resources for activities in production, institutional modernization, social investment and infrastructure, which underpin long-term projects. The Bank has also evolved over the years and has learned to listen and accept that the best policies are those that are implemented by internal initiatives. It has also begun to listen to its clients, the countries, and to adopt practices recognized in modern banking. I would even say that the advent of alternative sources for financing development have made the Bank more competitive and responsive than in the past.

Colombia has always kept up a productive dialogue with the International Monetary Fund and the World Bank. Both organizations have been permanent interlocutors of Colombia's economic authorities and have very often explicitly supported the prudent style with which our economic policies are managed and which is typical of the way in which we act in economic matters.

In spite of the undeniable success of the activities of the Bretton Woods institutions during their first 50 years, this meeting is not only pertinent as a celebration, but especially for an in-depth look at the path to be followed in the future.

Indeed, in the troubled times during which they have had to operate, the barriers to the development of backward countries and the eradication of poverty have been many and varied. Problems such as technological backwardness, the stagnation of export sectors, the debt crisis and serious fiscal imbalances, have been successfully faced and overcome by numerous countries in Asia and Latin America, while in some African countries the most elementary survival of entire populations is still at stake.

However, it is also necessary to recognize that, with very few exceptions, most developing countries have not been able to overcome structural barriers, such as poor distribution of income or the rigidity of political systems. Neither have they been able properly to meet social needs in areas such as health, education or housing. All of the above is difficult enough, without going into even more complex issues, such as racial tensions, migratory pressures or excessive population growth. This diagnosis is especially valid for the African countries where the adjustment processes have not created growth or contributed to solving their social problems.

At the same time, and although the Uruguay Round of the GATT has been completed, the whole developing world still faces challenges arising from the protectionism and discriminatory trade treatment to which it is subjected by the industrialized countries, the adverse behaviour of most commodity markets, and the need to ensure sustainable growth for the future. To round off the picture, the accelerated transformation of most former socialist economies demands from the international community an enormous effort in financing, investment and cooperation resources.

Faced with this new agenda, it is necessary to rethink the structure of the Fund and the Bank. Some of the old recipes are not enough for many of the needs we have mentioned. Considerations of fairness, social and institutional development and preservation of

the environment must become central issues in respect of development loans, so that these can be an effective instrument for economic development. Traditional schemes of conditionality must be revised and adapted to the magnitude and complexities of the adjustment and transformation programmes of the 1990s. Also, the organizations must reinforce their participation in issues such as the strengthening of national institutions, which include such diverse aspects as the modernization of the State and its regulatory capabilities in various economic activities, the strengthening of the system of justice, control of population growth and encouragement of savings and private investment. Also, in their role as facilitators of the dialogue between the industrialized and less advanced countries, these organizations must be more active and - while maintaining their independence - coordinate their objectives better.

The debt crisis of the 1980s was a significant shock which put to the test the validity and efficiency of the whole international monetary and financial system and, especially, the roles of the Fund and the Bank. The test referred, for example, to the coordination and cooperation mechanisms between these two organizations and their role as interlocutors for the governments and leading private banks in the international financial community.

It is obvious that, within the context of this experience - which I lived very closely when I was Colombian Minister of Finance and Public Credit in the mid 1980s - a certain institutional specialization became evident. In our country, the IMF did not provide resources, but rather technical assistance and monitoring, which facilitated the cooperation of the commercial banks. The World Bank, in turn, provided funds for structural adjustment programmes. This support was accompanied by technical support provided by the United States Treasury Department, and especially by the Federal Reserve Bank and the Federal Reserve Bank of New York, which coordinated with the Colombian Government and private banks a voluntary financing programme which allowed us to solve the debt problem in a fashion that was unique in Latin America. Thanks to that effort, during the past decade Colombia has had the highest cumulative growth record in the continent.

To conclude, I would like to outline, in a somewhat disorderly fashion, the way in which the Colombian Government sees the next step to be taken by the Bretton Woods system in order that it may continue to adapt to the conditions prevailing on our planet.

The International Monetary Fund, in addition to its traditional mandate to support the stabilization of economies in crisis, should concern itself more deeply with the issue of capital flows and their impact on national investment and growth. Also, the organization should play a major role in designing policies and mechanisms to stimulate internal savings in developing countries.

The World Bank and the regional development banks should not limit their contribution to the traditional credit programmes. Also, in those countries that have succeeded in the adjustment, the Bank should provide technical assistance to evaluate the quality of various public policies, in order to ensure proper market performance and to promote the internal savings and productive investment that are required for rapid economic growth. Issues such as investment and social security, urban development, institutional modernization, justice and civilian security, should also be part of the Bank's new agenda.

As far as global issues are concerned, let me say that both the Fund and the Bank will be forced, even if only by circumstances, to become more involved in the struggle against poverty and in social policies throughout the globe. And I do not say this based on the rhetoric of North-South cooperation which was so popular some decades ago. I say so convinced that any advances in economic aggregates, no matter in what part of the world, will be fragile and sooner or later will have political consequences if they are not supported by an improvement in the standard of living of the respective peoples. This is why, while the Fund and Bank should concern themselves with defending the principles of the market economy and economic liberalization throughout the world, they should also cooperate with countries in such areas as spreading knowledge of successful experiences in social policy and in the fight against poverty. This is the only way in which both institutions will anticipate the agenda of the next few years, when problems such as migrations, the struggle for natural resources and demographic pressures will be the order of the day.

I leave these questions for your consideration with the certainty that the experience and expertise of such distinguished participants will provide valuable insights for the design of these new goals, and will contribute to clarify the hopes and expectations that our countries have about the topics of this meeting in these crucial times.

I also express these opinions with the conviction that the world economy will con-

tinue along the road to growth. The expectations raised by the recently created World Trade Organization, the success of the regional trade agreements, the restructuring of numerous economies and other encouraging signs we are seeing from different parts of the world, give me grounds for optimism. In this context, both the World Bank and the International Monetary Fund are faced with a unique historical opportunity: the opportunity to make an even more decisive contribtuion to world development so that, during the next 50 years, mankind can make its final leap forward in the search for peace and progress.

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