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OVERVIEW

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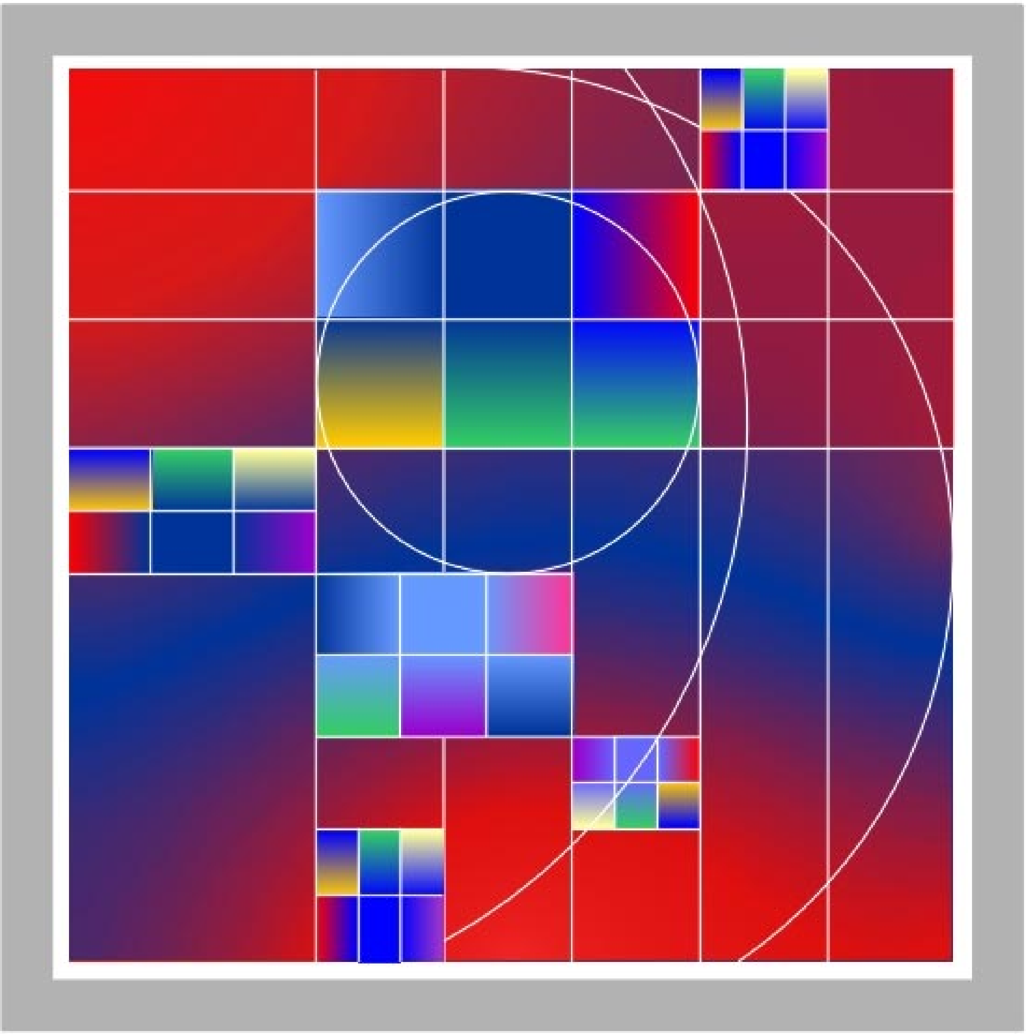

OVERVIEW

"The ascendancy of finance over industry together with the globalization of finance have become underlying sources of instability and unpredictability in the world economy. Financial markets have for some time had an independent capacity to destabilize developing countries; there are now increasing indications of the vulnerability of all countries to financial crisis. The evidence indicates that the costs of financial liberalization and deregulation can be quite high ... Overall, there appears to be a need for more collective control and guidance over international finance."

"Disruptions and disorder in such markets have so far been contained in that they have not led to crises with serious and widespread damage for the real economy. However, the crisis management has been costly. ... More important, so long as the international monetary and financial system remains structurally vulnerable, the potential for an extremely costly crisis will remain."

These passages were written in TDR 1990. Warnings fell on deaf ears. Since then the world economy has witnessed further bouts of financial instability at roughly two-yearly intervals. First, there was debt deflation in the United States, followed by the EMS crisis in Europe in 1992-1993; that crisis was followed by the Mexican crisis of 1994-1995, and most recently by the East Asian crisis of 1997-1998. Each time, the prevailing approaches have been based on the notion of the infallibility of markets and on an explanation of the crisis in terms of misguided domestic policies. Turning a blind eye to the systemic nature of financial instability is neither responsible nor acceptable.

As financial markets expand and integration deepens, each episode of crisis comes with greater force, inflicting greater damage on the real economy. The cost of the crisis in East Asia is about 1 per cent of global output this year alone, or some $260 billion, equivalent to the annual income of sub-Saharan Africa. Prospects for the years ahead are extremely uncertain, but the risks are on the downside. Further policy errors might well drive the world economy into a deep recession.

International financial instability and the world economy

For some time the UNCTAD secretariat has maintained that the world economy needs to grow by at least 3 per cent, year in, year out, if a dent is to be made in unemployment in industrialized countries and poverty in developing countries. Most countries in the South need to grow at twice this rate if they are to overcome their social and technological handicaps and close the income gap with the small club of rich industrial economies. During the 1990s this 3 per cent target has been reached only in 1996-1997, thanks to recovery in Latin America and Africa and continued strong growth in East Asia and the United States.

Last year's *Trade and Development Report* argued that international financial instability constituted the single most important impediment to attaining steady and rapid growth. Modern financial markets are organized less to create wealth and employment than to extract rent by buying and selling second-hand assets, and the "discipline" these markets exert on policymakers reinforces the advantages of existing wealth holders. The *Report* came out once more against "big-bang" financial liberalization in developing countries, pointing out that successful examples of modern industrialization and development distinguished themselves by the ways they managed integration into the global economy.

The dramatic turnaround in the economic fortunes of the East Asian economies leaves this conclusion unshaken. Contrary to the tenets of financial orthodoxy, the problems of those countries do not stem from resistance to a globalizing world and the discipline of global market forces. Rather, the crisis occurred because governments failed to manage integration into global capital markets with the same prudence and skill they had earlier shown in managing trade liberalization. Throwing caution to the wind, the voices of orthodoxy ordained even larger doses of financial liberalization.

The speed at which some of the most successful developing countries in East Asia have been derailed by volatile financial flows has taken the international community by surprise. During the annual meetings of the Bretton Woods institutions in Hong Kong, China, in September 1997, it was generally held that the ongoing disturbances were no more than a blip and would cause only a temporary slowdown of growth in the region. The IMF indicated that it expected growth to accelerate in 1998 in Thailand, and to remain broadly unchanged in other countries of the region. Even in its *Interim Assessment* of December 1997, the Republic of Korea and the countries of ASEAN, with the exception of Thailand, were expected to register positive growth in 1998. Since then, estimates have been constantly lowered, both for the region and for the world economy as a whole, as the promises of the policies adopted in response to the crisis failed to be fulfilled.

Countries that year after year enjoyed growth rates of 8-10 per cent per annum, maintained full employment and went a long way towards eradicating poverty are now suffering a severe economic contraction. Output is projected to decline for 1998 as a whole by at least 12 per cent in Indonesia and by 6-8 per cent in the Republic of Korea and Thailand. With the exception of China and its Taiwan Province, no country in the region can expect to register satisfactory growth this year. Expectations of a quick recovery have had to be pushed back several years into the future.

Clearly, and although there are no simple remedies, the international community has yet to learn how to manage such turmoil, let alone prevent it. Indeed, the international policy response has contributed to the severity of the crisis by failing to appreciate the full gravity of the situation, and by placing too much faith in conventional policy prescriptions. While the rash of bank closures undermined confidence throughout East Asia, the hike in interest rates failed to restore it. Rather, while unsuccessful in stopping the downward spiral in exchange rates, high interest rates added to the woes of debtors, forcing them to cut down on their activity and liquidate assets, while economies were driven into deep recession. Nor was confidence helped by official pronouncements on the alleged structural weaknesses of the economies in crisis. External financing was used not to support the domestic currency and stop the exchange rate losses of unhedged debtors, but to maintain convertibility and free capital flows. The credit crunch has bitten so deep that, despite favourable exchange rates, exports have stagnated or fallen as access to trade credit was drastically curtailed.

A strategy of introducing a standstill and bringing borrowers and lenders together with a view to rescheduling debt before committing external funds did not find favour, apparently for fear that the crisis would spread. But the course chosen did not prevent contagion. Rather, it precipitated the translation of what was initially a liquidity crisis into a solvency crisis, leaving behind a large stock of debt, part of which now appears to be unpayable.

A few lessons are now evident. First, the worst time to “reform” a financial system is in the middle of a crisis. Second, when currency turmoil is associated with financial difficulties, raising interest rates over an extended period may simply worsen the situation by bringing about widespread corporate and bank insolvencies. Finally, currencies should not be left to sink while funds are used to bail out the international creditors.

The events of the past year should serve to underline the warning in last year’s *Trade and Development Report* of a potential backlash against the contradictions of a globalizing world. When a colossal global market failure and measures taken to bail out creditors are paid for at the expense of the living standards of ordinary people, and of stability and development in the debtor developing countries concerned, who is to say that justice has been served?

In East Asia the trend of decades of rising incomes has been reversed, and unemployment, underemployment and poverty are reaching alarming levels. Many of the lost jobs have been in sectors that had helped to reduce poverty by absorbing low-skilled workers from the countryside. Rising food prices and falling social expenditures have further aggravated social conditions and contributed to growing poverty. Even on conservative estimates, the proportion of the Indonesian population living on incomes below the poverty line in 1998 is expected to be at least 50 per cent greater than in 1996. Similarly, poverty in Thailand can be expected to increase by at least one third.

As the crisis drags on, it will be increasingly difficult for the new poor to recover from deprivation and return to their previous occupations and living standards. Moreover, the social harm could persist long after economic recovery is achieved. Judging from the mounting evidence of growing child malnutrition and declining primary school enrolments, the impact of the crisis on human resources will spill over into future generations.

Safety net measures can act as palliatives to cushion the impact of the crisis on poor and vulnerable groups, but they are in no way a lasting solution. Only the resumption of rapid and sustained growth can bring unemployment and poverty levels back down to pre-crisis levels. Policy should turn from deflation to reflation, supporting the unemployed by lowering interest rates, expanding liquidity and raising public expenditure, thus breaking out of a vicious circle that could do incalculable harm.

Global ramifications

The consequences of the East Asian crisis for global growth and development will depend on the course taken by international trade and capital flows. A precise assessment is difficult, not only because of the complexities of global interdependence, but also because of the fickle nature of financial market sentiments, and uncertainties regarding policy response in other countries. However, the deflationary impact of the crisis is proving deeper than initially expected. Current projections for

1998 suggest a drop of at least one percentage point (at market exchange rates) in world output growth from the rate reached in 1997.

The revisions to estimated GDP growth have been more substantial for developing than for developed countries. Growth in developing countries in 1998 is expected to be half that of 1997, falling to less than 2.5 per cent. In view of the bleak prospects for recovery in East Asia, the tendency noted in *TDR 1997* for the income gap between North and South to widen can be expected to continue. For the first time for many years, growth in the developing world, excluding China, will fall below that of the developed world. Even in China it is unlikely to exceed 6 per cent, which would be only about one half of the average rate achieved since the beginning of the decade.

Developing countries are trapped in a corner. To lessen the risk of contagion, many emerging markets have introduced pre-emptive monetary and fiscal restrictions in an attempt to maintain market confidence and to reduce their vulnerability to a reversal of capital flows. In so doing they have choked domestic demand and lowered growth prospects still further.

According to current projections by some financial institutions no significant declines are expected in capital flows to emerging markets in Latin America and Eastern Europe. Nevertheless, it is notable that the spreads on bonds of such emerging markets that went up sharply last autumn have not come down significantly. Many emerging-market currencies are now trading at all-time lows against the dollar, despite hikes in domestic interest rates. The fruits of the hard work of the developing world, both assets and goods, are now going for a song. But they may decline even further in value before the appetite for risk of global investors returns. Flight to safety appears to underline much of the recent boom in bond prices and the continued stock market rally in the United States.

Since East Asia accounts for a quarter of world trade, much of the global impact of the crisis will be transmitted through changes in trade flows. The impact will depend primarily on what happens to exports to the region, shifts in relative competitive positions in third markets and, more importantly, the effect of the crisis on commodity prices.

By the spring of 1998, the East Asian countries most directly affected by the crisis had undergone an import compression in the order of 30-40 per cent, while their exports had stagnated or fallen. Other Asian developing countries have exhibited similar trends, though to a lesser extent. In consequence, world trade, which grew in volume by 9.5 per cent in 1997, the second highest rate in two decades, can be expected to grow much more slowly in the current year.

There is considerable variation among developing countries in their dependence on Asian markets for exports. Those markets absorb, on average, about 10 per cent of Latin America's total merchandise exports; the proportion is as high as 25 per cent for Peru and over 38 per cent for Chile. Also, almost 60 per cent of total Latin American exports to OECD countries are potentially vulnerable to Asian competition. While competition in third markets is less important for African countries, a number of them depend directly on East Asia for 25-35 per cent of their total export earnings.

East Asian economies provide important markets for metals, agricultural raw materials and energy products, both for domestic consumption and as inputs into their export industries. Thus, reduced or sluggish exports and cut-backs in domestic absorption are expected to exert a major influence on the prices of such commodities. By contrast, increases in East Asian exports of a small number of commodities may have only a limited impact on world commodity markets.

While other influences have certainly been at work, the crisis in East Asia is the single most important factor in the recent downturn in commodity prices. Non-oil prices, which had begun to decline in 1996 after two years of sustained increase, started to level off in 1997. However, with the outbreak of the crisis, further downward pressures were evident. Between June 1997 and April 1998, non-oil commodity prices declined by some 10 per cent. At one point in late spring 1998, the price of oil was down by over 40 per cent from its peak in 1997.

From Chile, Jamaica, Paraguay and Peru in Latin America to Gabon, Sudan, United Republic of Tanzania and Zambia in Africa, and to Kazakhstan, Mongolia and Myanmar in Asia, developing countries in all regions are dependent, to varying degrees, on metals and agricultural raw materials for much of their export earnings. The loss of export earnings may be as much as one quarter for some of these countries, corresponding to as much as 12 per cent of GDP in some cases. For oil exporters, expected shortfalls are equally or even more dramatic.

Declines in export earnings are already forcing cuts in government spending in countries where they are an important source of fiscal revenue, such as Chile and Mexico. They are also hurting major developed-country commodity exporters such as Australia, Canada and New Zealand, exerting pressure on their currencies. By contrast, in major industrial countries, particularly in the United States and Western Europe, the benefits of declining commodity prices and improving terms of trade appear, so far, to have outweighed the loss of earnings due to lower exports to East Asia. However, the longer-term impact of adjustment of the external balances of the Asian economies is expected to be quite different.

Latin America is perhaps the region most susceptible to adverse influences from East Asia. Growth is expected to slow to around 3 per cent on average, following the highest rate attained for a quarter of a century in 1997. Even so, current account deficits are expected to continue to rise. Latin America thus remains particularly vulnerable to an interruption of capital inflows.

In Africa, growth had already slowed down in 1997 due to declining commodity prices and adverse weather conditions. The impact of the crisis can be expected to vary considerably among countries: oil and food importers will benefit from lower prices, while exporters of metals and oil and other fuels are particularly vulnerable. For sub-Saharan Africa growth in 1998 is not expected to be much higher than in 1997, and even this forecast may be over-optimistic.

The impact of the crisis on transition economies will occur in large part through declines in prices of energy products. However, in view of the structural weaknesses in its financial system and of fiscal imbalances, the Russian Federation is particularly vulnerable to shifts in market sentiment, and its currency and stock markets have already suffered large declines. Many Central and Eastern European economies are not directly affected by the crisis because of weak trade linkages, and the region as a whole is expected to register a positive, though moderate, growth rate for the second successive year since the beginning of the transition, although there is considerable uncertainty surrounding prospects for the Federation.

Coming on top of a possible cyclical slowdown, the impact of the East Asian crisis on the United States economy may be quite important. The economy continued to grow vigorously in 1997, driven by private spending in excess of incomes. Inflation continued to fall even though growth exceeded by a wide margin the rate officially considered to be compatible with stable inflation. The process of adjustment in East Asia, the appreciation of the dollar, and lower commodity prices all contribute to lower inflation, but by the same token they lower incomes and purchasing power in United States export markets, with the result that there is likely to be a substantial increase in the United States trade deficit. Private spending cannot be expected to continue at the recent pace, while the fiscal surplus will be a drag on economic activity. All in all, it is probable that growth of the economy will slow down significantly in the second half of the year.

This prognosis of a benign slowing of the United States economy could be upset by financial factors. Since the extended period of recovery has been associated with an expansion of bank lending, the slowing down of growth may create repayment difficulties for many borrowers. Furthermore, declining company earnings and margins may lead to a reassessment of the level of equity prices. Difficulty in servicing bank loans or a sharp correction in stock prices would reinforce the existing deflationary impulses and lead to a rougher landing than currently foreseen.

Should domestic demand slow down sharply, the contribution of the United States to the growth of global demand would fall even as the trade deficit widened. There would consequently be an enlargement of the global demand gap brought about by the crisis in East Asia and the sharp swing in trade balances of the region. Any such gap is unlikely to be filled by strong demand in Europe or Japan. In the European Union, with the exception of the United Kingdom, growth has so far depended on exports, and the Asian crisis is expected to reduce both output and export growth by over 0.5 percentage points. The situation in the United Kingdom is similar to that of the United States, although inflation is faster. In the other major European Union countries exports to Asia have started to decline rapidly. Thus, any recovery in domestic demand would only replace the decline in net exports without creating any additional stimulus. Moreover, the uniform monetary policy of the newly operative European Central Bank cannot be expected to provide any stimulus to demand in the earlier stages of monetary union, but to err on the side of deflation rather than inflation.

Recovery of the Japanese economy will be crucial to recovery in the rest of Asia. The current recession in Japan has prevented it from playing the same role as that of the United States during the Mexican recovery. Despite the recently introduced package of public expenditures and tax cuts, growth is expected to remain negative for the year. A policy of relying on yen devaluation to boost external demand would create a risk of further currency instability in the region, and in international financial markets more generally. Without a strong recovery in domestic demand Japan will not be able to provide an expanding export market for other Asian economies.

However, there is no reason why Japan could not provide considerable external financing to those countries in the form of long-term lending. The impact of such lending would most likely be greater on growth in Japan itself, as well as in the newly industrializing economies (NIEs), than a domestic fiscal package of an equal magnitude, since the money would largely be recycled to Japan in the form of increased imports. Indeed, a regional approach could prove a more effective way of dealing with the crisis than has so far been the case under standard multilateral initiatives.

Because of the nature of the crisis, recovery in East Asia is likely to be much slower than it was in Mexico after 1995. A crisis of over-investment and financial fragility is more difficult to resolve than one of over-consumption. Restructuring balance sheets and adjusting the stock of debt and assets takes much longer than a realignment of consumer spending.

Perhaps the worst possible outcome of the crisis is further bouts of financial instability in emerging markets, a large correction of equity prices in the major industrial countries, together with a sharp slowdown in the United States economy, prolonged recession in East Asian NIEs and Japan, and increased trade imbalances in the major industrial countries. Any such outcome would put increased pressure on banking systems in the developed world. The result might not only be a world economy in deep recession, but also a re-emergence of trade conflicts that could wreak havoc. If that is to be avoided, countries in surplus, namely Japan and the members of the European Union, must increase their contribution to world demand, and deflationary policies in East Asia must be reversed.

The management and prevention of financial crises

The anatomy of financial crises

The East Asian crisis is only the latest in a string of financial crises which have disrupted the global economy since the breakdown of the Bretton Woods system. Such crises have been occurring with increasing frequency in both industrial and developing countries. In industrial countries the episodes of financial instability have involved either banking or currency crises; but in developing countries they have typically been a combination of the two, and have been accompanied by difficulties over external debt service. These differences reflect divergences in net external indebtedness as well as the increasing dollarization of the economies of developing countries.

A greater understanding of the causes and nature of financial crises is essential for their better management as well as for designing policies to reduce their likelihood. While each episode of financial instability has had its own special characteristics, a number of common features stand out:

- They have typically been preceded by financial deregulation and – where there was currency instability – by liberalization of capital transactions;

- Banking crises have been associated with excessive lending on certain categories of assets such as property and stocks, and with speculative bubbles, frequently following a large movement by banks into certain types of financing for the first time. Such lending has often, but not always, taken place in the context of weak financial regulation and supervision;

- Currency crises have typically been preceded by periods of sharply increased capital inflows attracted by a combination of an interest rate differential and relatively stable exchange rates. These act as an incentive to borrow abroad, but at the same time they increase exposure to currency risk;

- There is no known case in any country, developed or developing, of a large increase in liquidity in the banking sector resulting from capital inflows that did not lead to an over-extension of lending, a decline in the quality of assets and increased laxity in risk assessment;

- The inflows generate tendencies to currency appreciation and deterioration of the balance on current account. When there are excessive capital inflows, the worsening of external balances and the weakening of the financial sector are often two sides of the same coin;

- Much of the impetus for the increased capital flows is related to the crisis of commercial banking in the major industrial countries. Because it has exerted pressure on banks to find alternative sources of business to increase returns, greater competition in the financial sector brought about by deregulation has been an important cause of increased international financial instability;

- Reversals of capital flows are often associated with a deterioration of macroeconomic conditions resulting from the effects of the inflows, rather than with shifts in policies. But almost all major episodes of capital outflows and debt crisis in developing countries have been associated with rising international interest rates. The consequent currency depreciation leads to capital losses among those with unhedged exposures, and may become a force transforming the depreciation into a free fall owing to the rush for foreign exchange.

Other features of currency crises have varied. They have occurred under rather diverse conditions with respect to types of financial flows, borrowers and lenders. For example, they have been preceded by borrowing by the private and public sectors in different proportions. Likewise, the most important form of capital flows in many recent crises (including that in East Asia) was international bank lending, but in the Mexican crisis a large share consisted of portfolio investment in equities and in the paper of the Mexican Government.

Management of financial crises

The East Asian experience has laid bare certain weaknesses in the international approach to the management of crises involving sudden withdrawal of foreign capital and massive and sustained attacks on the currency. As a result of this approach, what appeared to be a liquidity crisis has been translated into a solvency crisis, through a collapse of currencies and asset prices. This process hurts not only those with external liabilities but also the economy as a whole, owing to its effects on output and employment.

There are four possible lines of defence against an attack on the currency:

- Domestic policies, primarily monetary policy;
- Maintaining a sufficiently high level of precautionary foreign reserves and credit lines;
- Recourse to an international lender of last resort; and
- Imposition of a debt standstill and exchange restrictions, accompanied by initiation of negotiations for a rapid debt workout.

Under normal conditions, interest rate differentials are important determinants of international capital movements, and monetary policy can alter the incentives for capital flows. However, as events in East Asia have shown, under conditions of panic, the effects of monetary tightening can be quite different, since interest rate hikes may simply point to declining creditworthiness and greater default risk. Intensified difficulties among debtors can eventually lead to exchange-rate stabilization owing to the resulting squeeze on sales of domestic currency, but at the expense of depressing the economy rather than through bringing back foreign capital.

Maintenance of precautionary reserves or credit lines in amounts adequate to meet outflows during a currency attack poses problems of cost and feasibility. One way of accumulating reserves for this purpose would be to sterilize some of the capital inflow, i.e. to purchase it with the proceeds of domestically issued debt. But such a strategy is likely to entail two sorts of costs: firstly, there is a cost to the economy as a whole, since the rate of interest on foreign loans usually exceeds the return on foreign reserves; and, secondly, there is a cost to the public sector, since the real interest on government debt typically also exceeds the return on reserves.

Alternative approaches might be to cover the short-term external liabilities of the private sector by long-term public borrowing matched by short-term investment abroad, or to arrange a private lender of last resort. But the borrowing or credit lines could be very large, especially if allowance is made also for withdrawals by non-residents from stocks and bonds. Moreover, a country may not have access to such borrowing or credit lines, and there is no assurance that monies under credit lines would be available as needed. Besides, net costs in both cases could be substantial.

Financial assistance coordinated by the IMF in recent years has usually come only after the collapse of the currency, and has taken the form of bailouts designed to meet the demands of creditors and to prevent defaults. Such operations have a number of drawbacks: they protect creditors from bearing the costs of their decisions, thus shifting the entire burden to debtors and creating moral hazard for creditors; and by securing *ex-post* public guarantees for private debt they reduce perceived default risks. More importantly, the sums required have been increasing and are reaching the limits of political acceptability in countries providing them. This is also one of the main impediments to the establishment of a genuine lender-of-resort facility which would stabilize currency markets and thus avoid the transformation of currency attacks into solvency crises.

In the absence of timely provision of adequate liquidity to counter attacks on a currency, a liquidity crisis will eventually lead to widespread defaults and bankruptcies. The most effective way to prevent such an outcome would be through extension and application of insolvency principles such as those in chapter 11 of the United States Bankruptcy Code. Based on the premise that the value of a firm as a going concern exceeds that of its assets in the event of liquidation, those principles are designed to address financial restructuring rather than liquidation. The procedures allow for a standstill on debt servicing in order to provide the debtor (who is left in possession) with a breathing space from its creditors, and so prevent a "grab race" for assets that is likely to be detrimental not only to the debtor but also to unprotected creditors. The debtor thus has an opportunity to formulate a debt reorganization plan, and equal treatment for creditors is also guaranteed. During the reorganization the debtor is provided with access to the working capital needed for its operations, by granting a seniority status to the new debt contracted. Reorganization is followed by resolution, and insolvency procedures may accelerate the process by discouraging holding-out by particular classes of creditors.

The application of such principles to international debtors was raised in *TDR 1986* during the sovereign debt crisis. It was there noted that under such conditions, the debtors "experience the financial and economic stigma of being judged *de facto* bankrupt, with all the consequences that this entails as regards creditworthiness and future access to credits. At the same time, they are largely without the benefits of receiving the financial relief and financial reorganization that would accompany a *de jure* bankruptcy handled in a manner similar to chapter 11 of the United States Bankruptcy Code".

The increasingly private character of external debt in developing countries has not only increased the likelihood of harmful debt runs and asset-grab races by creditors and investors, but also has given greater pertinence to these bankruptcy principles in the management and resolution of international debt crises. However, a full fledged international chapter 11 is neither practical nor necessary. Article VIII of the Articles of Agreement of IMF may provide a statutory basis for the application of debt standstills through the imposition of exchange controls if a currency comes under attack, and it can be combined with the existing practices for restructuring debt through negotiations.

While standstills could be sanctioned by IMF, a conflict of interest might arise since countries affected by its decisions are also its shareholders and the Fund itself is often a creditor. It may be desirable to place standstill authority with an independent panel whose rulings would have legal force in national courts. A standstill could be decided unilaterally by the debtor country facing an attack on its currency, once its reserves or currency fall below a certain threshold, and then be submitted for approval to the panel within a specified period. Such a procedure would help to avoid a panic, and be similar to GATT safeguard provisions allowing countries to take emergency actions. During the standstill and the subsequent negotiation of a debt reorganization debtor-in-possession financing could be provided by IMF "lending into arrears", which would require much smaller sums than bailout operations.

Procedures of this kind would meet the need once again evident in the East Asian crisis to safeguard debtor countries from the over-reaction of financial markets. In the words of the New York Court of Appeals, which had once ruled in favour of a debtor government that had imposed a unilateral standstill, this would be "in entire harmony with the spirit of bankruptcy laws, the binding force of which ... is recognized by all civilized nations."

Prevention of financial crises

The crisis in East Asia has once again focused the attention of the international community on ways and means of preventing such crises. A number of proposals have been made for measures to be taken at global, national and regional levels. However, global initiatives regarding the international financial system have not gone to the root cause of the problem. On the contrary, some such initiatives could reduce the autonomy and flexibility of national policymakers in introducing measures needed to protect their economies from volatile and speculative capital flows.

With greater integration of financial markets and increased scope for contagion, the international surveillance of national policies has gained added importance in ensuring the stability of the international monetary and financial system. However, it has so far been unsuccessful in preventing international financial crises and currency turmoil; nor is it clear that recently proposed improvements will lead to more effective implementation:

- Major financial crises are typically connected to large shifts in macroeconomic conditions external to countries where the crisis originated. External factors are as important as domestic ones in triggering both capital inflows and capital outflows. However, existing modalities do not address the problems of policy surveillance due to unidirectional impulses from changes in the monetary policies of the United States and a few other OECD countries which exert a strong influence on capital movements and exchange rates. There are no mechanisms under the existing system of global economic governance for dispute settlement or redress regarding these impulses;

- The focus of attention of the proposed improvements in surveillance continues to be the role of domestic policies in generating financial fragility and crisis. However, even in this more limited area, the record has been mixed, in large part because of the tendency to ignore that markets can go wrong;

- While improvements in the timeliness and quality of information concerning key macroeconomic and financial variables is essential for effective surveillance, emphasis on the inadequacy of information as the major reason for the failure to forecast the East Asian crisis appears misplaced or exaggerated. Although the crisis has pointed to certain weaknesses in available information, these did not play an essential role. Rather, there was inadequate evaluation of the implications of the available data, including those in the periodic reports of BIS, for countries' ability to continue to obtain funding from international financial markets.

Similarly, the contribution to the East Asian crisis of weaknesses in domestic financial regulation and supervision has led to increased attention to reform in this area. However, while such reform can reduce the likelihood of financial crises, experience indicates that, owing to the vulnerability of the financial sector to changes in economic conditions and to unavoidable imperfections in the regulatory process itself, even a state-of-the-art system of financial regulation does not provide fail-safe crisis prevention.

There are serious weaknesses in the regulatory framework for cross-border lending and investment at the source of such flows. They have been an important cause of the shifting of a disproportionate share of the cost of resulting crises onto debtors. A number of proposals have been made for new rules and institutions directed at exerting tighter control over international lenders and investors. While some could be adopted without major changes in existing institutions and policy regimes, others would require, to varying degrees, new and far-reaching international agreements, which might be difficult to achieve owing to uncertainties with regard to their effectiveness or to the concentration of power which they would entail.

Collaboration and consultation at the regional level are capable of contributing to the prevention of financial crises. Their potential role is particularly important with respect to the prevention of currency disorders and contagion effects. Initiatives in this area, which may involve monitoring mechanisms or more ambitious arrangements linked to the provision of mutual external financial support, can benefit from the long and wide-ranging experience of the European Union.

However, none of these proposals for crisis prevention is capable of eliminating the need for active national policies in respect of the balance of payments and external liabilities. In this respect exchange rate policies and controls over capital movements merit particular attention.

There is no reason to condemn managed-exchange-rate regimes and sacrifice currency stability in the interest of free capital mobility. The alternative of freely floating rates, combined with capital mobility, would undermine currency stability with attendant consequences for trade, investment and growth. A currency board system can eliminate problems for debt management due to currency mismatches, and has proved a useful vehicle in certain countries for halting hyperinflation. But such systems do not insulate economies from instability of external origin, since the effects of capital inflows and outflows are transmitted to levels of economic activity and to goods and assets prices, and may include threats to banking stability.

However, managed-exchange-rate regimes are vulnerable to large accumulations of short-term external debt and to other potentially volatile capital inflows. Even if used flexibly, such regimes are likely to be sustainable only if accompanied by active management of external liabilities, which may often entail recourse to capital controls.

Capital controls are a tried technique for dealing with unstable capital movements. The measures traditionally focused mainly on cross-border transactions of residents and non-residents. However, owing to deregulation and recent developments in banking technique, accounts and transactions denominated in foreign currencies are now often available to residents. Since they can affect macroeconomic variables such as the exchange rate in much the same way as cross-border transactions, they are also a legitimate target for controls. Postwar experience has been marked by frequent use of such controls in industrial countries, and they have also played an important role in policies adopted by several developing countries during recent years in response to large capital inflows.

The extent of successful recourse to capital controls suggests that current initiatives aiming to restrict national freedom of action in this area are inappropriate. The probability of financial crises can be reduced by better macroeconomic fundamentals, effective prudential regulation and supervision of the financial system, and improved corporate governance. But these entail structural reforms with an unavoidably long time-scale: in industrial countries decades were typically required to complete such reforms and to build the institutions needed. Moreover, such actions at national level will not provide fail-safe insulation against currency attacks, which also respond to conditions in international financial markets and in the countries of international lenders and investors. The harm inflicted by currency attacks could be contained by new arrangements for crisis management such as a proper international lender of last resort or a framework for debt standstills and work-outs, but these too are powerless to prevent them from starting and causing damage. Thus, in the absence of global mechanisms for stabilizing capital flows, controls will remain an indispensable part of developing countries' armoury of measures for the purpose of protection against international financial instability, so that for the foreseeable future flexibility regarding governments' options rather the imposition of new constraints is required.

African development in a comparative perspective

After two decades of almost continuous economic decline, Africa is now enjoying a recovery. In 1995, for the first time in many years, the region as a whole experienced an increase in per capita income, a performance that was repeated in 1996 and again, although to a lesser extent, in 1997. The recovery was underpinned by a strong growth in export earnings and owed much to better weather conditions as well as to diminished civil strife in a number of countries.

However, even if the growth of the past three years in sub-Saharan Africa (SSA) could be sustained in the coming decade, that would not reverse the marginalization of the region or make much dent in widespread poverty, and would do little more than recover the ground lost during the past two decades. The challenge for policymakers is to turn this recovery into a stronger and sustained economic take-off, with the aim of attaining the 6 per cent growth target for Africa set by the United Nations. In the past three years only a handful of countries have been able to sustain growth rates reaching or surpassing this target.

However, there should be no illusions about the difficulties in meeting this challenge. Nor should faith be placed in quick fixes or outside panaceas. Certainly, there are lessons that can be drawn from other developing countries which have emerged from economic and social instability into periods of fast and sustainable economic growth. But Africa must also regain the developmental momentum which underpinned the social and economic gains of many African countries in the decade following their independence.

Since the early 1980s many governments have pursued reforms under structural adjustment programmes that place emphasis on macroeconomic stability, a reduced role for the State, greater reliance on market forces and a rapid opening up to international competition as the key to unlocking growth potential. Greater macroeconomic stability and removal of large price distortions in key areas have no doubt made an important contribution to economic recovery in some countries. However, despite many years of policy reform, barely any country in the region has successfully completed its adjustment programme with a return to sustained growth. Indeed, the path from adjustment to improved performance is, at best, a rough one and, at worst, a disappointing dead-end. Of the 15 countries identified as "core adjusters" by the World Bank as recently as 1993, only three are now classified by IMF as "strong performers". Mainstream assessments of Africa's growth prospects have almost invariably proved over-optimistic largely because they have been based on an act of faith in growth-enhancing market forces, rather than on a careful examination of constraints and opportunities.

Such assessments, as well as the policy advice proffered, have not always taken proper account of the external constraints. Indeed, declining export prices and a sharp deterioration in external financial conditions in the early 1980s brought the already shaky foundations of many African economies to a state of near collapse. These losses were not offset by rises in official development assistance (ODA) or official lending; less than 15 per cent of the trade loss was compensated by ODA. Predictably, the resulting adjustment took the form of severe import compression and a sharp decline in investment; the share of investment in GDP, which had averaged over 25 per cent in the 1970s, had fallen to 16 per cent by the early 1990s. The region was caught in a vicious circle: the existing economic structure was unable to generate the growth in export earnings needed to maintain imports and investment, which in turn impeded structural change and economic growth.

The recent recovery has been greatly helped by improved external conditions. The 25 per cent rise in non-oil commodity prices from 1993 to 1996 accounts for much of the increase in export earnings. However, the medium-term outlook for commodities does not suggest that these gains will be lasting; the recent downturn in prices is accentuated by the weakening of global demand due to the East Asian crisis. Moreover, the downward trend in real ODA that emerged at the beginning of the decade continues unabated.

The international community should not, and need not, adopt a passive stance on African economic development. Indeed, on one key issue, that of debt, it can make a demonstrable commitment to the new generation of African policymakers.

There is now ample evidence that Africa‘s external debt burden is having a severe adverse impact on investment and renewed growth. Not only does it impede public investment in physical and human infrastructure, but also it deters private investment, including foreign investment. As a proportion of exports and GDP the external debt of Africa is the highest of any developing region. Most of it is public and owed to official creditors, and a good deal is simply unpayable. The extent of the debt overhang is indicated by accumulated arrears which, by 1996, had reached over $64 billion, amounting to more than a quarter of the total debt. Of even more concern is that two thirds of the increase in debt since 1988 has been due to arrears.

The launching of the Heavily Indebted Poor Countries Debt Initiative (HIPC Initiative) has allowed a more comprehensive, coordinated and equitable approach to be taken. However, it needs significant revision if it is to help decisively in establishing the conditions for sustained growth; the basic concerns relate to eligibility for, and the adequacy of, debt reduction as well as to the speed at which relief should be granted. A comprehensive assessment of the sustainability of African debt is now needed; it should be carried out by an independent body that would not be unduly influenced by the interest of creditors. Such a body could be composed of eminent persons experienced in questions of finance and development who could be appointed by mutual agreement between creditors and debtors, with a commitment by creditors to implement fully and swiftly any recommendations that may be made. Such a course of action would be in complete harmony with the recognized principles of debt workouts.

Raising net resource transfers through debt relief will not succeed, however, unless it is accompanied by appropriate domestic policies to overcome low productivity and heavy dependence on a small number of primary commodities. Expanding investment in both primary and secondary industries and in both the public and the private sector is a vital prerequisite for, if not a guarantee of, rapid structural change and productivity growth. Whilst there is a growing consensus on this point, the analysis in this *Report* suggests that the current approach to structural adjustment is unlikely to achieve such an outcome.

The most disturbing feature of policy reforms in SSA is their failure so far to bring about an investment recovery; the average ratio of investment to GDP during 1995-1997 was 17 per cent, only slightly above that of the early 1990s and well below that of other developing regions. Public investment has borne the brunt of the adjustment impact, but private investment has not, as conventional wisdom might suggest, stepped into the breach. Indeed, as a share of GDP, it is lower than in the 1970s.

One important reason for poor economic performance is slippage in programme implementation. Another is the failure to address the debt problem and to provide adequate external financing in designing the programmes. More importantly, while there is consensus that structural constraints and institutional weaknesses prevent an effective functioning of markets and impede a positive response to private incentives, these obstacles are often neglected. Thus, policies are promoted to get prices "right" when some of the more important agents and institutions of a modern market economy are underdeveloped or totally absent. Again, there is no proper sequencing of liberalization of product and factor markets with prior institutional reforms needed for its success. The outcome has been sadly predictable: greater instability in key prices and failure to generate appropriate incentives. Even when incentives are generated, structural constraints and institutional weaknesses prevent their resulting in a vigorous supply response:

- Weak supply response to liberalization of agricultural markets largely reflects inadequate assessment of the factors constraining production. Evidence strongly suggests that the assumptions about the taxation of agricultural producers through pricing policies which underline these reforms are not entirely valid. While for some products African farmers have been heavily taxed compared with more successful exporters in other regions, that has not been so for all products or all countries;

- Agricultural liberalization has not been associated with a strengthening of price incentives. The domestic terms of trade have generally turned against farmers more in those countries which have sought to link domestic prices to world prices. The shift from public to private marketing agents has not increased the proportion of export prices passed on to producers, mainly because of imperfect and underdeveloped markets;

- Dismantling of marketing boards has tended to enlarge the institutional hiatus, as private institutions are generally unable to take up many of the functions previously rendered by marketing boards;

- Financial liberalization has often been undertaken without first ensuring the conditions for its success, including a high degree of price stability and fiscal discipline, sound financial institutions and corporate finance, depth in financial markets, and effective prudential regulation. Consequently, it has lead to high and unstable interest rates, widespread insolvencies, a rapid accumulation of public domestic debt and fiscal instability;

- While there was certainly a need to move towards more realistic and flexible exchange rates, the pendulum has swung too far. Leaving exchange rates to markets has resulted in highly unstable rates as markets proved to be very thin. Instability has further been exacerbated by arrangements that have resulted in *de facto* liberalization of the capital account;

- Trade policy reforms have largely been driven by theoretical notions of neutral incentives, to be attained through low and uniform tariffs, rather than by pragmatism. Nor have tariff reforms always been supplemented by adequate arrangements to support exports and investment. As a result, while exports and investment are sometimes too heavily taxed, imports of luxury goods occasionally receive favourable treatment. Numerous exemptions from duties, large-scale smuggling, and tariff reductions create serious difficulties for domestic firms with the potential to form the basis of a more export-oriented industrial base.

A rethinking of policies is now needed that recognizes and addresses directly the structural constraints and institutional hiatus that pervade the African economies. It should draw on successful development experiences in Africa and elsewhere, and focus on capital accumulation and nurturing and building the institutions needed for an efficient market economy.

Policy intervention should also be based on the recognition by governments that in market-based systems capital accumulation is closely linked to the consolidation of property rights and the emergence of a strong and dynamic indigenous entrepreneurial class willing to commit its resources to investment. Fears associated with the emergence of such a class as a rival economic power to ruling elites need to be overcome if market-based development is to succeed.

There is no universal recipe, but some general principles can be laid down that are appropriate to Africa, in the light of its market imperfections and volatile economic environment:

- As elsewhere, private investment requires complementary public investment in physical and human infrastructure. Undercapitalization, including inadequate public investment, is the principal obstacle to sustained agricultural development in Africa. Neglect of agriculture in public spending is a more serious source of urban bias than pricing policies. At less than 5 per cent of GDP the current level of public investment is barely sufficient to meet the development challenge;

- The poor past performance of many marketing boards and *caisses de stabilisation* does not imply that their original rationale is no longer valid. Some of the needs which they were established to satisfy can now be met by the private sector, but government action remains indispensable in several areas of commodity trade such as financing, risk management, market promotion, and the provision of infrastructure and services unlikely to be forthcoming from other sources. Thus there is a strong case for institutional pluralism in which reformed and depoliticized marketing boards and *caisses* are part of a landscape that also includes private organizations, parastatals and co-operatives;

- A more pragmatic approach would be to reconsider the case for financial restraint linked to administered interest rates and institutions that would mobilize domestic savings, direct credits toward investment and meet the diverse needs of small- and medium-sized enterprises in the primary and secondary sectors;

- In a continent seeking export-led growth, the exchange rate is too important a variable to leave to shallow and volatile markets and the vagaries of capital flows. Its management requires, *inter alia*, the kind of regulations and control noted above. Opening up the capital account is not likely to bring back flight capital, which on some estimates accounts for 70 per cent of non-land private wealth in SSA. Much of the flight capital appears to have originated from the illicit diversion of public funds rather than to have been constituted by business incomes seeking economic stability or high yields abroad. A change in the banking regulations of those developed countries where these funds are hidden could produce effective results in this respect;

- The marginalization of SSA in world trade is a reflection of its inability to expand productive capacity, rather than a consequence of its resistance to openness. A gradual approach to trade liberalization is desirable in view of the existing weaknesses in supply capabilities. A trade regime that provides exporters with easy access to inputs at world prices, facilitates investment and discourages luxury consumption should also be built on a differentiated approach, supplemented by arrangements such as duty drawbacks and export retention schemes. The case for infant industry protection and industrial policies to promote learning and develop skills in domestic firms is no less relevant today in SSA than it has been for all successful late developers in this century. While WTO Agreements have reduced the scope for some policy options, selective strategies can still be applied, and exemptions provided under the agreements cover most countries in Africa. However, any such support must be time-bound and closely tied to performance criteria.

The experience of countries which have successfully launched a sustained process of economic growth based on a dynamic investment-export nexus built around primary activities gives ground for optimism that a similar process can be initiated in SSA. For most countries in the region the opportunities are ample, and their exploitation should be the initial focus of policy. As the successful experiences of resource-rich countries in Latin America and East Asia have shown, policy requirements at such early stages of export promotion and accumulation are less demanding and can yield rapid results. Those countries have indeed succeeded in initiating strong and sustained export and output growth following many years of instability and economic stagnation, and they did not always start from more favourable conditions than those now prevailing in Africa.

After a decade or more of reform in SSA premised on the assumption that government failures are far worse than market failures, the need to ensure complementarity between States and markets is now increasingly recognized. However, acknowledging market imperfections should not give way to a false ideology of state infallibility. Reforms are desperately needed if the African State is once again to assume its developmental role. This is a daunting task, and any comprehensive agenda of institutional reform can only emerge at the country level, where ownership of reforms can be ensured and the chances of success thereby increased. In general, governments need to diffuse a sense of national purpose. More specifically, there is an urgent need for a more efficient, dedicated and better remunerated civil service. At the same time, it is necessary to build greater trust and partnership between the state and private actors.

Political instability on account of social, especially ethnic, fragmentation is not an intrinsically African problem. While Africa is highly diversified in terms of social and ethnic minorities, there is less discrimination than in most other regions. But efforts since independence to build multi-ethnic political coalitions have entailed heavy economic costs. The experience of some South-East Asian countries illustrates that it is possible to achieve social and political harmony while nevertheless accelerating growth.

African countries should strengthen their regional economic ties, as they have already begun to do with their political ties. Special attention should be paid to a division of labour whereby trade and investment flows link countries at different levels of development. Intra-regional trade has been growing in SSA but is still very small. However, even marginal increases in such trade can help develop export capacities, which in turn can generate regional growth dynamics by easing balance-of-payments constraints and providing learning effects which will eventually make African exporters competitive globally.

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