# Part I
# Positive and Negative Aspects of Recent Reform Proposals

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# Facing the Volatility and Concentration of Capital Flows

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## I Introduction

The recent phase of financial turmoil in emerging markets generated a deep sense that fundamental reforms were required in the international financial architecture to prevent and improve the management of financial crises. The crisis led to the recognition that the potential benefits that globalisation offers is being seriously undermined by the high frequency of financial and currency crises. On the other hand, the expectation that rising private capital flows would substitute for decreasing official flows has not materialised. In particular, poor and small countries continue to have very restricted access to private capital markets.

The crisis has set in motion a number of positive responses: a special impetus to international efforts to strengthen standards of prudential regulation and supervision, as well as information; the drafting of codes and guidelines for macroeconomic management; a more preventive focus of IMF surveillance; the approval of new credit lines and the expansion of IMF resources; the recognition that financial liberalisation in the developing world generates risks and must thus be carefully sequenced; the partial acceptance by the IMF that fiscal overkill is inappropriate in adjustment programmes; the improvement of the Highly Indebted Poor Countries (HIPC) Initiative; and a greater emphasis given to the design of adequate social safety nets in developing countries.

Nonetheless, emphasis has been placed almost exclusively on domestic reforms in the capital recipient economies. Though useful, this asymmetrical approach wrongly implies that recent financial crises were largely caused by problems in the recipient economies. Most of the literature on these crises has argued, on the contrary, that imperfections in international capital markets were also a major – if not the main – cause of these crises. Moreover, to a significant extent, some of the domestic policies in recipient economies that led to crises – financial and capital-account liberalisation and pro-cyclical spending policies in the face of booming capital flows – were determined by pressure from private capital markets and even international financial institutions (IFIs). Therefore, significant complementary



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reforms in the source countries and in the approach of IFIs are required.

In some cases, responses during the recent crisis were insufficient or clearly inadequate: IMF conditionality was overextended; the issues associated with stable arrangements to guarantee the coherence of the macroeconomic policies of industrialised countries has not received sufficient scrutiny; strong unwarranted opposition to the 1997 proposal to create an Asian Monetary Fund led to its rapid dismissal, though it was revived in 2000 in the form of a swap arrangement among major Asian countries; more generally, the role which regional institutions can play in an appropriate international financial arrangement has not been given adequate attention; and no significant steps were taken to ensure a fair representation of developing countries in the discussion on reform or in a revised international architecture.

Even though international groups such as the G-22 and, more recently, the G-20 have been created in which some large developing countries participate, these groups are often only loosely related to the decisionmaking process. A major source of concern is that in the fora where important decisions on international reform are made (like the International Monetary and Financial Committee of the IMF), there is a significant underrepresentation of developing countries. Moreover, a very important and valuable new forum, the Financial Stability Forum (FSF), has no representatives from developing countries (for a very good review of these issues, see Culpeper, 2000).

The fairly rapid, though incomplete, normalisation of capital markets gave way to a sense of complacency that has slowed down the reform effort. Moreover, it could lead efforts in the wrong direction. One such step would be to give a new impetus to discussions on capital account convertibility. A negative road would be to follow recommendations (see, for example, Meltzer *et al.*, 2000) to significantly scale down lending – and several important functions and facilities – of the IMF and the World Bank. These recommendations are based on the incorrect diagnosis that government failures (both in developing countries and in the actions of IFIs) and, in particular, moral hazard played the key role in recent crises. On the contrary, as many analysts have stressed, recent crises have been caused, to an important extent, by imperfections in international capital markets linked to problems such as herding and multiple equilibria. Furthermore, private capital flows are still heavily concentrated and do not reach large parts and sectors of the developing world. Such recommendations are also based on the assumption that crises are intense but short, a fact that is contradicted by the fact that capital markets have not completely normalised more than three years after the onset of the Asian crisis.

This indicates that the reform effort in international finance should be broadened and deepened. Any relevant international financial reform should address the two major problems manifested by private capital flows to developing countries: *volatility* and *concentration*. To face the first problem, mechanisms need to be created or strengthened at an international level to guarantee macroeconomic and financial stability similar to the mechanisms that exist at the national level. These would include: (1) mechanisms to guarantee the coherence of macroeconomic policies worldwide and, particularly, to guarantee that macroeconomic policies in industrialised countries internalise the externalities that they generate; (2) a world financial regulatory authority; (3) an international lender of last resort that provides adequate liquidity to manage large capital account shocks, as well as emergency financing to manage more traditional shocks; and (4) international arrangements to facilitate debt work-outs. To face the second issue, official development assistance (ODA) should meet internationally agreed targets, and development finance should be strengthened to fill market gaps in countries and sectors which cannot access private flows as well as to catalyse additional private flows where feasible. Actions in these two areas should be complemented by the increasing participation of developing countries in international financial institutions and decisionmaking fora, and in the design of complementary regional and sub-regional mechanisms.

Though much of this agenda may be unrealistic in the short term, it is important that work continues to be done on a blueprint for such a future international financial order, as this type of vision is a valuable guide to current debates and efforts. Such a blueprint clearly argues, if anything, for an increased role of IFIs and other official resources, and for strong international as well as regional and sub-regional institutional arrangements.

This paper concentrates on some aspects of this broader reform agenda. Section II briefly summarises the problems that the current system faces. This serves as a background for analysis of the regulatory agenda, both in source (Section III) and recipient countries (Section IV), and on liquidity (Section V) and development finance (Section VI).

## II The Nature of the Problems Facing the System

International capital flows to developing countries have exhibited four outstanding features since the 1990s.[1] First of all, official and private flows have followed opposite patterns: whereas the former have tended to

1 For a full evaluation of trends, see UNCTAD (1999), Chapters III and V, and World Bank (1999, 2000).



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decline, private capital flows have experienced rapid medium-term growth. Secondly, different private flows have exhibited striking differences in terms of stability. Thirdly, private flows have concentrated in middle-income countries, with official flows playing only a very partial redistributive role at a world level. Finally, the instability of private financial flows has required the design of major emergency rescue packages of unprecedented size which have concentrated funds in a few large emerging economies.

The first two patterns are shown in Table 1. Both foreign direct investment (FDI) and all types of private financial flows have experienced strong medium-term growth. However, these flows have exhibited striking differences in terms of stability: whereas FDI has been resilient in the face of crises, private financial flows have experienced strong volatility and "contagion" effects. Although access to markets has tended to be restored faster than in the past, conditions of such access – spreads, maturities and special options to reduce the risks of investors – have deteriorated. Significant instability in capital flows has been the rule since the eruption of the Asian crisis.

In contrast to the growth of private flows, official development finance and, particularly, its largest component, bilateral aid, has lagged behind. Indeed, bilateral aid has fallen in real terms so that in 1998 it reached 0.24 percent of the GDP of industrialised countries, a significant fall with respect to the 0.33 percent of GDP reached in the early-1990s.[2] The reduction in bilateral aid has been the most significant in the case of the largest industrialised countries. This trend has been partly offset, in terms of effective resource transfers, by the increasing share of grants in official development assistance. Contrary to private flows, official finance has been stable and some components of it – particularly balance of payments support and multilateral development finance – have displayed an anti-cyclical character.

The third pattern is shown in Table 2. Private flows have been strongly concentrated in middle-income countries. Low-income nations' share of private financing has been lower than their proportion of the total population of developing countries, a fact that may be expected, but it is also lower than their proportion of developing countries' GDP. This fact is particularly striking in bond financing, commercial banking and portfolio flows, if India is excluded in the latter case. In all these cases, private financing to poor countries is minimal. Low-income countries' share of FDI is also smaller than their contribution to developing countries' GDP. Moreover, a striking feature of FDI is its high concentration in China, which captures, on the contrary, a smaller proportion of financial flows. In

2 World Bank (2000), p. 58.

**Table 1 Net Long-Term Flows to Developing Countries, 1990-1999[a]**
(in billions of dollars)

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

*Notes:*

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

b Preliminary.

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

turn, the high concentration of the most volatile flows in middle-income countries, excluding China, has implied, that issues of financial volatility and contagion are particularly relevant to them.

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

The volatility of private financial flows, on the one hand, and its strong concentration in middle-income countries, on the other, have jointly generated the need for exceptional official financing on an unprecedented scale concentrated in a few emerging countries. As a result, IMF (including ESAF) financing has exhibited both strong anti-cyclical behaviour, in relation to private flows, and concentration in a few countries. Both patterns are closely associated because cyclical borrowing by a few large countries is

**Table 2 Net Flow of Resources, 1992-1998**
(Annual averages, in billions of dollars and percentages)

| | Foreign direct investment | | Portfolio equity flows | | Grants | | Bilateral financing | |
|---|---|---|---|---|---|---|---|---|
| | Amount | % | Amount | % | Amount | % | Amount | % |
| **Developing countries** | **109.4** | **100.0** | **33.0** | **100.0** | **28.0** | **100.0** | **2.3** | **100.0** |
| Excluding China | 75.4 | 68.9 | 29.4 | 89.2 | 27.7 | 99.0 | 0.3 | 13.1 |
| **Low-income countries** | **7.4** | **6.8** | **3.0** | **9.0** | **16.2** | **58.0** | **0.8** | **36.7** |
| India | 1.8 | 1.6 | 2.2 | 6.6 | 0.5 | 2.0 | -0.3 | -11.2 |
| Other countries | 5.6 | 5.1 | 0.8 | 2.4 | 15.7 | 56.1 | 1.1 | 48.0 |
| **China**[a] | **34.0** | **31.1** | **3.6** | **10.8** | **0.3** | **1.0** | **2.0** | **86.9** |
| **Middle-income countries** | **68.0** | **62.1** | **26.4** | **80.2** | **11.4** | **40.9** | **-0.5** | **-23.6** |
| Argentina | 5.2 | 4.7 | 1.5 | 4.5 | 0.0 | 0.1 | -0.2 | -10.1 |
| Brazil | 9.8 | 8.9 | 3.6 | 10.9 | 0.1 | 0.2 | -1.1 | -49.6 |
| Russian Federation | 1.9 | 1.8 | 1.0 | 3.0 | 1.0 | 3.5 | 0.5 | 21.6 |
| Indonesia | 3.0 | 2.7 | 2.1 | 6.4 | 0.2 | 0.8 | 1.2 | 52.8 |
| Republic of Koreab | 2.0 | 1.9 | 3.5 | 10.5 | 0.0 | 0.0 | 0.1 | 3.1 |
| Mexico | 8.8 | 8.0 | 4.5 | 13.6 | 0.0 | 0.1 | -0.7 | -28.8 |
| Other countries | 37.3 | 34.1 | 10.3 | 31.3 | 10.1 | 36.2 | -0.3 | -12.6 |

*Notes:*
a The World Bank considered China as a low-income country until 1998. Since 1999, it has been classified as a middle-income country. In this table it is considered as a specific category.
b The World Bank classifies it as a high-income country, but it is included as a middle-income country in *Global Development Finance, 2000*.

the major determinant of the overall cyclical pattern. The latter feature has become even more marked in recent years. As a result, the share of IMF financing going to large borrowers has displayed a strong upward trend over the past two decades.[3]

The volatility exhibited by private capital flows is at the centre of recent debates and is certainly problematic. However, no less important problems are the marginalisation of the poorest countries from private capital flows and the decline in the bilateral aid on which they largely depend. International financial reforms must therefore also be focused on guaranteeing solutions to both of these problems.

3 Griffith-Jones and Ocampo (1999).

**Table 2 (continued)**

| Multilateral financing (excluding IMF) | | Bonds | | Commercial bank loans | | Other loans | | Total | | Memo: | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Amount | % | Amount | % | Amount | % | Amount | % | Amount | % | GDP | Population |
| **15.3** | **100.0** | **38.2** | **100.0** | **27.5** | **100.0** | **3.7** | **100.0** | **257.4** | **100.0** | **100.0** | **100.0** |
| 13.1 | 86.0 | 36.6 | 95.7 | 26.7 | 97.0 | 0.3 | 8.7 | 209.5 | 81.4 | 89.3 | 74.8 |
| **5.8** | **37.8** | **1.0** | **2.7** | **0.7** | **2.6** | **1.1** | **29.5** | **36.0** | **14.0** | **11.3** | **40.7** |
| 1.0 | 6.4 | 0.9 | 2.4 | 0.5 | 1.6 | 0.2 | 5.9 | 6.8 | 2.6 | 5.3 | 19.4 |
| 4.8 | 31.5 | 0.1 | 0.3 | 0.3 | 0.9 | 0.9 | 23.5 | 29.2 | 11.4 | 6.0 | 21.3 |
| **2.1** | **14.0** | **1.6** | **4.3** | **0.8** | **3.0** | **3.4** | **91.3** | **47.9** | **18.6** | **10.7** | **25.2** |
| **7.4** | **48.2** | **35.6** | **93.0** | **26.0** | **94.4** | **-0.8** | **-20.8** | **173.5** | **67.4** | **78.0** | **34.1** |
| 1.0 | 6.5 | 5.9 | 15.4 | 1.2 | 4.5 | 0.0 | -1.3 | 14.5 | 5.6 | 4.7 | 0.7 |
| 0.7 | 4.9 | 3.1 | 8.0 | 9.6 | 34.7 | -0.5 | -13.3 | 25.2 | 9.8 | 10.3 | 3.3 |
| 0.9 | 5.9 | 2.3 | 6.0 | 1.1 | 4.0 | 1.1 | 29.0 | 9.8 | 3.8 | 6.6 | 3.1 |
| 0.3 | 2.0 | 1.4 | 3.6 | 0.3 | 1.2 | 0.1 | 2.9 | 8.6 | 3.4 | 3.1 | 4.0 |
| 1.1 | 7.4 | 6.8 | 17.7 | 0.7 | 2.5 | -0.4 | -10.4 | 13.8 | 5.3 | 6.8 | 0.9 |
| 0.3 | 2.0 | 4.8 | 12.6 | 1.6 | 5.8 | -0.4 | -10.9 | 19.0 | 7.4 | 6.1 | 1.9 |
| 3.0 | 19.6 | 11.4 | 29.7 | 11.5 | 41.7 | -0.6 | -16.8 | 82.7 | 32.1 | 40.4 | 20.1 |

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

## III Financial Crisis Prevention: Regulation in Source Countries

The issues associated with financial crisis prevention have received extensive attention in recent discussions.[4] The most important area of agreement relates to the need to improve the institutional framework in which financial markets operate: to strengthen prudential regulation, supervision and accounting practices of financial systems worldwide, to adopt minimum international standards in these areas and sound principles of corporate governance, and to improve the information provided to financial markets.

4 See, among others, IMF (1998, 1999, 2000a and 2000b), G-7 (1998), UNCTAD (1998), Part One, Chapter IV, United Nations Task Force (1999), Council on Foreign Relations (1999), Miyazawa (1998), Rubin (1999), Summers (2000), Akyüz and Cornford (1999), Eatwell and Taylor (2000), Eichengreen (1999), Griffith-Jones (1998), Griffith-Jones and Ocampo (1999), Ocampo (2000a, 2000b), White (2000a, 2000b), and Wyplosz (1999).

The recent Working Group reports of the Financial Stability Forum have stressed the crucial role of stricter regulation and supervision of highly leveraged institutions and operations, controls on offshore centres, and the greater weight that should be given to the risks associated with operations with countries engaging in large-scale net borrowing, particularly of a short-term character, to discourage risky financing at the source. Although important progress has been made on defining these issues, far less progress has been made on implementation, particularly at the international level.

Nonetheless, some divergence of opinion remains. First, there is no consensus on institutional arrangements for international regulation. It is clear that the BIS should continue to play a leading role, but this would require an expansion of developing country membership in this organisation and, more broadly, in the definition of all sorts of international standards and codes of conduct. A crucial role will also be played by the Financial Stability Forum to coordinate regulation between countries and financial sectors but, as noted, this also requires that developing countries should participate in its decisionmaking process. Secondly, there are some differences of opinion as to what can be expected from enhanced prudential regulation and supervision, given their inherent limitations. Regulations will tend to lag behind financial innovations, supervisors are likely to face significant information problems, and macroeconomic events may overwhelm even well-regulated systems. Thirdly, traditional prudential regulation and supervision tend to have pro-cyclical macroeconomic effects: they may be unable to avoid excessive risk-taking during the booms and accelerate the credit crunch during crises, when bad loans become evident and the effects of provisioning standards are thus felt. Finally, there are disagreements on the best methodologies for regulation and in particular on how large a role should be given to market actors (e.g. rating agencies) themselves.

### *The Welfare-Enhancing Effects of Regulation*

In spite of the limitations of international financial regulation, a very clear case can be made that strengthening it will be welfare enhancing. This is particularly true, if, as we discuss below, such regulation has explicit counter-cyclical elements to compensate for inherent pro-cyclical behaviour by financial actors, that can also partly characterise traditional financial regulation.

Indeed, there is growing support for the view that the welfare of both source and recipient countries can be increased by regulatory changes (through measures in source and/or recipient countries) that would reduce excessive lending and borrowing. It is noteworthy that Alan Greenspan proposed – for the case of interbank lending – that it could be appropriate for either borrowing or lending countries to impose reserve requirements to "deter aberrant borrowing: sovereigns could charge an explicit premium, or could impose reserve requirements, earning low or even zero interest rates, on interbank liabilities. Increasing the capital charge on lending banks, instead of on borrowing banks, might also be effective" (Greenspan, 1998).

There is growing recognition that it may often be desirable to regulate excessive surges of potentially reversible capital flows in recipient countries. An important part of the responsibility for discouraging such excessive reversible inflows, as well as managing them, lies with the recipient countries. However, the experience of the 1990s, with a very large scale of international funds – compared to the small size of developing country markets – leads to the question of whether measures to discourage excessive short-term flows by recipient countries are sufficient to deal with capital surges and the risk of their reversal.

Aizenman and Turnovsky (1999) have formalised such analysis by developing a rigorous model that considers the impact via externalities of reserve requirements on international loans (both in lending and recipient countries) on the welfare of both categories of countries. In particular, they evaluate the macroeconomic impact of reserve requirements in a second-best world where there is moral hazard due to likely bailouts on the lender's side and sovereign risk on the borrower's side; both generate large negative externalities on welfare. The general conclusion of their model is that the introduction of a reserve requirement in either the source or the recipient country reduces the risk of default and improves welfare in both countries.

### *Removing Distortions and Introducing Anti-Cyclical Provisions in Banking Regulation*

There is broad agreement that the 1988 Basel Capital Accord was a major step forward in the design of minimum common standards for banking regulation. Nonetheless, it has also generated some distortions and, particularly, has maintained incentives for bank lending to behave in a pro-cyclical fashion. Due to significantly lower capital adequacy requirements for short-term lending than for long-term lending, it contributed to the build up of short-term bank lending and its reversal in East Asia and elsewhere. The new proposal published in June 1999 attempts to address this distortion by reducing somewhat (though perhaps not sufficiently) the differential between capital adequacy for short-term and other lending.

The new Basel recommendations, though including many positive elements (see, for example, Cailloux and Griffith-Jones, 1999), also have suggestions that are widely seen as problematic. These include increasing the role of rating agencies to determine country weightings for capital adequacy, which could aggravate the pro-cyclical nature of bank lending, thus encouraging larger surges and larger reversals – clearly an undesirable outcome. There is significant evidence that rating agencies act in a pro-cyclical fashion. Indeed, as pointed out by various authors (see, for example, Turner, 2000; and Reisen, 1999), rating agencies failed to downgrade the East Asian countries before the crisis and then worsened it because they brought down the ratings as the crisis unfolded. Reisen and von Maltzan (1999) find that sovereign ratings lag rather than lead the market.

The major problem with current regulatory practices, including the Basel accord is, however, that they do not serve to moderate pro-cyclical market behaviour (Ocampo, 2000a, 2000b). Indeed, current rules do not seem adequate to internalise the rising risks which banks incur during booms. On the contrary, during crises, increased amounts of bad loans (which are usually not fully covered by provisions) will impact upon the lending bank's capital and can lead to a credit crunch if the bank is already facing a relatively low capital asset ratio, and – as is likely in a recession – is unable to raise new capital.

The answer thus may lie in the implementation of an explicit counter-cyclical mechanism which would, in boom periods, and in contrast to ratings, dampen excess bank lending. In periods of slowdown and of scarcity of finance, the new mechanism should not further accentuate the decline in lending but rather encourage it. Counter-cyclical elements can also be introduced in regulating other financial agents (see below, for mutual funds).

There would be two linked objectives for introducing counter-cyclical elements into regulation. One would be to help smooth capital flows and the other would be to smooth the impact of volatile capital flows on the domestic financial system and therefore on the real economy. Introducing counter-cyclical elements into regulation would help build a link between the more microeconomic risks on which regulators have traditionally tended to focus and the macroeconomic risks which are becoming increasingly important, both nationally and internationally. Counter-cyclical elements in regulation related to bank lending could be applied, either internationally, nationally or at both levels.

Several mechanisms could be used to introduce a counter-cyclical element into regulation of bank lending. One mechanism would be to require a higher capital asset ratio in times of boom, and to allow banks to use the additional cushion provided by the higher ratio so they could sustain lending in times of recession at a lower capital asset ratio. Some practical difficulties may arise in implementing such a mechanism, of which the most serious one may be getting international agreement on a general formula for cyclically adjusted capital asset ratios.

A second mechanism for introducing counter-cyclical elements in bank lending regulation is to strengthen provisioning rules during booms, requiring, for example, banks to provision larger proportions of due loans or special provisions linked to the rapid increase in lending. Prudential supervision should certainly be strengthened for institutions experiencing a very rapid growth of lending. Also, generally precautionary provisioning could be encouraged or forced on intermediaries to cover normal cyclical risks (Turner, 2000). Any of these mechanisms would allow for provisions built up in good times to be used in bad times, without affecting reported capital. A problem that must be faced is the limited tax deductibility of precautionary provisioning. The large-scale application of this mechanism would require a change in tax laws, as indeed was done in the late-1980s in the UK.

A third mechanism, relevant particularly for domestic bank lending, is for regulators to place caps on the value of assets (such as real estate or stocks and shares) to be acceptable as collateral, when the value of such assets has risen sharply in a boom and is at risk of declining sharply in a recession. Rules could be used such as averaging values for the last five years, or accepting only 50 percent of current prices in the peak of a boom. The latter mechanism seems to have the least problems of implementation (it is already applied in some jurisdictions, e.g. Hong Kong).

A fourth possible counter-cyclical mechanism would be to limit or discourage lending for property, construction and personal consumption, as these items tend to increase substantially – and are often even a major factor – in booms (McKinnon and Pill, 1997). A possible implementation problem would be that it may be difficult to verify final use of credit, allowing such measures to be partially evaded.

Furthermore, regulators should be flexible in the downturn, particularly to allow banks to easily use cushions (e.g. of capital or of provisioning) in times of recession. It may even be advisable, if a recession is very serious, to allow capital asset ratios to fall below normally required levels, with the understanding that they will be rebuilt as soon as the economy starts recovering. A tension may arise here between the regulatory concerns about individual bank liquidity and solvency and the macroeconomic externalities of their actions, particularly in recessions.

Several issues require further scrutiny. What are the best mechanisms through which counter-cyclical measures should be introduced (e.g. flexible capital adequacy ratios, higher provisioning against losses, more "realistic" pricing of collateral)? How can the distinction between a temporary boom and a permanent increase in growth be best made? After what period of "boom" should regulatory changes be introduced? How large should such changes be? Should such measures be introduced for both international and domestic lending, or preferably for one of them? The previous remarks provide only initial thoughts on these important issues.

### *Filling Gaps*

The broad welfare case for applying reserve requirements in both source and recipient countries can also be applied to institutional investors and, in particular, to mutual funds, which grew in relation to banks in the 1990s. This occurred both within the developed countries, and particularly within the US – where mutual funds receive more than 50 percent of total deposits in the financial system – and in capital flows from developed to developing countries (see d'Arista and Griffith-Jones, 2000). The narrowing of differences between banks and institutional investors, and the fact that securities markets and thus mutual funds also have access to the lender of last resort – nationally in the US but, more importantly, in our context also internationally, due to the frequent rescue packages put together by the IMF in recent serious currency crises – suggests the importance of improving prudential standards for institutional investors such as mutual funds.

As regards portfolio flows to emerging markets, there is an important regulatory gap, because there is presently no regulatory framework internationally for taking account of market or credit risks on flows originating in institutional investors, such as mutual funds (and, more broadly, for flows originating in non-bank institutions). This important regulatory gap needs to be filled, both to protect retail investors in developed countries and protect developing countries from the negative effects of excessively large and potentially reversible portfolio flows.

Given the very liquid nature of their investments, institutional investors can play an important role in contributing to developing country currency crises (for recent evidence, see Kaminsky, Schmukler and Lyons, 1999). It seems important, therefore, to introduce some counter-cyclical regulation to discourage excessive surges of portfolio flows. This could perhaps be best achieved by a variable risk-weighted cash requirement for institutional investors. These cash requirements would be placed as interest-bearing deposits in commercial banks. Introducing a dynamic risk-weighted cash requirement for mutual funds (and perhaps other institutional investors) is in the mainstream of current regulatory thinking and would require that standards be provided by relevant regulatory authorities and/or agreed upon internationally. The guidelines for macroeconomic risk, which would determine the cash requirement, would take into account vulnerability variables as defined by the IMF and BIS (for a more detailed discussion of this proposal, see Griffith-Jones, 2000).

The September 1998 Emerging Markets IOSCO Report (IOSCO, 1998) has in fact described in some detail and evaluated rather positively the above proposal. This report emphasised that "there appears to be scope – and an urgent need for further work. This is very likely to require a multilateral effort – i.e. by regulators from both source and recipient countries in collaboration with the industry."

As regards highly-leveraged institutions (HLIs), the corresponding FSF Working Group rightly focused on two problems: systemic risk linked to high leverage and reduction of market and economic impact of collapse of unregulated HLIs. Particular emphasis was placed on their activities in small- and medium-sized open economies where the potential damage that can be caused by large and concentrated positions can seriously amplify market pressures.

The Working Group considered the possibility of introducing formal direct regulation of currently unregulated institutions. This would include a licensing system, minimum capital and liquidity standards, large exposure limits, minimum standards for risk management, and even an enforcement regime with fines for transgressions. Such regulation was seen to have several very desirable effects, such as regular oversight and the reduction in the likelihood of disruptive market events. However, due to what were seen as both philosophical and practical problems, the Working Group did not recommend applying a system of direct regulation to currently unregulated HLIs at this stage, though it did not reject the possibility of establishing such a regime in the future. It emphasised that the failure to carry through their recommended measures would prompt such reconsideration (FSF, 2000a).

The philosophical objection relates to the fact that direct regulation would not be aimed at investor protection (as investors are sufficiently wealthy or sophisticated to do their own due diligence), but on the mitigation of systemic risk. Nonetheless, it can be argued that mitigation of systemic risk is also an increasingly valid regulatory aim. There are also practical objections, including how to avoid leakage through offshore centres. However, current efforts to improve and complete regulation in off-shore centres should help overcome those problems (see FSF, 2000b). Other practical technical issues are more valid, including the need to adapt capital adequacy and large exposure rules to the specific risk profile of HLIs. This should be done in ways that avoid the adverse effects that capital requirement could have on the efficiency and liquidity of markets in which HLIs



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are significant participants. This seems particularly important in a context when several large hedge funds have been wound down, which may diminish some of the negative impacts they had in recent crises, but could, according to some observers, deprive markets of contrarian actors, with some useful roles to play in financial markets.

The need to directly regulate HLIs may need to be revisited, partly in relation to the implementation (or not) of other measures recommended by the FSF Working Group and their perceived impact.

## IV Capital Account and Prudential Regulations in Recipient Countries

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

The experience of developing countries indicates that the management of capital account volatility requires: (1) consistent and flexible macroeconomic management; (2) strong prudential regulation and supervision of domestic financial systems; and (3) equally strong "liability policies", aimed at inducing good public and private external and domestic debt profiles.[5] Despite the traditional emphasis on crisis management, the focus of the authorities should instead be on the management of booms, since it is in the periods of euphoria of capital inflows, trade expansion and terms-of-trade improvements that crises are incubated. Crisis prevention is thus, essentially, an issue of the adequate management of boom periods. Most of all, unsustainable expansion of spending and currency overvaluation, facilitated by extraordinary access to external financing or temporary export windfalls, should be avoided.

The regulation of capital inflows may be essential in open developing

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5 The literature on national policies is extensive. See, among recent contributions, ECLAC (2000, ch. 8); World Bank (1998), Chapter 3; Ffrench-Davis (2000); Helleiner (1997); and *Ocampo (2000c)*.

economies as a mechanism for monetary and domestic credit restraint and for avoiding unsustainable exchange rate appreciation during booms. Although some appreciation may be inevitable and even an efficient way to absorb the increased supply of foreign exchange, an excessive revaluation may also generate irreversible "Dutch disease" effects. The macroeconomic effects of the regulation of inflows have, unfortunately, received much less attention in the past than the issue of the regulation of outflows during crises. Regulations governing outflows may also play a role as a way to avoid the overshooting of interest or exchange rates, which may have adverse macroeconomic effects, including the greater risk of domestic financial crises. Such regulations are also essential to put in place debt standstill and orderly debt workout procedures. They generate, nonetheless, credibility issues that should not be ignored by the authorities and they would be subject to considerable leakage if improvised during a crisis (see below). It is essential, of course, that any sort of capital account regulation be used as a complement and not a substitute for fundamental macroeconomic adjustment.

Simple rules are preferable to complex ones, particularly in underdeveloped regulatory systems. In this sense, quantitative controls (e.g. flat prohibitions on certain activities or operations) may actually be preferable to price-based signals. An interesting, simple price-based policy tool is reserve requirements on capital inflows, such as those used by Chile and Colombia in the 1990s. These requirements are a particular type of Tobin tax, but the equivalent tax rates (3 percent in the case of Chile for one-year loans and 10 percent or more in Colombia during the boom) are much higher than the percentage proposed for an international Tobin tax. The effects of this system on the magnitude of flows have been the subject of a heated controversy. In any case, since tax avoidance is costly and short- and long-term borrowing are not perfect substitutes, the magnitude of flows should also be affected.[6] A basic advantage of this instrument is that it is targeted at capital inflows and is thus a preventive policy tool. It also has other specific advantages: it is a non-discriminatory price instrument[7] and affects both financial and non-financial agents, thus avoiding arbitration between domestic and external borrowing.

Any mechanism in place must also meet an additional requirement: it must have adequate institutional backing. A *permanent* system of capital account regulations, which can be strengthened or loosened throughout

6 Agosin (1998), Agosin and Ffrench-Davis (1999), Le Fort and Lehman (2000), Ocampo and Tovar (1999), and Villar and Rincón (2000).

7 Ocampo (2000a). Indeed, this instrument is similar to practices used by private agents, such as the sales fees imposed by mutual funds on investments held for a short period in order to discourage short-term holdings. See J. P. Morgan (1998), p. 23.

the business cycles, is thus preferable to the alternation of free capital movements during booms and quantitative controls during crises. Indeed, the latter system may be totally ineffective if improvised during a crisis, simply because the administrative machinery to make it effective is not operative, and it may thus lead to massive evasion or avoidance of controls. Such a system is also pro-cyclical and leaves aside the most important lesson learned about crisis prevention: avoid overborrowing during booms and thus target primarily capital inflows rather than outflows.

From the point of view of borrowing economies, there is growing agreement that in domestic prudential regulation and supervision greater weight needs to be given to the accumulation of short-term liabilities in foreign currencies, to risks associated with the rapid growth of credit, and to currency mismatches of assets and liabilities. This implies that not only the micro- but also the macroeconomic risks typical of developing countries should be taken into account. In particular, due account should be taken of the links between domestic financial risk and changes in key macroeconomic policy instruments, notably exchange and interest rates. Moreover, given these macroeconomic links, prudential regulations should be strengthened during years of financial euphoria to address the increasing risks being incurred by financial intermediaries. These links also imply that the application of contractionary monetary or credit policies during booms (e.g. higher reserve requirements or ceilings on the growth of domestic credit) are strongly complementary to stricter prudential regulation and supervision.

Due to the important externalities which large non-financial firms can generate for the domestic financial sector, particularly in the context of exchange rate depreciation, the external liability exposure of these firms should also be subject to some regulation. Such exposure should be taken into account in risk evaluation, by requiring stricter rules on classification and provisioning standards for domestic lending to non-financial firms with high currency mismatches. Tax provisions (e.g. explicit taxation on external borrowing or exposure, or limits on the deductibility of exchange rate losses) and rules that force non-financial firms to disclose information on their external liabilities may also be relevant complements to such prudential rules. It is unclear, however, whether a system based on such tax and prudential rules is a substitute for direct capital account regulations. A basic advantage of this alternative is that it would facilitate financial integration. However, it would not tackle the direct source of the problem and would be more complex than a simple price-based instrument such as the Chilean-Colombian reserve requirement.

It should also be noted that, due to the strong link between financial and macroeconomic risks, prudential standards should probably be stricter in developing countries. This would be reflected, however, in higher spreads on domestic lending, generating strong incentives for non-financial firms to borrow directly abroad. This confirms that capital account regulations are complementary to stronger prudential regulation.

As the recent literature has emphasised and as the recent experience of many developing countries indicates, crises are associated not only with high debt ratios but also with inadequate debt profiles. The basic reason is that, under uncertain conditions, financial markets respond to gross – rather than only to net – financing requirements, or in other words, the roll-over of short-term debts is not neutral in financial terms. This gives an essential role to "liability policies" aimed at improving debt profiles. Although improving the external debt profile should be the central role of such policies, there is a strong complementary relationship between good external and internal debt profiles. Hence, excessive short-term domestic borrowing may force a government that is trying to roll over debt during a crisis to raise interest rates in order to avoid capital flight by investors in government bonds. Also, excessively high short-term private liabilities increase the risks perceived by foreign lenders during crises, a fact that may induce a stronger contraction of external lending.

In the case of the public sector, direct controls by the Ministry of Finance are the appropriate instrument of a liability policy. Exchange rate flexibility may deter some short-term private flows and may thus partly operate as a "liability policy", but its effects are limited. Direct controls on inflows may also be an appropriate instrument to achieve a better private debt profile. A flat tax or reserve requirement on external borrowing has positive effects on the debt profile, as it induces longer-term borrowing, for which the tax can be spread over a longer time period, and is easier to administer. This effect has been subject to less controversy than the effect of such regulations on the magnitude of inflows.

The former analysis indicates that capital account regulations may be an essential instrument for crisis prevention and management in the face of strong volatility of capital flows and weak international financial safety nets. They may be complementary to other desirable policies in the macroeconomic and financial regulatory areas, and in some cases they may actually be preferable to the alternatives. The foregoing analysis argues, moreover, in favour of using capital account regulations as a *permanent* policy instrument. Of course, they are not foolproof, and some developing countries may prefer to use policy mixes that avoid their use (e.g. more active use of fiscal and exchange rate policies, as well as of prudential regulations) or may prefer a less interventionist environment even at the cost of greater GDP volatility. Thus, the most compelling argument is for maintaining the autonomy of developing countries to manage their capital accounts.



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There are actually no strong arguments in favour of moving towards capital account convertibility.[8] There is no evidence that capital mobility leads to an efficient smoothing of expenditures in developing countries through the business cycle. On the contrary, there is strong evidence that in these countries the volatility of capital flows is an additional source of instability. There is also no conclusive evidence of an association between capital account liberalisation and economic growth, and there are some indications that point in the opposite direction.[9] A simple way to pose the issue is to argue that, even if it were true that freer capital flows, through their effects on a more efficient savings-investment allocation process, have positive effects on growth, the additional volatility associated with freer capital markets has the opposite effect. Furthermore, the absence of an adequate international financial safety net is an equally important argument in this connection. Why should developing countries give up this degree of freedom if they do not have access to an adequate amount of contingency financing with well-defined conditionality rules, and no internationally agreed standstills and debt workout procedures?

## V Emergency and Counter-Cyclical Financing

The enhanced provision of emergency financing during crises is another pillar of the system to prevent and manage financial crises. Although the direct focus of emergency financing is crisis management, it also has crisis prevention effects, as it plays an essential role in avoiding the destabilising expectations that are responsible for the deepening and spreading of crises (contagion) and, ultimately, for systemic failures. This has been, in fact, the essential defense for the role that central banks play at the national level as lenders of last resort. Current international arrangements are weaker in this regard. Indeed, the IMF provides "emergency financing" but certainly not *liquidity*, a fact that is reflected in the lack of automaticity in the availability of financing during crises.[10] Even though the Fund has the capacity to create fiat money, through the issue of Special Drawing Rights (SDRs), it has used this capacity only in the past and in a very limited way.

It is important to emphasise that emergency financing is not a substitute but a complement to strong regulation and debt workout procedures.

8 For a more extensive analysis of this subject, see United Nations Task Force (1999), UNCTAD (1998), Part One, Chapter IV, ECLAC (1998), Part III, Eichengreen (1999), Griffith-Jones (1998), Grilli and Milesi-Ferreti (1995), Krugman (1998a, 1998b), Ocampo (2000a) and Rodrik (1998).

9 See, in particular, Eatwell (1996), Rodrik (1998) and, for Latin America, Ocampo (1999).

10 This important distinction is made by Helleiner (1999). For a fuller discussion of this issue and its relation to IMF access to adequate resources, see Mohammed (1999).

Regulatory changes help smooth capital flows to emerging markets. Together with private sector involvement in crisis resolution, through adequate debt workouts, they are essential to avoid moral hazard. However, the view that the appropriate way to combat moral hazard is by scaling down the role of the IMF in providing financial packages would make crises even more costly and/or lead to a sharp reduction in private flows to developing countries. In the current context of large and volatile private flows there may even be a case for significantly larger official emergency financing than currently exists. The great majority of recent reports support this view, with the major exception of the Meltzer Report (although the minority view in Meltzer also strongly values the broad role of the IMF).

The main lessons from recent crises are that: (1) as a preventive measure, wider use should be made of private contingency credit lines that are agreed during periods of adequate access to capital markets, following the (partly successful) pioneering experiences of some emerging economies; (2) large-scale funding may be required, though not all of it needs to be disbursed if support programmes rapidly restore market confidence; (3) funds should be made available *before* – rather than after – international reserves reach critically low levels; and (4) that, due to strong contagion effects, contingency financing may be required even by countries that do not exhibit fundamental disequilibria. Positive measures have been adopted in this area, including a significant expansion of IMF resources through a quota increase and the New Arrangements to Borrow, which finally entered into effect in late 1998; the launching of a new window in December 1997 to finance exceptional borrowing requirements during crises; and the creation of the Contingent Credit Line in April 1999 to provide financing to countries facing contagion and its redesign in September 2000.

The major controversies relate to inadequate funding, the design of some specific credit lines and the broadening scope of conditionality. With respect to the first issue, bilateral financing and contributions to the IMF will continue to be scarce during crises. This might reduce the stabilising effects of rescue packages, if the market deems that the intervening authorities (the IMF plus the major industrial countries) are unable or unwilling to supply funds in the quantities required. As bilateral financing and contributions to the IMF will continue to be scarce and unreliable in crises, the best solution may be to allow additional issues of SDRs during episodes of world financial stress; these funds could be destroyed once financial conditions normalise.[11] This procedure would create an anti-cyclical element

11 See United Nations Task Force (1999), Council on Foreign Relations (1999), Group of 24 (2000), Camdessus (2000).



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in world liquidity management and would give SDRs an enhanced role in world finance, a principle that developing countries have advocated in the past and should continue to endorse in the future. Second-best alternatives are to make a more active use of central bank swap arrangements under IMF or BIS leadership, and or to allow the IMF to raise the resources needed in the market.

It is useful to put the discussion of the second issue in the broader context of the functions that IMF facilities have to perform in today's world. There is, first of all, the traditional need for emergency financing to face balance of payments crises due to two sets of causes or a mixture of both: (a) inconsistent macroeconomic policies, and (b) traditional external shocks, such as a deterioration in the terms of trade, increased interest rates in developed countries, and/or a slow-down in developed countries' growth. The Stand-By Arrangement (SBA), the Extended Fund Facility (EFF) and the recently modified Compensatory Financing Facility (CFF) have for some time dealt with this traditional need.

There is, secondly, the new need for specific credit lines that are linked to "21st century-style" currency and financial crises, which are mainly caused by the interaction of volatile capital flows and domestic financial fragilities, and which can spread via contagion amongst countries (including those with fairly sound macroeconomic fundamentals). The challenges here are both improved crisis prevention and better crisis management if these crises do occur. Recent crises have led to the creation of the Supplemental Reserve Facility (SRF) and the above mentioned Contingent Credit Line (CCL). While these facilities reflect the clear new need for significantly enhanced public liquidity provision in a globalised world, where the risk of crises has significantly increased, they do not go as far as may be desirable and necessary in the provision of official liquidity financing.

There is, thirdly, the special need to provide credit lines to low-income countries, to strengthen in a sustainable way their balance of payments position, whilst supporting growth and poverty reduction. In 1999, the traditional facility in this area, ESAF was transformed into the Poverty Reduction and Growth Facility (PRGF).

This broad menu is essential to respond to the call by the G-24 for the Bretton Woods institutions to "maintain a range of instruments to address the needs of their diverse membership". It should be added that in the first two cases, but possibly also in the third, IMF lending should be perceived as "a bridge to and from private sector lending" (Summers, 2000).

Some IMF facilities seem to function fairly well, as regards the scale of financing they provide, and the circumstances under which they are used, although the nature and the scope of the conditionality applied should be narrower, as will be argued below. The facilities that function reasonably well to meet current needs are the stand-by arrangement (SBA), which will remain the Fund's main instrument, and the Extended Fund Facility (EFF). Some observers have challenged the value of the EFF, in spite of its importance to developing countries because it allows longer periods of adjustment to balance of payments disequilibria of a structural character. The simplified CFF can also perform a useful function in helping primary-producing countries cope with exogenously determined terms of trade shocks. However, the CFF should be expanded to cover the full extent of export shortfalls, and its conditionality reduced, given the fact that the cause of the problem is international. The fairly recently created Supplemental Reserve Facility (SRF), designed to provide exceptional financing during crises, has also worked well, even though resource limitations make it fall short of what would be desirable in today's world.

The CCL was created as "a precautionary line of defense readily available against future balance of payments problems that might arise from international financial contagion" (IMF, 1999). The philosophy of the IMF moving more strongly into precautionary lending – to reduce the chances of countries being caught by contagion, and give leverage to the IMF to encourage countries to pursue policies that would make crises less likely – is clearly the right one. However, the fact that the CCL has not been used since its creation in April 1999 reflects design problems that were only partly corrected in the recent redesign of this facility. These include: (a) the limited scale of the facility; (b) the lack of automatic triggering in the original design, which was partially corrected by making "activation" a fairly automatic process, though still requiring a "post-activation" review that would result in a conditional adjustment programme; (c) the "two-phase or double conditionality" that characterises such design; and (d) the fear of countries that private lenders and investors might see the use of the CCL as "the ambulance outside the door", which could contribute rather than deter a speculative attack or withdrawal of flows.

An active monitoring of the experience with the CCL is thus necessary to improve this clearly innovative facility. As pointed out above, if these and other new facilities (the SRF, in particular) are to be made more effective, they must be accompanied by better regulation to avoid problems of excessive moral hazard. Debt standstills and orderly debt workouts would also help reduce the excessive costs borne by debtor countries in crises under present arrangements (for detailed discussions, see UNCTAD, 1998, and United Nations Task Force, 1999). However, care must be taken in designing such measures so that they do not excessively discourage private flows to developing countries nor significantly increase their cost (Soros, 2000).



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As regards the issue of Fund conditionality, it is now accepted that it should be streamlined, refocusing on the IMF's central competencies (see IMF International Monetary and Financial Committee, 2000), thus reversing the trend towards increase in its areas and scope over the past two decades. Furthermore, while conditionality is clearly valuable when domestic policies are the source of macroeconomic diseliquibria that lead to balance of payments and financial difficulties, its relevance is unclear when difficulties are generated by external shocks such as contagion.

As Rodrik (1999) clearly warned in relation to the recent widening of conditionality, "An unappreciated irony is that conditionality on developing countries is being ratcheted up at precisely the moment when our comprehension of how the global economy works and what small countries need to do to prosper within it has been revealed to be strongly lacking (...) The reality is that our prescriptions often go considerably beyond what can be supported by careful theoretical reasoning or empirical demonstration". Conditionality should thus be carefully tailored to the specific circumstances of the particular balance of payments problem faced.

The Fund's core competence has traditionally been in macroeconomic policy and has rightly been expanding into financial vulnerabilities, as their interactions with the macroeconomy are strong. The new emphasis on growth and poverty reduction as a key aim for Fund programmes and of countries' macroeconomic policies, especially in low-income countries, is clearly welcome, as is its greater collaboration with the World Bank on these issues. However, it should not lead the Fund into involvement in detailed poverty-related conditionality. Similarly, great care must be taken that in both middle-income and low-income countries, the large number of standards and codes of conduct that have arisen after the Asian crisis, however useful they may be individually, do not collectively pose an excessive burden (via IMF conditionality) on countries' administration and policymaking. Indeed, it seems best if implementation of such standards remain voluntary. On the other hand, to ensure that Fund conditionality truly contributes to growth, automatic rules could be included in Fund agreements with countries to ease the restrictions of the adjustment programme, should evidence of overkill become clear.

Finally, but most importantly, the principle of ownership of policies should be respected, not just in rhetoric but in actual practice, and should cover all areas of policies, including short- and long-term macroeconomic policies and poverty-reduction strategies. This can only be possible if policy alternatives suggested by the authorities are actually discussed, even if they contradict the traditional preferences of IMF and World Bank programmes. Indeed, the principle of ownership can only be effectively pursued in the context of a broad policy discussion which goes beyond the narrow range of alternatives that have been the focus of both macroeconomic and structural conditionality over the past two decades.

## VI Development Finance

Private capital flows can and should play not only an important, but hopefully a growing role in international development finance. However, there are clear and important market gaps in private lending and investing in developing countries, which can only be filled by official development assistance and multilateral lending. There are also important circumstances where such aid and multilateral lending can help catalyse additional developmentally valuable private flows, which would otherwise not take place. Many private bankers and institutional investors are aware of such limitations and welcome official flows both to fill market gaps and to help catalyse new private flows.

The unwillingness of private lenders and investors to provide long-term financing is particularly critical for low-income countries (see Table 2). This is also true for smaller economies (even middle-income ones), given that entering these economies has high transaction costs. Therefore, the share of multilateral lending in total external lending tends to be far higher in smaller than in larger countries. Also, private lenders and investors are less willing to channel resources to activities where the social returns (such as education, health and sustainable development) may be higher than the private returns, especially in the short to medium term, or that are riskier but developmentally essential (such as lending to the financial sector in times of crises).

Official financing is provided on clearly advantageous terms and conditions as Table 3 indicates. Loans from both bilateral and multilateral sources have longer payback periods and lower interest rates than private credit. These characteristics are especially strong in new lending to the relatively less developed countries, but are equally valid for middle-income ones. Indeed, a very large proportion of bank lending to developing countries is very short term – less than one year. According to BIS data, in mid-1999, the proportion of short-term lending to total bank lending for all developing countries was 49.6 percent, a proportion that had been even higher in the previous years. As a result, any large shift from official to private sector borrowing would significantly decrease the average maturity of the debt of these countries, which would increase, in turn, the risk of volatility and *reversibility* of such flows.

It should be added that these problems are even more acute in domestic financing. In certain developed economies (e.g. Greece or Portugal), but



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**Table 3 Developing Countries: Average Terms of New Commitments**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|---|---|---|---|
| **Average maturity** (years) | | | | | | | | | |
| ***Official*** | | | | | | | | | |
| All Developing Countries | **22.2** | **20.9** | **21.1** | **21.4** | **22.1** | **19.2** | **21.2** | **20.1** | **18.5** |
| Income Groups | | | | | | | | | |
| Low Income | 27.0 | 25.9 | 26.8 | 25.4 | 26.2 | 24.4 | 26.8 | 26.2 | 26.6 |
| Middle Income | 18.8 | 17.8 | 17.0 | 18.1 | 18.4 | 15.8 | 17.2 | 17.2 | 14.2 |
| ***Private*** | | | | | | | | | |
| All Developing Countries | **13.9** | **10.2** | **10.0** | **9.4** | **8.9** | **7.4** | **8.3** | **10.0** | **8.8** |
| Income Groups | | | | | | | | | |
| Low Income | 13.7 | 11.5 | 12.3 | 11.3 | 11.2 | 8.0 | 7.5 | 7.0 | 7.0 |
| Middle Income | 13.9 | 9.9 | 9.0 | 8.4 | 8.1 | 7.2 | 8.6 | 10.8 | 9.0 |
| **Average interest** (%) | | | | | | | | | |
| ***Official*** | | | | | | | | | |
| All Developing Countries | **5.5** | **5.5** | **5.3** | **4.8** | **4.9** | **5.8** | **4.8** | **5.4** | **5.2** |
| Income Groups | | | | | | | | | |
| Low Income | 4.0 | 4.5 | 3.8 | 3.8 | 3.9 | 4.5 | 3.9 | 4.2 | 3.7 |
| Middle Income | 6.6 | 6.1 | 6.4 | 5.6 | 5.8 | 6.7 | 5.6 | 6.0 | 6.0 |
| ***Private*** | | | | | | | | | |
| All Developing Countries | **8.5** | **7.8** | **6.8** | **6.3** | **6.3** | **6.4** | **7.3** | **7.3** | **7.9** |
| Income Groups | | | | | | | | | |
| Low Income | 7.9 | 7.5 | 6.7 | 6.0 | 5.7 | 6.4 | 6.6 | 6.4 | 6.9 |
| Middle Income | 8.8 | 7.8 | 6.9 | 6.4 | 6.5 | 6.4 | 7.5 | 7.5 | 8.0 |

*Source:*
World Bank, *Global Development Finance, 2000*, Washington, D.C., April.

more so in middle-income developing countries and even more in low-income developing countries, domestic capital and financial markets are relatively underdeveloped, especially for long-term maturities. Country risk is seen as relatively higher than elsewhere, which means that only shorter maturities are available.

Not only is multilateral lending more long term, it also tends to be counter-cyclical. During the debt crisis of the 1980s, World Bank lending increased significantly, thus helping to compensate the contractionary effects on the economy of the large falls in private lending. A similar pattern has been observed during the years of contraction in private flows to developing countries that was unleashed by the Asian crisis (see Griffith-Jones and Ocampo, 1999, Table 4). As we will see below, the role that development banks play in this regard is complementary to that of the IMF.

Not only does multilateral lending step in to fill important market gaps; also, of clear importance, is its catalytic role in encouraging additional private flows, especially to countries (e.g. poorer and smaller countries) or sectors (e.g. social and infrastructure) with limited access to private finance. It can also play a useful role in supporting the renewal of capital flows after crises. The preferential relations of development banks to countries are seen as the crucial factor in reducing the risks to private lenders or investors. It should be emphasised that the financial corporations associated to development banks play an essential role in this regard. Private lenders and investors clearly appreciate and value this catalytic role.

For low-income countries, the major issue is the reversal of trends in ODA flows, particularly those originating in the largest industrialised economies. ODA levels should meet the target of 0.7 percent of industrialised countries' GDP agreed upon in the framework of the United Nations. It is important that efforts to accelerate the Highly-Indebted Poor Countries (HIPC) Initiative should not crowd out new ODA financing in the budgetary processes of the industrialised countries. ODA should also provide additional resources to support the provision of global public goods, or those with strong international externalities, including peace processes, the global sustainable development agenda (climate change and conservation of biodiversity) and the fight against the worldwide drug problem. Recipient countries should obviously improve the efficiency and transparency with which resources are used.

Equally important, however, is the acceleration of the growth of multilateral lending. Multilateral lending should continue to play an essential role in at least four areas: (1) to channel funds to low-income countries; (2) to provide long-term financing to middle-income countries that do not have adequate access to private funds; (3) to act as a counter-cyclical balance to fluctuations in private capital market financing; and (4) to play a catalytic role for attracting additional private flows. To these we should add the traditional "value added" of multilateral financing: lending-associated technical assistance. Given the fact that old functions are still relevant and new ones (such as counter-cyclical lending) have been added, there is a case for additional resources.

The first of these functions underscores the central role that financing from IBRD-IDA and the regional and sub-regional development banks will continue to play in the immediate future with respect to low-income countries, as a complement to ODA flows. It has received widespread support in recent debates. The second and third functions emphasise the role that multilateral development financing will continue to play even for middle-income countries.[12]

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12 Some authors reject, nonetheless, the validity of these arguments. The strongest argument in this regard is that of Meltzer *et al.* (2000) but a weaker version can be found in Gilbert, Powell and Vines (1999), who nonetheless argue that the World Bank should be allowed to lend to middle-income countries to improve its portfolio.

The central role that multilateral banks play in the provision of counter-cyclical financing should be seen as a complement to balance of payments financing provided by the IMF. Financing from multilateral banks constitutes for many countries the only long-term financing that is available during crises. This type of funding is essential to smooth out necessary fiscal adjustments, averting the need to cut critical social programmes and making it possible to introduce social safety nets (see below). No less important, the support provided by multilateral banks, together with IMF financing, have acted, as major catalysts in shoring up or regaining confidence in countries at times of crises and hence in helping to restore private flows. In this regard, there have been some pioneering operations aimed at guaranteeing service on public debt in bond issues made at times of great uncertainty in capital markets.

The large-scale requirements for counter-cyclical financing to middle-income countries during crises may crowd out financing to poor countries. If multilateral development financing is not significantly expanded, its role as a counter-cyclical device will necessarily be very limited, and it would certainly be of secondary importance relative to its first two roles, particularly the provision of long-term development financing to poor countries. This is underscored by the data from Table 2, which indicate that multilateral financing in 1992-1998 represented only 15 percent of that provided by the private sector, excluding FDI, and only 8 percent in the case of middle-income countries. Thus, a useful counter-cyclical function would certainly require a significant increase in resources available to multilateral development banks or a more active use of co-financing and credit guarantees by these institutions.

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

Multilateral banks have been involved in the former for a long time and have also accumulated some experience with the latter. However, the preferred mechanism since the late 1980s has been social emergency funds (later transformed in many countries into more stable social investment funds). Although they have introduced some innovations in social policy (e.g. competitive mechanisms to allocate resources and civil society participation in social policies), their effects have been rather limited, their targeting has not always been effective and they may have crowded out resources from long-term social policies.[13] Other instruments have also been used in the past by developing countries, including some types of unemployment insurance (the major instrument of its kind in the industrialised world), emergency employment or emergency labour-intensive public works programmes, income-support schemes in conjunction with training, and some nutrition programmes. The recent crisis seems to have led to the design of new instruments: special subsidies to households with school-age children that are tied to school attendance, and various support programmes aimed at ensuring that families with an unemployed head of household do not lose their home during crises.

Recent analyses have come to some basic conclusions about these programmes. Firstly, safety nets must be part of *permanent* social protection schemes, as only a permanent scheme guarantees that the programme coverage will respond without lags to the demand for protection of vulnerable sectors during crises.[14] Secondly, given the heterogeneity of labour markets in developing countries, a combination of several programmes, with different target groups, is necessary. Thirdly, these programmes must be adequately financed and should not crowd out resources from long-term investment in human capital. This leads to a fourth conclusion: the effective functioning of social safety nets requires that public sector expenditure should include anti-cyclical components. This would be impossible – without generating inefficiencies in the rest of public sector expenditure – unless fiscal policy as a whole is counter-cyclical, a point that has not been sufficiently emphasised in current discussions. In the absence of this anti-cyclical fiscal pattern, external financing from development banks during crises will be unnecessary or, at best, illusory, as overall net fiscal financing requirements will actually decrease despite the increased spending associated with social safety nets.

Development banks and their associated financial corporations should also act as catalysts for private resources through three different mechanisms: guaranteeing timely payment of public debt, or the timely discharge of liabilities (in the form of guarantees or subsidies) assumed by the State in support of private projects; the direct financing or co-financing of innovative private projects, provided by the banking system directly or by the related financial corporation; and risk capital provided by the financial corporation to innovative firms. These mechanisms have been developed in a

13 See, in particular, Cornia (1999).

14 This issue is highlighted in the best available analysis of the subject (Cornia, 1999), which also emphasises the need for adequate financing.

variety of ways by the development banks and their corporations, and have served particularly to boost private sector investments in infrastructure. One new mechanism could be to underwrite bond issues by countries that have not previously used this financing modality.

In all these cases, as well as in the guarantees offered on public sector bond issues at times of crisis, private investors value not only the solidity of multilateral institutions, but also their privileged relationships with governments, which gives added value to their support, beyond the funds they provide. Guarantee mechanisms need to be carefully designed, so that they only cover those risks which the markets themselves are unwilling on their own to cover, thus leading to additionality of flows. Both multilateral lending and guarantees should only be given when projects have been carefully evaluated and are economically viable. Naturally, the modalities used by the multilaterals to help catalyse private flows need to be reviewed and evaluated carefully, so that relevant modifications, improvements and updating can be introduced to maximise their development impact and minimise any problematic effects, not least of which are possible negative effects on the rating of multilateral banks.

The preferential relationship with developing countries as well as risk dispersion have resulted in multilateral development banks obtaining better risk-ratings than the countries or the regions they belong to, even when such institutions are entirely owned by developing countries (such as the Andean Development Bank – C*orporación Andina de Fomento*). This enables them to gain access to external funds at a lower cost than the countries can individually, thus performing useful intermediation activities. The overestimation of risk, typical of private capital markets, is another source of profitable intermediation by such institutions.

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# Comment on "Facing the Volatility and Concentration of Capital Flows," by Stephany Griffith-Jones and José Antonio Ocampo

*Wouter Raab*

## Introduction

Stephany Griffith-Jones and José Antonio Ocampo have written a broad and wide-ranging paper that touches on almost every aspect of today's discussion on the international financial architecture. In the short time that is allotted to me, I cannot do justice to the wealth of arguments they have put forward. It is not possible to state all the things that I agree with because they are too many. Let me therefore concentrate on a few issues where I have a divergent view and where I may have some additional observations to offer.

I would like to comment on the following subjects: (i) the role of the IMF and whether it should develop into an international lender of last resort (LOLR); (ii) regional cooperation and institutions; and (iii) national autonomy and current account convertibility. I will make these observations on a personal basis and not as a representative from the Ministry of Finance.

## International Lender of Last Resort

Griffith-Jones and Ocampo say that one of the fundamental tasks of the international financial institutions (IFIs) is the provision of liquidity and that, as a result of recent capital account crises, the role of the IMF should further develop into that of an international lender of last resort. They are in good company (Stanley Fischer). I have my doubts:

- It would give the wrong signal to private lenders, since without significant changes to the framework under which private lenders operate, it would amount to bailing them out;
- Countries are not like banks: a country cannot be declared insolvent and bankrupt; you can't close a country down, nor can you replace the management. Consequently, there is no exit strategy: once you started



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to provide emergency liquidity assistance, there is no choice but to continue, even if a country is not mending its ways;

- To enable the IMF to play a credible role of international lender of last resort it needs to have much more resources which are not going to be forthcoming: the worst thing is to have an international lender of last resort without sufficient resources. There are three ways to increase resources to the IMF which all face serious stumbling blocks: (a) a quota increase which the US Congress will block; (b) borrowing on the capital markets; and (c) SDR creation;
- The political realities under which an international LOLR operates would be totally different from a national LOLR: the provision of liquidity is driven more by political considerations than by economic and financial ones (e.g. large emerging markets have powerful allies; the IMF is just a pawn in the hands of the large countries). Although it is not a new issue, countries like the Netherlands are concerned about a further shift of the IMF into the political arena.

In the Netherlands, we have become very concerned about the very large size of the rescue packages to Korea, Brazil and Indonesia. The result has been a concentration of IFI resources in a small number of countries. Through the contribution of the multilateral development banks to these packages, our government guarantees were abused by providing balance of payments assistance to middle-income countries instead of financing development programmes.

In my view, the emphasis in the discussion is too much on the provision of large-scale emergency packages, which should be made available more upfront and more automatically with less conditionality, even beyond the present IMF Supplemental Reserve Facility (SRF) and Contingent Credit Line (CCL) as Griffith-Jones and Ocampo argue. The origin of the crisis and subsequent developments are characterised more by the imperfect functioning of capital markets (e.g. herd behaviour, lack of information or asymmetrical information, and the concentration in a small number of countries) and by unfortunate policies of the countries concerned. By and large, the response of the international community (i.e. IFIs and creditor countries) has been appropriate. Evidence to this fact is the relatively quick recovery of the countries concerned and the modest impact on the world economy as a whole.

It is fine to think about streamlining the provision of emergency assistance, because the process has been murky, *ad hoc* and time-consuming on occasion, but the emphasis should be much more on enhancing the IMF's role as a lender that catalyses private lending and involving the private sector more directly from the outset in the resolution of a liquidity crisis. No emphasis should be placed on automatic gap-filling by the IMF or any other public institution. It is more a question of balance than a black and white distinction of whether the IMF should or should not provide quick and large-scale liquidity assistance.

### A New Framework for Private Sector Involvement

Much of the policy responses of the past couple of years have addressed the right issues. Financial sector regulation and frameworks for prudential supervision have been strengthened in emerging markets while governments have also been made more aware of the trade-offs in macroeconomic policies, such as between exchange rate policy and domestic monetary policy. There has also been more attention paid to asset and liability management, including the appropriate level of reserves against short-term foreign currency liabilities.

However, much less progress has been achieved with regard to the functioning of international capital markets. For example, risk is still not being factored in enough into lending decisions by private lenders. That can only be changed by changing the framework in which they operate. Prudential supervision and increasing the risk weightings and provisioning requirements for lending to emerging market countries are essential. But, in addition, we need to change the distribution of benefits and risks for private lenders in situations of liquidity crises.

There has been too little progress on private sector involvement. There is too little assurance that the next time around, which hopefully doesn't come, the private sector will be involved more directly from the outset. Therefore, in consultation with the private sector, we need to explore a framework for private sector involvement. This framework should not be rigid and could include a couple of principles that we can follow when a country is in a international liquidity crisis. This framework should be made public beforehand so that private lenders can factor it in into their lending decisions.

Contemporary liquidity crises originate in the volatility of foreign capital inflows and their large size relative to that of the domestic financial sector and capital markets. When a sudden decrease in capital inflows takes place in a crisis situation, the liquidity needs will almost certainly exceed standard IMF access limits.

Instead of immediate and automatic gap-filling through some kind of emergency facility by the IMF, the IMF should first determine the adjustment effort of the country concerned and determine the size of the financing gap. Subsequently, it would have to decide which part of the gap would have to be filled by the public sector and which part by the private sector (through roll-overs and new exposure). If private sector financing is not forthcoming, the country concerned could declare a temporary debt standstill during which an orderly debt work-out arrangement would be negotiated. As long as the country negotiates in good faith, the IMF and other official creditors could continue to lend to that country during these negotiations.

Such a framework would have to be made public beforehand, before any liquidity crisis takes place. The private sector would then know that there would be no more bailouts and that, in a liquidity crisis, it would have to roll over its exposure, and come forward with new loans or take losses. If this leads to higher spreads on loans to emerging markets reflecting the higher risk and lower loan volumes, it would be desirable because it would reflect the risks of lending to emerging markets.

Such a framework would bring private benefits and costs more in line with social costs. This approach would be more efficient than solutions which rely on an international lender of last resort creating a wide and probably increasing divergence between social and private returns from international lending. I am convinced that private agents should be confronted with the social costs of their actions and that pure contagion is a rarely observed phenomenon in emerging markets. This is not to deny the serious consequences of financial crises. However, they do not justify a remedy (an international LOLR) that allows policies to continue in which the benefits of international lending fall to the private sector and the costs are borne by the public sector.

In addition, an international lender of last resort is not able to prevent a crisis. By providing the wrong incentives, it would only make matters worse. As a tool of crisis management, I even doubt whether it would be able to achieve much. Given the political sensitivities involved, the activation of liquidity support would first require the occurrence of a negative shock. Most probably, it would be activated only after capital flight had occurred, and after the drying up of capital inflows would have already attacked the currency and stock market. Confidence would have already been shocked and, if contagion exists, it would already have done much harm to other debtor countries. Thus, most of the costs of an international liquidity crisis would have already been incurred. The only thing a lender of last resort would then do is transfer money from the public to the private sector. This would, in my view, only be justified if the social benefits exceed the costs, which I am not convinced would be the case in an international context.

Obviously, the case of a single private bank is different from a country. Because the general public's knowledge about an individual bank is much less than the knowledge of international banks about a country's economic situation, a lender of last resort can provide assistance to a private bank before the general public knows that there is a problem and before the confidence in the financial system is shaken. This is not the same for a borrowing country. Lending goes on too long and is rationalised by false arguments. A crisis is rarely invoked by the country concerned, but almost always by private lenders who finally realise that the debt build-up is unsustainable. As a result, the crisis occurs and the liquidity assistance from the LOLR comes too late to prevent it.

## Regional Cooperation and Institutions

Griffith-Jones and Ocampo say many things about regional cooperation with which I agree. I represent a region which has far-reaching forms of cooperation. I do not belong to the group of people from industrialised countries that frown upon attempts at regional economic and financial cooperation. Of course, there is an issue about the relationship between regional cooperation and the IMF, but what is good for us in Europe can almost certainly not be wrong for other parts of the world.

Particularly in Asia, there are good reasons for exploring the possibilities for further economic and financial cooperation. There are some highly-developed financial centres in the region, and alongside the high-deficit countries there are some high-surplus countries. In short, there is money and expertise in the region. Financial stability can be enhanced by recycling Asian current account surpluses through Asian institutions and financial centres to countries with current account deficits. Currency and maturity mismatches could be diminished in this way.

At the same time, we need to be realistic as well. It will take some time before Asia will have developed well-functioning forms of regional economic and financial cooperation. There is no such thing in Asia as a Franco-German axis to provide balanced leadership. There is great cultural, political and economic diversity in Asia, making it more difficult to find forms of cooperation in which every country can participate on an equal footing. It will be essential to prevent the pitfalls that Europe experienced when providing balance of payments assistance to member countries. In Europe, Greece, for example, received financial assistance from the EU in the 1980s and early 1990s with hardly any conditionality. This seriously slowed down the necessary adjustment in Greece. In order to avoid these same traps in Asia, I believe it is essential to work closely together with the IMF on the terms and conditions when providing balance of payments support. As cooperation within Asia matures and intensifies, the link with the IMF can be gradually loosened. The stronger the economic integration in Asia becomes, the stronger the incentive to exert strong multilateral surveillance and peer pressure on participating country's economic policies.

This is clearly demonstrated by developments in Europe. Economic policy coordination in Europe under e.g. the Stability and Growth pact, provides much stronger pressure on countries to change their fiscal policies than any IMF advice could ever have.

The role of the IMF for Europe is now to give an independent non-political expert's advice on a country's economic policy. But above all, the IMF now focuses on the appropriateness of the overall policy mix in the euro area and the interaction of EU policies with the rest of the world. So a division of labour between European institutions and the IMF is gradually developing which leads to better results for the region and the world as a whole. I subscribe to Griffith-Jones and Ocampo's views regarding the division of labour between regional institutions and the IMF. To the extent that it keeps the IMF on its toes and makes it more responsive to outside experts' views, it will also improve the functioning of the IMF.

Since it will take time to build up well-functioning and credible forms of regional cooperation, there is nothing to argue against starting with such forms in Asia or any other part of the world.

**Current Account Convertibility**

Having once been an enthusiastic supporter of capital account liberalisation, recent developments have led me to believe that capital account convertibility is not automatically good for every country. In addition to the arguments put forward by Griffith-Jones and Ocampo (consistent and flexible macroeconomic management, adequate prudential regulation and supervision, and well-articulated liability management), I want to mention the size and the development of the domestic capital market. If this market is small in comparison to the size of capital inflows, it would be absolutely incapable of absorbing or dampening any shock from the inflow of foreign capital. It would make the country very vulnerable to the shock-waves coming from the volatile international capital markets. Any country in such a situation would do well to have mechanisms in place to control or regulate the inflow of foreign capital. Simultaneously, such a country would need to develop both the depth and breadth of its capital markets before it could seriously consider a further dismantling of capital controls. Of course, such restrictions should not substitute for sound macroeconomic adjustment. Depending on the level of development and sophistication of the domestic capital market and financial sector, the liberalisation of capital flows should be sequenced in such a way as to take them into account.



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# Reforming the International Financial System: Prospects for Regional Financial Cooperation in East Asia

*Yung Chul Park and Yunjong Wang*

## I Introduction

The painful lessons learned from the emerging market crises since 1997 raise the question of the adequacy of the current global financial system, and has awoken interest in rethinking and redesigning the international financial architecture. Numerous proposals have been made by academics, policymakers and financial experts. They include the G-7 Finance Ministers' Report, the Meltzer Commission Report, the Task Force Report sponsored by the Council on Foreign Relations, and the Financial Stability Forum's recommendations. However, these proposals have been frequently criticised because emerging market views are not fully recognised and because they do not address emerging markets' vulnerability to global financial systemic risks.

These proposals begin with the premise that structural weaknesses and short-run macroeconomic imbalances in the East Asian countries were responsible for triggering and spreading the crisis through East Asia and beyond. As such, these proposals focus on structural reforms in these countries: strengthening the prudential regulatory system for banks; improving accounting practices and disclosure requirements for increased transparency; creating accountable and transparent corporate governance; and promoting greater flexibility in the labour market.

In a recent paper, Furman and Stiglitz (1998) suggest that these structural weaknesses were not necessarily the cause of the crisis, since structural reforms were not needed in gaining access to international capital markets. This does not mean that the crisis countries in East Asia do not have to carry out structural reforms. Such reforms will reduce the vulnerability of these countries to speculative attack. Be that as it may, a more balanced approach toward creating a new international financial architecture should be taken; it should address the problem of market failures that beset international capital markets and that often trigger financial panic and herd behaviour.

Frustrated by the lack of progress in reforming the international finan-



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cial system, East Asians have begun to search for a regional defense mechanism to complement the G-7 led reform efforts. They believe that the establishment of a regional credit support mechanism will help prevent the recurrence of crises, and will be a more effective mechanism to manage future crises.

Before the Asian financial crisis broke out in 1997, few would have argued for the creation of one or another form of regional arrangements in East Asia. East Asians did not have major incentives to encourage regional integration. According to Lawrence (1996), East Asians, or more broadly Asians, faced great obstacles to forming arrangements of their own that are patterned after those in Europe and North America. In contrast to the policy-led integration of Europe, a market-led process of integration was already taking place in East Asia. Given their history of enmity, competition and the uneven distribution of power, many neighbouring countries did not dream of creating a regional bloc. The East Asian countries had no impelling need to engage in any regional arrangements. They were also hardly prepared to make the structural adjustments and policy changes that a regional arrangement would require.

For these reasons, the achievements of ASEAN have fallen short of the initial expectations and much of the earlier skepticism that surrounded APEC still remains, as Lawrence has pointed out. Without a major breakdown in the global trading system, East Asia did not have any incentive to form a regional cooperative arrangement. However, the financial crisis that erupted in 1997 was a major financial breakdown that gave East Asians a strong impetus to search for a regional mechanism that could forestall future crises. This search is now gathering momentum, despite the fact that recovery has been much faster than expected.

Section II discusses a number of recent developments – both intra- and extra-regional – that have moved East Asians toward forming regional financial arrangements and the pros and cons of such arrangements in general. Section III examines the adoption and enforcement of global standards and codes of conduct proposed by a number of international financial institutions and other international organisations. In Section IV, the role of the IMF as a crisis manager and lender and its relevance to emerging market economies (EMEs) are considered. Concluding remarks are found in Section V.



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## II Regional Financial Arrangements in East Asia

### *Arguments Against Regional Arrangements*

The speed of recovery in East Asia since the middle of 1999 has been impressive. It is expected that recovery will continue in 2000 and help East Asia to return to the pre-crisis trend of growth. Despite the optimistic outlook for East Asian growth, there are widespread concerns that the current economic upswing in the crisis-hit countries does not necessarily mean that the region is out of the danger zone. In the eyes of many western investors, many of the vulnerabilities in East Asia that brought about the crisis have not disappeared. In the eyes of East Asians, few of the structural deficiencies of the international financial system that contributed to the crisis have been rectified.

For over two years, all of the East Asian crisis countries, except for Malaysia, have dutifully followed the IMF reform programmes to make their corporate and financial sectors more transparent, efficient and resilient to financial market instability. Although the reform processes in these countries are far from over, there is a growing concern that the economic reform they have embarked on, even if it is completed to the satisfaction of the IMF and western investors, may not necessarily safeguard them against future crises so long as the reform of the international financial system is deferred or pushed forward without consideration of the institutional and structural characteristics of emerging market economies (EMEs).

The reform effort, led by the G-7, has been losing steam and, from the point of view of East Asians, does not address the supply side problem of international financial markets. The small and medium-sized open economies in East Asia in particular may not be able to fend off speculative attacks on their own in the rapidly globalising and virtualising world economy. East Asians do not believe that the proposed domestic reforms, even if fully implemented, will help them secure their financial stability.

For these reasons, there has been increasing support in East Asia for developing a regional mechanism of defense in the form of financial cooperative arrangements. This support has culminated in the Chiang Mai Initiative of the ASEAN members and three other Asian countries to create currency swap arrangements.[1] The agreement is widely perceived as

1 Asia's three economic powerhouses – China, Japan and Korea – along with the 10 members of ASEAN, agreed during the Asian Development Bank (ADB) annual meeting in Chiang Mai, Thailand, to expand an existing network of arrangements designed to ward off a crisis similar to the one that rocked the region in 1997. The plan, dubbed the Chiang Mai Initiative, calls for a network of bilateral currency swap-and-repurchase arrangements and implies the establishment of a system of pooled reserves that central banks could draw upon to buy time when their currencies come under speculative attack.



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a major step toward strengthening financial cooperation among the East Asian countries.

After the crisis touched off in July 1997, Japan's proposal to create a regional monetary fund in East Asia received a positive response from a number of East Asian countries. The idea was, however, strongly opposed by the US, the European countries and, of course, the IMF for a number of reasons.

Eichengreen (1999) and others dismiss the contention that an East Asian regional fund may have a comparative advantage in diagnosing regional economic problems and prescribing appropriate solutions on the basis that it will increase competition in the market for ideas. A more serious argument is that East Asians are not ready for or capable of creating and managing an effective regional monetary fund. According to Eichengreen, East Asia lacks the tradition of *integrationist* thinking and the web of interlocking agreements that espouse monetary and financial cooperation in Europe.

For over a half century, European countries have worked very hard to develop a web of political and diplomatic agreements which encourage them to cooperate in monetary and financial matters. Such a web does not exist in East Asia. Furthermore, East Asians are not yet fully accustomed to or comfortable with negotiating an international treaty which includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly. This unwillingness would make it difficult for the regional fund to impose politically unpopular policies on the member countries and hence may pose a serious moral hazard problem.

Moral hazard is not a problem that will beset only regional arrangements. The IMF is also not immune to this problem and the task force report of the Council on Foreign Relations (1999) advises the Fund to adhere consistently to normal lending limits. The reasons why East Asian financial arrangements would suffer more from the moral hazard problem than the IMF, or any other regional institutions, have not been made clear. As Sakakibara (2000) puts it, if those countries unaffected by the East Asian crisis do not have any political incentive to contribute their own resources, they should say so instead of using the moral hazard argument as an excuse for opposing regional arrangements in East Asia.

Another controversial argument against regional financial arrangements is that there may be no need for regional funds and other arrangements in a global economy where much of the trade in goods and services is being conducted increasingly in cyberspace. The ongoing revolution in information and communication technology will accelerate globalisation and virtualisation. Therefore, what the world economy needs is a new system of global governance, which may include a global central bank and global regulatory authorities. In the case of financial markets and financial serv-



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ices industries, the scope of governance should be increased to the world level so as to realise scale economies and to accommodate the market forces driving financial globalisation. Public goods, such as the services of a lender of last resort and regulatory institutions, might be better provided at a global level.

While, in theory, the creation of a system of global governance may sound reasonable, in reality, it is politically unacceptable and must be dismissed as quixotic (Eichengreen, 1999). As a second-best alternative to the global governance system, global standards and codes of conduct on banking, corporate governance, management of monetary and fiscal policies and many others have been proposed. However, doubts were raised as to the effectiveness of international standards and the legitimacy of imposing them on EMEs.

As for East Asia's limited institutional capacity, Eichengreen (1999) has a point. If the European experience is any guide, East Asia may take many years to develop an effective cooperative arrangement for finance. However, it must also be noted that having suffered such a painful and costly financial crisis, the East Asian countries are prepared to set aside their differences and work together to develop a region-wide defense mechanism to help protect them from future crises. After three years of crisis management, East Asia has developed a large pool of skilled and experienced experts capable of managing regional financial cooperation among the countries of East Asia. Furthermore, the type of arrangements currently being discussed in East Asia does not necessarily require integrationist thinking or a web of interlocking agreements, as in Europe.

### *Rationales for Regional Arrangements*

In this section, a number of arguments that support regional financial cooperative schemes in East Asia will be presented. Any argument for regional arrangements must begin with answering the most fundamental question of whether regional groupings, whatever forms they may take, are conducive to, or likely to interfere with multilateral free trade and the orderly globalisation of financial markets.

Despite many misgivings about the role of regional economic arrangements that have grown in number in recent years, experiences of the past decade suggest that they have been a complement and supplement to multilateral trade and financial liberalisation. That is, they have been building blocks rather than stumbling blocks for a more integrated world economy. There is no evidence suggesting that an East Asian financial arrangement would be oriented toward a withdrawal from the global economy and, hence, erect barriers to global financial integration.

As Lawrence (1996) points out, the forces driving the current regionalism may differ fundamentally from those driving earlier moves in this century to regionalisation and the current initiatives represent efforts to facilitate their members' participation in the world economy rather than their withdrawal from it. Developing countries are motivated to join regional groupings because their participation might facilitate implementation of strategies to liberalise and open their economies. Since most of the East Asian EMEs are pursuing export-cum-foreign investment-led policies, they will gain very little by forming a regional arrangement that is designed to thwart globalisation.

There have been several other developments which encouraged the formation of a regional financial arrangement in East Asia. One development has been the slow progress of the reform of the international financial system. The urgency of reform in the G-7 countries has receded considerably with the rapid recovery of East Asia. The already slow progress has been further complicated by the perception that a new architecture, as it is now designed, may not be effective in sustaining global financial stability. Moreover, it would not safeguard financial stability in the EMEs. As long as the structural problems on the supply side of capital are not addressed, the East Asian countries will remain as vulnerable to future crises as they were before. Instead of waiting until the G-7 creates a new architecture, whose effectiveness would be at best questionable, it would be in the interest of East Asia to create its own system of defense through coordinated endeavours.

Many EMEs, in particular those which have experienced a financial crisis, are taking measures to build up their foreign currency reserves above the level regarded as adequate in terms of their import requirements. For instance, Korea is currently targeting a level of reserves equivalent to 20 percent of its GDP, largely because of the increased volume of its capital account transactions. By any measure, this level is excessive, and represents a clear case of resource misallocation. To reduce the amount of reserve holdings, at least some of the EMEs could enter into an arrangement for precautionary lines of credit with private financial institutions. They could also rely on the IMF as a quasi-lender of last resort, which could provide an additional issuance of SDRs.

There are other schemes for reducing the holdings of foreign currency reserves. For example, a group of countries, not necessarily from the same region, may decide to pool a certain percentage of their reserves to create new credit facilities for themselves. An individual country belonging to the arrangement can borrow from the credit facility and would not have to hold as much reserves as it otherwise would.

The group of thirteen East Asian countries of the Chiang Mai Initiative commands a large amount of foreign currency reserves estimated at more than $800 billion. Depending on how these reserves are pooled together and managed, a mere ten percent of the total amount will be sufficient to provide first and second lines of defense against any speculative attack. If the East Asian countries had been able to cooperate to use part of their reserves to supply short-term liquidity to Thailand in 1997, East Asia could have been spared the misery of recession and social dislocation.

There is also the argument that regional financial management could be structured and administered in a way complementary to the role of the IMF. For example, an East Asian regional fund could provide additional resources to the IMF while joining forces to work on matters related to the prevention and management of financial crises. An East Asian monetary fund could also support the work of the IMF by monitoring economic developments in the region and taking part in the IMF's surveillance activities. It could also be initially designed as a regional lender of last resort while the IMF assumes the role of prescribing macroeconomic policies to the member countries of the former.

Finally, East Asians must begin to examine the possibilities and desirability of cooperation and coordination in exchange rate policies, creation of a regional currency unit and eventually an East Asian common currency. Even though these monetary options are not feasible at this stage, an East Asian monetary fund could serve as a forum for such an examination.

## III Standards and Enforcement

Most proposals for a new international financial architecture advocate establishing a set of international standards and encouraging countries to adopt them. Many standards already exist: the Basel capital adequacy accord, the IASC accounting standards, the IOSCO principles of securities regulation and the OECD standards of corporate governance. The IMF has developed Special Data Dissemination Standards (SDDS) and has prepared codes of good practices on fiscal, monetary and financial transparency. Since it may not be feasible, from a national sovereignty standpoint, to establish and enforce strict global rules or create global authorities such as a world central bank and a world regulatory authority, setting and enforcing international standards are recommended as a second-best solution.

Many agree that such standards are not a panacea. They are often too vague to mean very much. Even the major industrial countries cannot agree on specific standards for banking, corporate governance, disclosure, and accounting, because they understandably insist on standards that will serve their own interests. In most of the forums drawing up standards, emerging market economies and developing countries (DCs) are not included or are, at best, underrepresented.

Even if the G-7 and emerging market economies and other developing countries could come to an agreement on international accounting standards, banking and other regulatory issues, there still remains the question of enforcement. Some proposals suggest that cooperation and coordination between different supervisory organisations should be strengthened. Others argue that the IMF should be entrusted with the role of monitoring and supervising the compliance of its member countries with standards. Still others recommend that enforcement should rely more on incentives to induce countries to observe standards voluntarily.[2]

The IMF does not have either the manpower or the expertise to undertake the detailed international supervision of the financial and other standards of emerging market economies. This means that the IMF will have to create an incentive structure that directly links the amount of money a member country can borrow to its banking and other standards. Along with the IMF, it has also been suggested that the financial regulators of the advanced countries could help enforce standards by controlling the access of EMEs and DCs to international capital markets on the basis of their compliance record.

Many EMEs and DCs will find it difficult to accept these incentive-based proposals, because such schemes raise the issues of fairness and national sovereignty. If the incentive system is determined and administered by both the IMF and the regulatory authorities of the advanced countries, this would mean that advanced countries, in reality, can dictate the access of EMEs and DCs to world capital markets and IMF credit facilities. The most serious concern with regard to IMF conditionalities is that such standards may act as the wedge with which a broader set of institutional preferences – in favour of open capital account, deregulated labour markets, arms-length finance and Anglo-Saxon style corporate governance – will be imparted to the recipient countries (Rodrik, 2000).

It took the GATT member countries seven years (1986-1993) to negotiate an agreement on new rules for more open trade in goods and services and to create the WTO in the Uruguay Round. Standards are not rules, but if the member countries of the IMF cannot agree on setting and enforcing standards, then a negotiation process, à la the Uruguay Round, may be an alternative solution. This may be particularly necessary if the inter-

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2 The Financial Stability Forum (FSF) has recently published a paper on implementation issues of standards and codes — Issues Paper of the Task Force on Implementation of Standards. The paper recommends the provision of incentives for fostering implementation of standards, while it emphasizes country ownership in its process of implementing standards.

ests of the advanced countries, on the one hand, and those of the EMEs and DCs, on the other, diverge.

The G-7 countries could take the initiative of starting a negotiation process among the IMF members towards introducing international standards. The negotiations may not take as many years as the Uruguay Round did, but they will have to go through an arduous and protracted process of settling the differences between the advanced countries and the EMEs and DCs. Such a negotiation process will be costly, but unless the IMF member countries come to an agreement on common standards, one cannot ensure the compliance of firms, banks and governments of the EMEs and DCs. In order to reduce the number of participants and make the negotiations more manageable, one possibility would be to limit participation in the initial stage to those EMEs and DCs with open trade and financial regimes. Without such a process, it is likely that there will be only two sets of competing standards supported by the US and EU respectively. Neither set of standards would, in that case, reflect the needs or wishes of EMEs and DCs. They would then either adopt the standards of one or the other, or remain outside both.

## IV The IMF as a Crisis Manager and Crisis Lender

Fischer (1999) argues that the IMF can act as a crisis lender or as a crisis manager, although it does not have the power to create international reserves. As a crisis lender, it has access to a pool of resources contributed by its members which it can lend to member countries in need. Because it has the responsibility of negotiating with member countries in a crisis and arranging financial packages, it also serves as a crisis manager.

One might question whether the IMF will have enough resources at its disposal to serve as an effective crisis lender, but let us assume it could and would. Then, looking into the future, the IMF will mostly be lending to EMEs and DCs in emergency, and serve as their crisis manager. In this scenario, the IMF would seldom lend to the G-7 countries even in times of a crisis.

On paper, the IMF will continue to play the role of an international lender of last resort, but in practice that role will be taken over by a group of large countries which would directly administer the trust fund to combat systemic threats to the international financial system. For the purpose of constructive ambiguity, it would be desirable to make country eligibility, financing amounts, and the role of conditionality unknown *ex ante*. However, this constructive ambiguity may be interpreted as a lack of transparency and could become a source of confusion and arbitrary decisions.

The Meltzer Commission (2000), suspicious of IMF management and the institution's principal shareholders alike, wants hard-and-fast rules for IMF lending. It recommends permitting the Fund to lend only to the countries that pre-qualify for assistance by building impeccably strong financial systems. However, rigid rules for IMF lending are patently unrealistic. Lending only to countries that pre-qualify for assistance would mean standing idly by when the weak, as well as the strong, are hit by systemic crises (Eichengreen, 2000).

Suppose a financial crisis breaks out in an EME. The trust fund will not be activated unless the crisis is believed to threaten the systemic stability of the international financial system. However, the crisis is likely to be contagious and spread to other countries and regions. At what point, then, should the trust fund be activated? One might ask why the G-7 countries should have the authority to make that decision and assume the role of international lender of the last resort.

The structure of the IMF is similar to that of a credit union. However, unlike a typical credit union, there is a clear demarcation between net depositors (lenders) and net borrowers. Advanced countries constitute the majority of lenders whereas EMEs and DCs make up practically all of the IMF's borrowers. A few rich industrial countries control the decisionmaking process as well as operations of the IMF. Given this dominance, one could legitimately raise the concern that the IMF may be "too responsive to its principal shareholders, which are high-income, international creditor countries whose interests do not necessarily coincide with those of the global society as a whole" (De Gregorio, Eichengreen and Wyplosz, 1999).

One might go one step further by saying that the IMF is constrained in reflecting the needs and wishes of EMEs and DCs. Even though international creditor countries are as much responsible for the East Asian crisis as East Asian countries themselves are, the IMF has been preoccupied with the structural reform of the EMEs and DCs, while not effectively rectifying the problems on the supply side of capital flows.

In order to redress the imbalance between advanced countries and EMEs in managing the IMF, the EMEs and DCs should be given the opportunity and be prepared to contribute more resources for the operation of the IMF. Commensurate with their enlarged contribution, the EMEs and DCs should be accorded greater representation both on the board of directors and in the management. Many EMEs are more willing and able to share the burden of financing various IMF credit facilities than ever before. This issue of representation will become more contentious in the future if the IMF is given a central role in the surveillance and enforcement of various standards.

One should, of course, recognise that the IMF is an international institution providing the public good of international financial stability. Crisis management and prevention has externalities, and is not only the responsibility of EMEs and DCs, but also of advanced countries. Nevertheless, it is only natural and logical for EMEs and DCs to have a greater voice in managing the organisation that is primarily serving as their crisis lender as well as manager.

Advanced countries are likely to object to the idea of giving EMEs and DCs a larger representation in running the IMF. They may argue that without the dominant participation of the advanced countries, the IMF may suffer from leadership problems, deterioration in the quality of staff output and laxity in the enforcement of standards and loan conditions. Criticisms of the same type have been leveled against those who support the establishment of regional monetary funds.

If the decisionmaking process at the IMF is not politically neutral, and for this reason EMEs and DCs cannot expect more active participation in the IMF decisionmaking process, then the G-7 and the IMF should consider amending the IMF Articles of Agreement to strengthen the independence of the Executive Board and give the Fund financial independence (Gregorio, Eichengreen and Ito, 1999). Failing this, the G-7 and the IMF should be more positively disposed to the idea of creating regional monetary arrangements. Indeed, if one can argue that regional economic arrangements could serve as building blocks rather than stumbling blocks, then the same argument can be made for establishing regional monetary arrangements.

As noted in Section II, regional arrangements could be structured in a way that would complement, not substitute for, the role of the IMF. The Uruguay Round established the WTO with much-enhanced enforcement powers and gave birth to a large number of regional economic arrangements. In fact, more than 90 percent of all the contracting parties in the GATT are signatories to such arrangements.

In discussing the reform of the IMF, a consensus has emerged that it cannot be the sole locus of future financial liberalisation and stabilisation of international financial markets. Regional arrangements could complement and supplement IMF efforts to liberalise capital account transactions provided, of course, that such arrangements are subject to an outside discipline and do not become preoccupied with regional issues and initiatives.

Both multilateral and regional approaches can be effective and efficient in maintaining international financial stability. The reason is that financial crises tend to be regional mainly because trade is regional (Rose, 1998). With a large increase in intra-regional trade in recent years, financial crises are more likely to spread through trade linkages than before.

## V Concluding Remarks

There has been an emerging consensus in East Asia that East Asians must join forces to establish regional financial arrangements which will help them fend off speculative attacks and, in so doing, stabilise the East Asian financial markets. However, it is not altogether clear at this stage whether they will be able to successfully negotiate the creation of such arrangements, given the different interests of different countries in regional financial cooperation. Details of the swap arrangement among the ASEAN members and China, Japan and Korea (the Chiang Mai Initiative) will have to be worked out. At this stage, it is too early to tell whether ASEAN will be able to design a scheme acceptable not only to the ASEAN member states but also to China, Japan and Korea.

Now that China is about to join the WTO, Chinese policy makers realise that they may have to liberalise and open their financial markets and financial services industries sooner than expected. They also realise that as the country with the largest market, they must contribute to, and cooperate with other countries, to sustain financial stability in East Asia. However, China will find it very difficult to support any regional arrangements dominated by Japan.

In promoting regional cooperation in East Asia, Japan has a very important role to play as the second largest economy in the world and as a member of the G-7. While Japan and the other East Asian countries cannot, and should not, ignore the wishes of the US and the European Union, the East Asian countries must decide whether a regional cooperative mechanism will help restore the dynamism and vitality the region was accustomed to before the crisis.

During the Asian crisis, Japan was less active and forthcoming than it could have been in articulating the predicament of, and extending financial support to, the crisis-hit countries. To many East Asians, Japan was watching the demise of the East Asian countries, one by one, on the sidelines. As Sakakibara (2000) puts it, however, no one can criticise Japan, or the US for that matter, for their failure to come to the rescue of the East Asian crisis countries, including Korea, because both superpowers were also acting in their own national interest. In recent months, nevertheless, Japan has become more active in advocating the creation of East Asian monetary and financial arrangements, at least informally.

Japan must spell out to the other East Asian countries what its' national interests are and what it is prepared to do to support the establishment of East Asian financial arrangements. Japan must find ways in which it could collaborate with China on resolving regional economic issues.

East Asia has a long way to go before formalising and putting the



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Chiang Mai Initiative into effect and launching other types of cooperative mechanisms. In this respect, Japan should be able to provide leadership in accomodating the differences among the East Asian countries that are likely to surface in the negotiation process and, most of all, be prepared to provide a large share of the resources needed to facilitate regional financial cooperation without dominating the other countries. It will be a deciding challenge for Japan to redefine its status in the region.

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# Comment on "Reforming the International Financial System: Prospects for Regional Financial Cooperation in East Asia," by Yung Chul Park and Yunjong Wang

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## Introduction

Africa and, in particular, the East African region has a lot to learn from the East Asian crisis. Over the past two decades, economies of East Africa have followed more market-based policies. The reform programmes have focused on macroeconomic stability, liberalisation of foreign exchange, trade and marketing, improving incentive structures to promote both savings and investments, and rehabilitating the economic, social and institutional infrastructure.

In conjunction with these domestic developments, the world economy has experienced fundamental changes on account of increased globalisation of financial markets and issues relating to the movement of capital between countries have become central in the international monetary system. There are questions of whether African countries should promote capital account convertibility to take advantage of increased capital movements. Related to this are the risks Africa would be exposed to in case of market failure in either the domestic or international financial markets and how these risks would be mitigated.

Africa, in general, unlike East Asia, is not strongly integrated into the international capital markets. Capital flows to countries in Africa are small relative to flows to other regions, but large relative to the size of the economies and, at times, compare favourably with flows to other regions. Due to its limited integration into the international capital markets, Africa was largely protected from the contagion problems associated with the East Asian crisis. But this is not to say that Africa is fully protected from any dangers related to market failures in international financial markets. A large number of countries of the region are associated with and influenced by developments in South Africa. The South African private sector has



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increased its exposure in Eastern and Southern Africa. To the extent that South Africa is integrated into the international capital markets, there is a greater likelihood of second-round effects on African countries. In addition, African financial systems are prone to volatility. The markets are thin and lack sophistication and flexibility to effectively deal with minor changes in expectations and the switch in demand from domestic to foreign assets and vice versa.

In particular, a number of countries depend on one or two major export products subject to seasonality and commodity price shocks. The markets lack instruments to smooth out market behaviour during booms and busts, placing most of the burden on the monetary authorities. Unfortunately, the challenges to macroeconomic management and possibilities of market failure in a liberalised environment in Africa are unlikely to attract international response and concern since there is no systemic risk to the international financial system.

The solutions to the problems faced in Africa are therefore, primarily, domestic. Africa has to promote a sound financial system, develop and deepen markets, close regulatory and legal gaps and strengthen the supervision of the financial system. Without a doubt, progress in these above areas will reduce the probability of volatility in the financial sector but is unlikely to guard against future asset price bubbles, self-financing panics and bank runs. Uganda, in the recent past, suffered from instability in the foreign exchange market triggered by events in the Congo and a terms of trade shock. Similarly, Kenya, Malawi and South Africa have had to deal with volatility in their foreign exchange markets which can be traced to developments in Zimbabwe leading up to parliamentary elections in that country. On several recent occasions, private sector investors in Kenya have shifted savings and investments to neighbouring countries, especially Uganda and Tanzania as uncertainties heightened. The recent regional banking crisis problems affected cross-border interests of the banks and required coordination by the regulatory authorities.

There is, therefore, a strong case for monetary and financial cooperation among groups of countries in Africa. As a first step, countries belonging to a group need to agree on:

- codes and practices;
- sharing of information; and
- harmonisation of policies.

## Policies at the Regional Level to Prevent Financial Crises

An effort at monetary and financial cooperation is already underway in East Africa. Uganda and its East African neighbours are currently developing financial crisis prevention measures through the Monetary Affairs Committee (MAC) of the East African Cooperation (EAC). The MAC comprised of the Governors of the three East African central banks is undertaking the following programmes for coordinating and harmonising common approaches to stem the contagion effects of financial crisis:

- *Licensing Banks:* This would ensure that uniform criteria are applied by all the three central banks in the licensing of new banks, especially with respect to entry requirements. In the MAC's view, banks should have adequate unimpaired minimum capital and the region should guard against malpractices infiltrating the system.
- *Supervision and Regulation:* All acts and statutes are being reviewed and harmonised to strengthen the regulatory and supervisory capacities of the three central banks. Joint on-site inspection of banks with cross-border branches are currently being conducted.
- *Harmonising the Payments System:* This is meant to reduce risks (such as fraud) and enhance efficiency in the payments system. The countries have agreed to a uniform cheque standard.
- *Information Sharing:* The MAC meets once a year to review resolutions of previous decisions and harmonise approaches to common problems in the financial system. The sub-committees on Supervision, Monetary, Information Technology and Payment Systems follow up the decisions and prepare the groundwork for future MAC meetings.
- *Currency Convertibility:* The MAC has also agreed on convertibility of the three East African currencies to enhance payments and funds transfers. Although they have yet to agree on harmonisation of fiscal, monetary and exchange rate policies, the EAC countries have adopted the principle of a single currency. They have not yet set up a regional emergency fund to bail out a member in case of financial turmoil not associated with macroeconomic imbalances. Such a fund would give the countries of the region the capacity to quickly respond to problems as they emerge.

## Challenges

### *Credibility*

There are serious doubts that cooperation and harmonisation will be binding on all the members given a history of weak implementation of regional agreements and a lack of appetite to enter regional blocs. Unlike East Asia, Africa has not yet gone through a painful and costly financial crisis which could be used to motivate strong regional financial cooperation. Apart from South Africa, Africa lacks a powerful and financially sound country to take the leadership role in promoting such cooperation. It is highly doubtful that Kenya or Zimbabwe, in their current state, can offer the required leadership role. At the moment, South Africa is best positioned to take that role but it begs the question of whether South Africa's national interests stretch to the whole of Eastern and Southern Africa.

### *Lock-In Mechanisms*

Some researchers have proposed that it may be in the best interests of regions like East Africa to negotiate a financial cooperation arrangement with the European Union. This would introduce the required credibility and penalties for non-compliance. In addition, the IMF could play a critical role in facilitating financial agreements with the region and providing a line of credit that can be used in case of financial turmoil.

### *Rationalisation of Groupings*

Politics have tended to dictate the formation of regional groupings in Africa. This explains the setting up of overlapping organisations with little economic rationality. There is a need for a rationalisation of these groupings guided by economic interests. It would help greatly if domestic institutions such as central banks are strengthened and given the necessary autonomy to deal with issues and forces that stretch beyond national borders.



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# Floor Discussion of "Positive and Negative Aspects of Recent Reform Proposals"

## Regional Versus Global Arrangements

On the issue of regional versus global arrangements, Mark Allen suggested distinguishing between three different aspects of regional arrangements: regional swap arrangements, regional surveillance and regional standards. He believed that there could be a role for regional swap arrangements but the issue would be when to use them and under what conditions? "One problem with regional swap arrangements is that countries in a region tend to be affected simultaneously, because there is little diversity in the suppliers of funds. Another question, which applies when the financing needs to be supplied conditionally, is whether the region is better placed than the multilateral to apply such conditionality. The US has a network of swap arrangements with Canada and Mexico. However, when the Mexican crisis happened in 1994-95, the swap arrangement turned out to be of little use in those circumstances."

Allen also believed there would be scope for regional surveillance. "Countries can get together and give each other more candid and better focused policy advice than a multilateral can. After all, the G-7 goes through its own form of surveillance so that its members can potentially put peer pressure on each other, which they wouldn't want to do in a broader setting. There is scope for regional surveillance, for example, amongst the ASEAN countries or amongst the Central European countries where the actions of one country affects the reputation of the other countries in the region because they are seen as a group from the outside. However, in practice, it can be very difficult to apply that sort of candid pressure in a meeting of finance ministers inside the region. There is a tendency to just be nice to each other and spend all their time blaming outsiders rather than focusing on what one member could do to make life easier for the other members of the group."

Allen did not see any role for regional standards and codes. "These codes and standards are what the globalised international capital markets are looking for. But, since the capital markets themselves are globalised, there aren't any reasons why these codes and standards should be regionalised."



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Amar Bhattacharya suggested that it would also be useful to distinguish between dealing with "short-run" volatility versus dealing with systemic crisis. "The Chiang Mai swap arrangement is a perfectly reasonable arrangement to deal with short-run volatility. The difficulty arises in dealing with systemic crises, both because the covariance risk is higher in a regional context and because of the globalisation of financial markets."

Bhattacharya observed that in the absence of a true international lender of last resort and an arbiter of financial markets one has to deal with three questions. "First, do regional arrangements help in augmenting the overall envelope? I would argue that, especially in East Asia, we might actually have a true second line of defense (as opposed to a phantom second line of defense) if we have regional arrangements. So, in a resource envelope sense, regional arrangements could actually play a very useful role, especially in East Asia. Second, what do you do if you want to bail in the private sector? How is that going to work and who is going to be the arbiter? I would argue that the IMF needs to be the arbiter. Whatever regional institution is put in place, it has to play under the overall umbrella of the Fund. Third, regarding the issue of conditionality, there cannot be two types of country conditionality or, worse still, a regional institution undermining IMF conditionality. You would need to have complementarity between the institutions in a similar way to the regional peer surveillance that Mark Allen mentioned."

Yilmaz Akyüz made yet another distinction: between the existing regional institutions such as the UN regional economic commissions and the development banks, on the one hand, and new forms of regionalism that are developed as a response to the failure of global arrangements, on the other. "The regional financial cooperation that Yung Chul Park is suggesting falls in the second category. The Asian swap arrangement emerges from the failure of global arrangements and should be seen as a second-best option. Therefore, I don't see the logic of incorporating this into the discussion of global architecture. It departs from the idea that the global arrangement is not working."

Ariel Buira dwelled on the holding of international reserves as a way for a country to insure itself against financial crises. "Holding reserves is the most primitive sort of insurance, namely self-insurance. The next step is group insurance, which is certainly better, if still very costly. Thus, regional arrangements make economic sense vis-à-vis self-insurance. The best approach would be to take insurance to the global level. However, the global system is not prepared to give prompt and sufficient financial support. So in the face of the failure of the global system one has to fall back on regional systems, not because they are the most desirable arrangement, but because the IMF has failed to adjust to changing circumstances."



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Buira said that the chances of success of monetary cooperation were higher in Asia than in Latin America. "In Latin America, we made some attempts at monetary cooperation but they have not been very successful for one very strong objective reason: most of the countries are permanently in deficit on the current account. This is a major difference with Asia. A group of countries with large surpluses have a much better chance of success than if they were all borrowers. Also, regional surveillance and conditionality are much more difficult when you are all borrowers. You need both surplus and deficit countries to have a reasonable balance of conditions and policies to be followed."

Bill White added that the crucial factor for regional swaps would be the willingness of surplus countries to lend to deficit countries. "The real question is whether the creditor countries, let us say Japan or China, are prepared to take the credit risk on their books by lending money to countries that are running deficits. That is a significantly greater committment than the willingness to do swap for good collateral. The jury still seems to be out on that issue."

José Antonio Ocampo stressed that the rationale for regional cooperation is not the failure of global institutions, but the significant complementary role that regional institutions have to play. He gave three reasons for this complementarity. "First, there are services that cannot be provided at the international level. For example, the coordination of macroeconomic policies, such as between Argentina and Brazil, cannot be done by the IMF; it has to be done at the regional level. Second, it is good to have competitive development finance systems. It is excellent for a country, particularly a small country, in Latin America for instance, to have access to the World Bank and, at the same time, to the Inter-American Development Bank and a sub-regional development bank. It is particularly good for the small players. Third, since the IMF is controlled by advanced countries and the world is made up of many small countries, it is good for those small countries to have regional and sub-regional institutions in which they have a real voice. Voice gives a sense of belonging which cannot be substituted by any other means."

Ocampo said that he was aware of the limitations of a regional response to financial crisis – "a crisis of Mexico or Brazil cannot be managed by a regional reserve fund, though a crisis of Central America could be managed at the regional level" – but observed that its role should not be underestimated.

"I come from one of the few regions of the world, the Andean region, which developed a reserve fund and a development bank at the very start of its integration process in the 1960s. During the crisis of the 1980s, we lent to all the member countries at different times, and thus played a useful role in a very severe time of crisis. Of course, it wasn't sufficient because the size of the fund was relatively small compared to the crisis, which was of a global order, but, it was useful."

Yung Chul Park disagreed with Mark Allen's rejection of regional variations in standards and codes. "Whether you like it or not we are living with different standards in different regions. Look at the accounting standards. The Europeans and Americans are never going to agree to a single standard when it comes to details. Flexibility in regional standards is important to allow the firms and banks in different regions to trade, transact, borrow and lend across different regions. Instead of trying to develop a single worldwide set of standards, we need a regional variation in standards."

Howard Brown was very surprised that representatives of some emerging markets have argued that the Basel Core Principles are a problem for them. "If I were in the finance industry or the central bank of an emerging market, the Basel Core Principles would be something I would want to implement quickly. It's not the case that it's a 'one size fits all' that forces you into a straight jacket: it doesn't. Canada and the US have as different regulatory regimes as you could possibly find; they are completely different in terms of philosophy and approach. Yet, Canada is substantially compliant with the Basel Core Principles as, I assume, the US also is. One standard allows a lot of variation in terms of institutions and methods of implementation."

Park agreed with Amar Bhattacharya on the distinction between short-run crises and systemic crises. "Amar is 100 percent right that the regional swap and other arrangements we are thinking about are basically designed to deal with short-run crises. However, we still do not have an answer for the systemic problem we suffered from, an answer that will determine the success and failure of the regional arrangements."

Park supported Ocampo's view that regional arrangements should not be seen as a response to the failure of the global system. "Regional arrangements should be viewed as building blocks towards a completely free multilateral and global system. In other words, we are trying to move towards an idealistic state and in order to get there we have to go through intermediate stages. Regional arrangements are one of those intermediate stages."

## Lender of Last Resort and Standstills

Yilmaz Akyüz distinguished between financing for current account purposes and financing for capital account purposes. He observed a contradiction in the paper by Griffith-Jones and Ocampo regarding the need to have both a lender of last resort and capital controls. "On financing for current account purposes, let's take the example of a country that has run



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out of reserves and is unable to finance its imports. This is very much like 'debtor-in-possession' financing in Chapter 11. The other form of financing is to provide money in order to maintain an open capital account and to meet the demands of the creditors; this is the lender of last resort. By definition, a lender of last resort assumes that under crisis conditions we have open capital accounts, no standstills and no exchange controls. I am not sure what kind of capital control José Antonio and Stephany have in mind, but there is a degree of contradiction in this argument that we need both a lender of last resort and capital controls. Certainly, this was not the case under the Bretton Woods System."

José Antonio Ocampo felt that it was unclear whether the rules for an emergency financier like the IMF are exactly the same as those for a true lender of last resort. "There is the issue of lending to countries rather than banks. In order to have a truly international lender of last resort, you would have to lend to banks. I agree with Yilmaz that you would have to have perfect convertibility of capital account because otherwise it doesn't make sense. Although I doubt that we will have a lender of last resort in the visible future for political reasons, there are at least two important issues on the international table.

First, do you want to generate new mechanisms with more onerous credit conditions? There is a choice between shorter-term and higher interest rates together with conditionality, or the older philosophy of the lender of last resort, that is, to have lending of some type but with no conditionality. In some credit lines, it would be better to move in the latter direction to have a faster disbursing mechanism.

The second issue is: do you want to have pre-qualifications? I differ with Stephany on this point. I don't like pre-qualifications by the IMF because it would generate a new function of the IMF as a credit rating agency and I don't think that is the function of the IMF. I prefer some mechanism that has no conditionality but higher costs."

Stephany Griffith-Jones explained her view on pre-qualification. "As for the point of pre-qualification, the British Treasury suggested that there could be a short-term CCL, of six or even three months, both of which would be automatically activated. That would be more interesting because there would be no additional conditionality.

I disagree with José Antonio on the point of pre-qualification. If you are in favour of managing booms and an individual country doesn't want to do this, you have to deal with it at the international level. In that case, there is the issue of how you increase leverage for the Fund or another institution to influence policy in times of boom. I find pre-qualification quite attractive. But, of course, it has to be pre-qualification and there should not be another take on conditionality once a crisis comes."

Yilmaz Akyüz agreed with Ocampo that there are problems with an international lender of last resort. "Typically, a lender of last resort is supposed to support the currency and the country, not just meet the demands of the creditors, watch the currencies collapse and then come in and give them money. The latter is how it happened in Asia."

He then illustrated, with the Brazilian case, that pre-qualification is not going to avoid the kinds of conditionalities Griffith-Jones and Ocampo are criticising. "The Brazilian case was perhaps the first attempt at a genuine lender of last resort. There was an agreement between Brazil and the IMF to put together a package of $40 billion dollars contingent on the Brazilians making some fiscal adjustments and some gradual depreciation of the real by 6 percent. After the Russian crisis, Brazil came under attack and the IMF stood by and watched until the real went from 116 to 200 to the dollar. In the end, it sat down with Brazil to impose additional conditions and made one tranche of some $8 billion available. From this case, it seems clear that pre-qualification is not going to avoid the kinds of conditionalities you are criticising because you have to monitor it constantly after a country passed the test. In the meantime, various events take place that are subject to interpretation. You always have to sit down and talk about the conditions. So pre-qualification does not work as long as there is a lag between the time of qualification, Article IV Consultation for instance, and the provision of money.

Since the 1980s' debt crisis, UNCTAD has argued very strongly for temporary standstills, perhaps combined with Article VIII.2b of the IMF, as the most viable solution to provide some global framework. I see many countries in the Interim Committee – now the IMFC – thinking in this way, but facing opposition from the United States. I see Canada's six point plan and some other European countries advocating temporary standstills."

Ariel Buira suggested that the role of the lender of last resort, capital controls and standstills come in at different moments. "A change in market sentiments and a loss of confidence provokes a sudden interruption in capital flows. It would be very nice if you had already established a lender of last resort beforehand which could reassure the market that you will not become insolvent and unable to pay your bills, thus avoiding a panic. Another way to prevent this insolvency is to have capital controls on inflows so that you discourage capital inflows beyond a certain level, such as a certain proportion of your market, etc. Once you are faced with a crisis, standstills, Chapter 11 and restructuring come in. At this point, it would be very helpful for the Fund to have amended Article VIII.2b in order to be able to do all these things. The rationale of the system should require that you have a lender of last resort to give confidence to the market and avoid



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a crisis. In contrast, the way it works now is that you run into a crisis and then you try and pull the country out of it. This is contrary to the stipulation in the Articles of Agreement that the Fund should try to prevent measures that are destructive of national and international prosperity."

Aziz Ali Mohammed suggested that, from a political perspective, the CCL is not going to work. "We are forgetting the political angle. The Fund may have negotiated a CCL with one government, but when a crisis approaches during an electoral cycle, the government might change. At this point, the Fund may not be sure if the new government, which might be coming in on a totally anti-IMF platform, would repay the debt. Things like the CCL simply won't work given the reality of political electoral cycles."

**Capital Controls**

Amar Bhattacharya argued that the emphasis in the balance between international and domestic action should lie on domestic actions. "If Hong Kong Bank lends one percent of its equity to an Indonesian conglomerate, it won't represent a systemic risk to Hong Kong but a systemic risk to Indonesia. That is why the balance of actions must lie on the national side."

He stressed that domestic action should not be limited to the imposing of Chilean type of controls. "Much of the domestic actions, whether they are macro- or microeconomic, take time and institutional underpinnings. Because of that, José Antonio Ocampo emphasises regulation and, in particular, Chilean type of controls. But, important as Chilean types of controls may be, I think it is vital not to put your eggs all in one basket because financial systems are crucial and have a cross-border aspect. Good banking sector regulations such as better capital adequacy, having regulations on net foreign assets, and making leverage, for example, a criteria to determine risk rates in banking systems, are equally important. Similarly, there are regulatory options on the corporate side. Joe Stiglitz and I wrote a proposal linking tax deductibility of corporations to disclosure and tilt it against incentives for foreign borrowing. You could, for example, make a registry of foreign transactions as a criteria of eligibility for domestic bankruptcy procedures. There is a whole menu of things you can do which makes good sense for risk management, corporations, banks and for the entire economy, before you come to a Chilean type of control."

Mark Allen stressed the need to distinguish between controls on capital inflows and outflows. "Controls on inflows or outflows are a totally different set of problems. The control of inflows, such as the Chilean type, is a question of countries being wise at boom times and turning capital down which would otherwise be coming in and resist domestic demands to finance itself this way. This is probably something that ministers of finance and central bank governors should do but it is very difficult to achieve. It implies that when people are offering you the money, you should be applying a self-denying ordinance.

On the other hand, controls on outflows involve a very different set of costs and benefits. One of the reasons there has been so much liberalisation on the outflow side is not that the IMF and the industrial world have been putting pressure on countries to liberalise – although there has been an element of that – but that the costs of capital controls in everyday business life are indeed very high in middle-income countries. The main advantage of the controls is that you may actually need them to prevent capital outflows when a crisis comes. Whether they are effective is another story."

On capital inflow regulations, Guillermo Le Fort commented that he liked the pragmatic approach taken by José Antonio Ocampo and Stephany Griffith-Jones as opposed to the ideological kind of discussion that tends to separate two possible worlds: one with and one without capital controls. "I think of these regulations as instruments of macro-policy that have advantages and disadvantages, generating benefits and risks. It is important to note that these regulations cannot be used in isolation of other elements of a coherent macroeconomic policy in order to be effective and they should not be overextended because their effectiveness has some limitations."

He then distinguished between price-based and quantitative regulations of capital inflows. "I think that the price-based mechanisms are much more flexible and can be used counter-cyclically while the quantitative tend to generate no type of environment that allows graduated use. In addition, price-based regulations can be used in a non-discriminatory way while the quantitative tend to generate, if not discrimination, then what we could call 'discontinuities', by affecting some people or operations while not affecting others, which can have damaging effects.

However, a price-based mechanism like the unregulated reserve requirement does have leakage problems and only provides incomplete coverage of the system. The larger the leaks, the lower the macroeconomic effectiveness of the mechanism. At the same time, the existence of leaks and incomplete coverage implies larger macroeconomic costs because the generated distortions are larger when financing costs are differentiated between sectors or operations of the economy. Moreover, I agree with José Antonio that the price-based mechanism cannot compensate for expected jumps in the exchange rates. One way to misuse it is to try to avoid the appreciation of the exchange rate through it. If there is an expected appre-



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ciation of the rate, the potential gains of that appreciation cannot be absorbed by the costs of the unregulated reserve requirement which tends to be 200 or 300 basis points. These costs are not enough to compensate for the gains that could be made by a jump in the exchange rate in a very short period of time.

Nonetheless, quantitative capital inflow regulations tend to have much more important shortcomings and problems. Two such regulations were used in Chile. One was the withholding period for investment that was set at one year; investments coming in had to stay in the country for one year before being repatriated. The other was the authorisation to issue instruments, such as bonds and equity, in public markets abroad. Both of these had important problems. They tended to be more easily circumvented as markets developed. First, local market development was hampered by this type of quantitative restriction because the withholding period makes it very difficult to attract portfolio investments and develop the domestic financial – bond and equity – markets. At the same time, other problems like the discontinuity and discrimination in access to the external market is much more evident when some companies with a certain level of risk are authorised to issue in the international market and others are not. When this happens, you generate a discontinuity in the costs of and access to external financing that creates problems and distortions.

Not only do quantitative regulations generate important macroeconomic costs, as compared to the price-based regulations, they are also more easily circumvented through financial innovations. The authorisation to issue abroad was circumvented very early by the development of the private issue. The one-year withholding period was circumvented more recently a few years ago with the development of the offshore forward market for foreign exchange, the so-called non-delivery forward markets. The unregulated reserve requirement is not affected by either of these two innovations."

## Equal Rules in North and South

Mark Allen was struck reading in Griffith-Jones and Ocampo's paper that a lot of work has been done on trying to improve standards at the emerging market level while very little has been done at the level of industrial countries. He explained why he found this quite normal: "Why is there a set of problems related to access to capital markets for emerging markets which don't seem to relate to industrial countries? Since finance to emerging markets is a very small tail on a rather large international capital markets dog, it is somewhat unrealistic to expect industrial countries to make major changes which would affect the entire international capital markets purely to deal with the problem of emerging markets."

Stephany Griffith-Jones recognised this "tail wagging the dog" problem when it comes to the international regulation of capital flows, but stressed that such regulation would also be in the interest of industrial countries. "International regulation is desirable if developing countries are allowed to participate in the discussion. There are a number of possible regulations in the industrial countries. One regulation might be tax changes, changes in incentives for actors so they don't hurt someone else. But, there is still the problem as to why the developed countries should do it. Why would the UK or the US want to do this if it doesn't affect them? The only argument we can give is the risk of spill-overs. These crises happen in very strange ways that can jump across borders. The US and the world economy were lucky that the Long-Term Capital Management (LTCM) crisis was contained, but the fact that it came from the emerging markets should be a cause for concern."

Griffith-Jones added that the distinction Mark Allen made between industrial and emerging markets should not be overplayed because developed countries have also used very tight controls for a long time. "I think the Chilean reserve requirement was exactly copied from Spain's because about ten years ago, just as they were joining the EU, Spain had a 20 percent reserve requirement."

Roy Culpeper underscored Stephany Griffith-Jones' point that one of the developments since the Asia crisis with which we should be most concerned is the asymmetry in the world system between rules for the North and the South. He illustrated this with the example of the Basel capital adequacy standards. "A manifestation of this so-called two-tiered system that is emerging is what is coming out of the new Basel capital adequacy standards. These new standards create one system for the big money centre banks, a sort of self-regulatory requirements through their own risk management systems, and another system for everyone else. This puts banks and financial institutions in the South at a competitive disadvantage."

Mark Allen pleaded for caution with respect to a two-tiered system. "We tend to create one set of rules for the industrial countries, one set of rules for the emerging markets and perhaps another set of rules for the other developing countries which haven't yet reached emerging market status. We have to be very cautious about doing this. There are a number of problems with setting up this sort of group approach. One is the 'Groucho Marx problem', especially for the emerging market group, meaning that countries don't really want to belong to clubs that have people like them as members. One of the great aims of the more advanced emerging markets is to prove in their actions, deeds and statements that they are not really emerging markets but industrial countries. Therefore, they believe that the rules which apply to the emerging market group shouldn't



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apply to them and that they should have the freedom of action that is given to industrial countries. I sympathise very much with that, but its dangers must also be brought out. We need to be much more clear about what the objective conditions are, in terms of the economic structures of countries, which permit them to gradually move into the universe where the freedoms of the industrial countries apply. We need a better sense of the objective conditions and the sequencing of policies to be able to bring this out, rather than grouping countries and saying 'this set of rules applies to this group', and 'this set of rules applies to that group'."

Allen added that such caution, with respect to a group approach, also applies to capital controls. "We have been arguing here that the Chilean type of controls on inflows is probably a pretty good thing and that countries should be encouraged to have them. That means that we would suggest that a particular group of countries apply such controls whereas we would not suggest this to another group, including such countries as the United Kingdom. I am not saying that this is not a good idea, but we need to be objective about what distinguishes these groups of countries from one another."