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## I. Introduction

The recent phase of financial turmoil that started in Asia, crossed through Russia and reached Latin America generated a deep sense that fundamental reforms were required in the international financial architecture to prevent and improve the management of financial crises. The crisis led, indeed, to a recognition that there is an enormous discrepancy between the sophisticated and dynamic financial world and the institutions that regulate it, that “existing institutions are inadequate to deal with financial globalization” <sup>1/</sup>.

2. The crisis set in motion positive responses: a concerted expansionary effort led by the United States in the midst of the crisis, which was probably the crucial step that facilitated the fairly rapid though incomplete normalization of capital markets; the approval of new credit lines and the expansion of IMF resources; the recognition that incentives must be created to induce adequate debt profiles in developing countries, and that some capital account regulations may serve this purpose and provide a breathing space for corrective macroeconomic policies; the parallel recognition that financial liberalization in developing countries should be carefully managed and sequenced; a special impetus to international efforts to establish minimum standards of prudential regulation and supervision, as well as of information; the acceptance that no exchange rate regime is appropriate for all countries under all circumstances; the partial acceptance by the IMF that fiscal overkill is inappropriate in adjustment programs; the improvement of the Highly Indebted Poor Countries’ (HIPC) Initiative; and the greater emphasis given to the design of adequate social safety nets in developing countries <sup>2/</sup>.

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

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<sup>1/</sup> United Nations Task Force (1999), Section 1.

<sup>2/</sup> See on some of these issues, the regular reports of the IMF Managing Director to the Interim, now International Monetary and Financial Committee. See IMF (1999, 2000a, 2000b).

regional institutions can play in an appropriate international financial arrangement was not given adequate attention; and no (or only very partial) steps were taken to ensure a fair representation of developing countries in the discussions on reform or in a revised international architecture.

4. The fairly rapid normalization of capital markets gave way to a sense of complacency that slowed down the reform effort. Moreover, it could lead efforts in the wrong direction. One such step would be to give new impetus to discussions on capital account convertibility. The calmer environment could be taken, on the other hand, as an opportunity to broaden the agenda and to set in motion a representative, balanced negotiation process. The ongoing process for a United Nations Consultation on Financing for Development in 2001 constitutes an important opportunity in this regard. The agenda should be broadened in at least two senses: first of all, it should go beyond the issues of financial crisis prevention and resolution (which may be termed the “narrow” financial architecture <sup>3/</sup>) to include those associated with development finance and the “ownership” of economic and, particularly, development policies; secondly, it should consider, in a systematic fashion, not only the role of world institutions, but also of regional arrangements and the areas where national autonomy should be maintained. This is the focus of this paper. As a background, the first section presents brief reflections on the nature of the problems that the system faces and the political economy of the reform effort. Then the paper deals with crisis prevention and management, development finance, the issue of conditionality vs. “ownership” which concerns both of them, the role of regional institutions, and national regulations and autonomy. The last section draws some conclusions.

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<sup>3/</sup> Ocampo (2000a).

## II. The Nature of the Problems that the System Faces

International capital flows to developing countries have exhibited four outstanding features in the 1990s <sup>4/</sup>. First of all, official and private flows have exhibited opposite patterns: whereas the former have tended to 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 been concentrated in middle-income countries, with official flows playing only a very partial redistributive role at the global level. Finally, the instability of private financial flows has required the design of major emergency rescue packages, of unprecedented size, which have concentrated funds in a few large “emerging” economies.

6. 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. In contrast, official development finance and particularly its largest component, bilateral aid, has lagged behind. Indeed, bilateral aid has tended to fall throughout the decade and currently stands at one-third of the internationally agreed target of 0.7% of the GDP of industrialized countries <sup>5/</sup>. The reduction in bilateral aid has been strongest in the case of the largest industrialized countries. This trend has been partly offset, in terms of effective resource transfers, by the increasing share of grants in official development assistance. Also, contrary to private flows, official finance has not been procyclical and, indeed, some components of it –particularly balance of payments support but also multilateral development finance—has displayed anti-cyclical behaviour.

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

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<sup>4/</sup> For a full evaluation of trends, see UNCTAD (1999), Chapters III and V, and World Bank (1999, 2000).

<sup>5/</sup> World Bank (2000), p. 58.

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

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

Table 1: Net Long-term Flows to Developing Countries<sup>a</sup>, 1990-1999

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

<sup>a</sup> 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.

<sup>b</sup> Preliminary.

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

| Table 2: Net Flow of Resources, 1992-1998 (Annual averages, billion dollars and percentages) |                           |              |                        |              |             |              |                     |              |  |              |
|--|---------------------------|--------------|------------------------|--------------|-------------|--------------|---------------------|--------------|--|--------------|
|  | Foreign direct investment |              | Portfolio equity flows |              | Grants      |              | Bilateral financing |              | Multilateral financing (excluding IMF) |              |
|  | Amount                    | Percentage   | Amount                 | Percentage   | Amount      | Percentage   | Amount              | Percentage   | Amount                                 | Percentage   |
| <b>Developing countries</b>  | <b>109.4</b>              | <b>100.0</b> | <b>33.0</b>            | <b>100.0</b> | <b>28.0</b> | <b>100.0</b> | <b>2.3</b>          | <b>100.0</b> | <b>15.3</b>                            | <b>100.0</b> |
| Excluding China  | 75.4                      | 68.9         | 29.4                   | 89.2         | 27.7        | 99.0         | 0.3                 | 13.1         | 13.1                                   | 86.0         |
| <b>Low-income countries</b>  | <b>7.4</b>                | <b>6.8</b>   | <b>3.0</b>             | <b>9.0</b>   | <b>16.2</b> | <b>58.0</b>  | <b>0.8</b>          | <b>36.7</b>  | <b>5.8</b>                             | <b>37.8</b>  |
| India  | 1.8                       | 1.6          | 2.2                    | 6.6          | 0.5         | 2.0          | -0.3                | -11.2        | 1.0                                    | 6.4          |
| Other countries  | 5.6                       | 5.1          | 0.8                    | 2.4          | 15.7        | 56.1         | 1.1                 | 48.0         | 4.8                                    | 31.5         |
| <b>China<sup>a</sup></b>   | <b>34.0</b>               | <b>31.1</b>  | <b>3.6</b>             | <b>10.8</b>  | <b>0.3</b>  | <b>1.0</b>   | <b>2.0</b>          | <b>86.9</b>  | <b>2.1</b>                             | <b>14.0</b>  |
| <b>Middle-income countries</b>   | <b>68.0</b>               | <b>62.1</b>  | <b>26.4</b>            | <b>80.2</b>  | <b>11.4</b> | <b>40.9</b>  | <b>-0.5</b>         | <b>-23.6</b> | <b>7.4</b>                             | <b>48.2</b>  |
| Argentina  | 5.2                       | 4.7          | 1.5                    | 4.5          | 0.0         | 0.1          | -0.2                | -10.1        | 1.0                                    | 6.5          |
| Brazil   | 9.8                       | 8.9          | 3.6                    | 10.9         | 0.1         | 0.2          | -1.1                | -49.6        | 0.7                                    | 4.9          |
| Russian Federation   | 1.9                       | 1.8          | 1.0                    | 3.0          | 1.0         | 3.5          | 0.5                 | 21.6         | 0.9                                    | 5.9          |
| Indonesia  | 3.0                       | 2.7          | 2.1                    | 6.4          | 0.2         | 0.8          | 1.2                 | 52.8         | 0.3                                    | 2.0          |
| Republic of Korea <sup>b</sup>   | 2.0                       | 1.9          | 3.5                    | 10.5         | 0.0         | 0.0          | 0.1                 | 3.1          | 1.1                                    | 7.4          |
| Mexico   | 8.8                       | 8.0          | 4.5                    | 13.6         | 0.0         | 0.1          | -0.7                | -28.8        | 0.3                                    | 2.0          |
| Other countries  | 37.3                      | 34.1         | 10.3                   | 31.3         | 10.1        | 36.2         | -0.3                | -12.6        | 3.0                                    | 19.6         |
|  | Bonds                     |              | Commercial bank loans  |              | Other loans |              | Total               | Memo:        |  |              |
|  | Amount                    | Percentage   | Amount                 | Percentage   | Amount      | Percentage   | Amount              | Percentage   | GDP                                    | Population   |
| <b>Developing countries</b>  | <b>38.2</b>               | <b>100.0</b> | <b>27.5</b>            | <b>100.0</b> | <b>3.7</b>  | <b>100.0</b> | <b>257.4</b>        | <b>100.0</b> | <b>100.0</b>                           | <b>100.0</b> |
| Excluding China  | 36.6                      | 95.7         | 26.7                   | 97.0         | 0.3         | 8.7          | 209.5               | 81.4         | 89.3                                   | 74.8         |
| <b>Low-income countries</b>  | <b>1.0</b>                | <b>2.7</b>   | <b>0.7</b>             | <b>2.6</b>   | <b>1.1</b>  | <b>29.5</b>  | <b>36.0</b>         | <b>14.0</b>  | <b>11.3</b>                            | <b>40.7</b>  |
| India  | 0.9                       | 2.4          | 0.5                    | 1.6          | 0.2         | 5.9          | 6.8                 | 2.6          | 5.3                                    | 19.4         |
| Other countries  | 0.1                       | 0.3          | 0.3                    | 0.9          | 0.9         | 23.5         | 29.2                | 11.4         | 6.0                                    | 21.3         |
| <b>China<sup>a</sup></b>   | <b>1.6</b>                | <b>4.3</b>   | <b>0.8</b>             | <b>3.0</b>   | <b>3.4</b>  | <b>91.3</b>  | <b>47.9</b>         | <b>18.6</b>  | <b>10.7</b>                            | <b>25.2</b>  |
| <b>Middle-income countries</b>   | <b>35.6</b>               | <b>93.0</b>  | <b>26.0</b>            | <b>94.4</b>  | <b>-0.8</b> | <b>-20.8</b> | <b>173.5</b>        | <b>67.4</b>  | <b>78.0</b>                            | <b>34.1</b>  |
| Argentina  | 5.9                       | 15.4         | 1.2                    | 4.5          | 0.0         | -1.3         | 14.5                | 5.6          | 4.7                                    | 0.7          |
| Brazil   | 3.1                       | 8.0          | 9.6                    | 34.7         | -0.5        | -13.3        | 25.2                | 9.8          | 10.3                                   | 3.3          |
| Russian Federation   | 2.3                       | 6.0          | 1.1                    | 4.0          | 1.1         | 29.0         | 9.8                 | 3.8          | 6.6                                    | 3.1          |
| Indonesia  | 1.4                       | 3.6          | 0.3                    | 1.2          | 0.1         | 2.9          | 8.6                 | 3.4          | 3.1                                    | 4.0          |
| Republic of Korea <sup>b</sup>   | 6.8                       | 17.7         | 0.7                    | 2.5          | -0.4        | -10.4        | 13.8                | 5.3          | 6.8                                    | 0.9          |
| Mexico   | 4.8                       | 12.6         | 1.6                    | 5.8          | -0.4        | -10.9        | 19.0                | 7.4          | 6.1                                    | 1.9          |
| Other countries  | 11.4                      | 29.7         | 11.5                   | 41.7         | -0.6        | -16.8        | 82.7                | 32.1         | 40.4                                   | 20.1         |

a. a specific category

b. Global Development Finance 2000

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

9. The volatility of private financial flows, on the one hand, and its strong concentration in middle-income countries, on the other, have jointly generated the need for exceptional financing on an unprecedented scale, which has been concentrated in a few “emerging” countries. As a result, IMF (including ESAF) financing has exhibited both strong anti-cyclical behaviour in relation to private flows and a concentration in a few countries. As Figure 1 indicates, both patterns are closely associated, as cyclical borrowing by a few countries is the major

determinant of the overall cyclical pattern. The latter feature has become even more marked in recent years. Thus, whereas India and the three largest Latin American borrowers received less than half of net real flows from the Fund in 1980–1984, net real flows to only four large borrowers (Indonesia, Republic of Korea, Russia and Mexico) accumulated close to 90% of total net real flows from the Fund in 1995–1998. As a result of this feature, the share of IMF financing going to large borrowers <sup>6/</sup> has displayed a strong upward trend over the past two decades. Indeed, in recent years, IMF financing underestimates the magnitude of emergency financing to large borrowers, as the bilateral contributions to the rescue packages of six nations (Indonesia, Republic of Korea, Thailand, Russia, Brazil and Mexico) are not included in the data <sup>7/</sup>.

10. Strictly speaking, however, “crowding out” by the largest borrowers does not seem to have taken place, as overall Fund financing has responded elastically to the needs of these large borrowers, with financing to other poorer or smaller middle-income countries remaining stagnant or even increasing marginally when they also require additional balance of payments financing. This was the case in the 1980s for much of the developing world and has also been true of the supply of financing to the smaller East Asian and Pacific nations in recent years. In any case, Fund and counterpart bilateral liquidity financing have complemented private funds through the business cycle. Given the high concentration of private financing in middle-income countries, this has led to a similar pattern of concentration in the case of official liquidity financing. In the context of a significant scarcity of official financing for low-income countries, the high concentration of balance of payments financing in a few large “emerging” economies raises significant concerns as to the global rationality with which global capital flows, and even official flows, are distributed. It certainly raises question about whether the problems of the largest developing countries generate specific biases in the response of the international community.

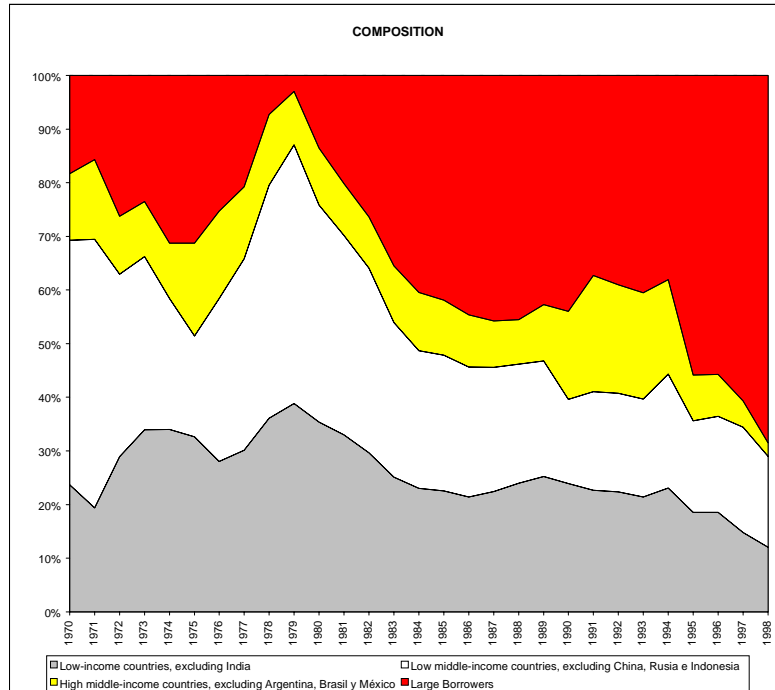
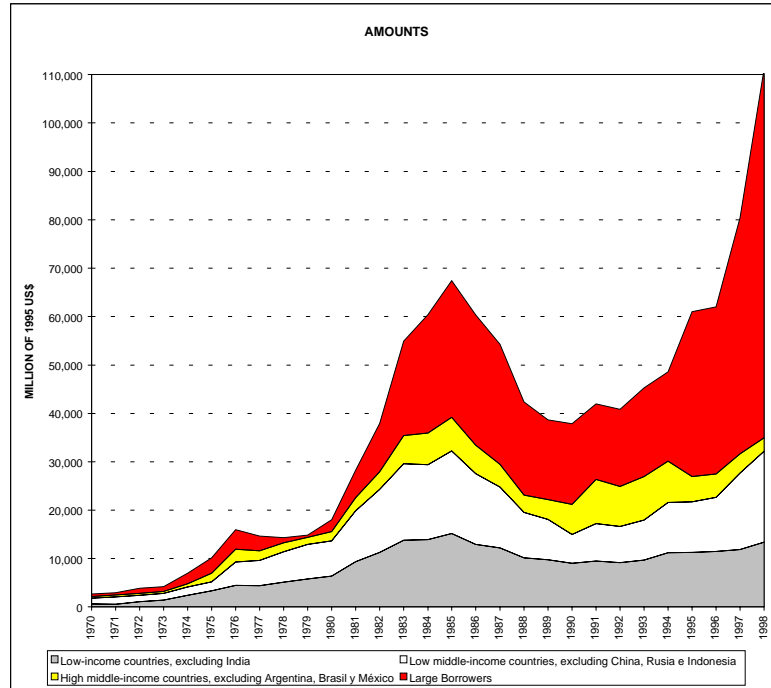
11. Thus, although the volatility and contagion exhibited by private capital flows, the centre of recent debates, are certainly problematic, no less important problems are the marginalization of the poorest countries from private capital flows and the decline in the bilateral aid on which they largely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

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<sup>6/</sup> This group includes Argentina, Brazil, China, Indonesia, India, the Republic of Korea, Mexico and the Russian Federation.

<sup>7/</sup> It must be emphasized, however, that pledged bilateral financing tends to be disbursed in smaller proportions than the multilateral shares in rescue packages.

**FIGURE 1**  
**USE OF IMF CREDIT**





### III. Financial Crisis Prevention and Resolution

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

The issues associated with financial crisis prevention and resolution have received extensive attention in recent discussions<sup>8/</sup>. The most important area of agreement relates to the need to improve the institutional framework in which financial markets operate: to strengthen prudential regulation, supervision and accounting practices of financial systems worldwide; to adopt minimum international standards in these areas, codes of conduct of fiscal, monetary and financial policies, and sound principles of corporate governance; and to improve the information provided to financial markets. From the point of view of industrialized countries, the central issues are stricter regulation and supervision of highly leveraged institutions and operations, controls on offshore centres, and the greater weight that should be given to the risks associated with operations with countries engaging in large-scale net borrowing, particularly of a short-term character, to discourage risky financing at the source. In this regard, it should be emphasized that, despite the recognition of the central role that strengthening regulations of highly leveraged institutions has, moves in this direction have rather timid and biased towards indirect rather than direct regulations.

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

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<sup>8/</sup> See, among others, IMF (1998, 1999, 2000), IMF Interim Committee (1998), Group of Seven (1998), UNCTAD (1998), Part One, Chapter IV, United Nations Task Force (1999), ECLAC (2000b), Miyazawa (1998), Rubin (1999), Summers (1999), Camdessus (1998, 2000), Fischer (1999), Akyüz and Cornford (1999), Eatwell and Taylor (2000), Eichengreen (1999), Griffith-Jones (1998), Griffith-Jones and Ocampo (1999), Ocampo (1999, 2000a), White (2000a, 2000b) and Wyplosz (1999).

14. Nonetheless, a substantial divergence of opinion remains. Firstly, there is no consensus as to which institutions should be entrusted with enhanced responsibilities in this field. The BIS should certainly play the leading role, but this requires a significant expansion of developing-country membership in this organization. The more ambitious proposal to create a World Financial Authority on the basis of BIS, IOSCO and IAIS should also be considered <sup>9/</sup>. Secondly, the lack of adequate representation of developing countries in the definition of all sorts of international standards and codes of conduct is a basic deficiency of current arrangements <sup>10/</sup>—which the launching of the G-20 only partly solves—and violates the central principle that G.K. Helleiner has formulated: “No harmonization without representation” <sup>11/</sup>. It also works against the necessary adaptation of rules to developing country conditions <sup>12/</sup>.

15. Thirdly, although the essential role of regulation and supervision is to make financial intermediaries more risk-conscious, there are clear limits to the appropriateness of discouraging private risk-taking. Stronger prudential regulation in developing countries increases the costs of domestic financial intermediation and thus encourages the use of more external borrowing in the absence of adequate regulation of the latter. Fourthly, differences exist as to the relative merits of prudential regulations and supervision vs. alternative instruments in key areas. One particularly relevant issue in this regard, as we will in Section VI, relates to capital account regulations. Moreover, there are significant 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. Finally, traditional prudential regulation and supervision tend to have pro-cyclical macroeconomic effects (they may be unable to avoid excessive risk-taking during the booms but accelerate the credit crunch during crises, when bad loans become evident and the effects of provisioning standards are thus felt), a fact which may increase rather than decrease credit risks through the business cycle.

16. Equally important, there is some doubt as to what can be expected from better information. Indeed, although improved information enhances microeconomic efficiency, it may not improve macroeconomic stability, which is dominated by the evolution of opinions and expectations rather than information, in the correct sense of that term (i.e.,

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<sup>9/</sup> Eatwell and Taylor (2000).

<sup>10/</sup> A very strong statement in this regard has been recently been made by the Governor of the People’s Bank of China: “The monopoly by a handful of developed countries on the rule-making in the international financial field must be changed” (Dai, 2000).

<sup>11/</sup> Helleiner (2000a).

<sup>12/</sup> Ahluwalia (1999).

factual information). Indeed, the tendency to equate opinions and expectations with “information” is one of the greatest weaknesses in the recent literature. Well-informed agents (rating agencies and institutional investors, for example) are equally subject to the whims of opinion and expectations, a fact that accounts for their inability to stabilize markets and, indeed, under certain conditions, the additional instability which they may generate <sup>13/</sup>. To use modern terminology, more than “information cascades”, what characterizes macroeconomic financial instability are “opinion and expectation cascades”, i.e., the alternate “contagion” of both optimism and pessimism through the business cycle. The best information system will be unable to correct this “market failure”, as the whims of expectations involve “information” about the future, which will never be available <sup>14/</sup>. Developing countries have also strongly argued for “a symmetrical application of transparency criteria between public institutions and the private sector” <sup>15/</sup> and thus against the tendency to emphasize the former over the latter in current proposals. Heated debates still surround the advantages vs. the disadvantages of the disclosure of IMF surveillance reports, which reflect the relative virtues of greater information and transparency vs. “the importance of maintaining the Fund’s role as confidential and trusted advisor” <sup>16/</sup>.

## B. The need for coherent macroeconomic policies worldwide

17. The consensus on the need to strengthen the institutional framework in which financial markets operate has not been matched by a similar emphasis on the role played by the coherence of macroeconomic policies worldwide, i.e., on appropriate mechanisms to internalize the externalities generated by national macroeconomic policies. A particularly crucial area, which the G-24 and other analysts have emphasized, are the high costs that fluctuations among major currencies have for developing countries <sup>17/</sup>.

18. The need for coherent macroeconomic policies is crucial in relation to both booms and crises, but the need to strengthen the extremely weak existing arrangements is particularly crucial during booms, when IMF surveillance is perceived by national authorities as an academic exercise, consultative mechanisms seem less necessary and “market discipline” has perverse effects, as it does not constrain excessive private risk-taking or the adoption of national pro-cyclical policies. Indeed, the focus of current institutions –both national and international– on

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<sup>13/</sup> See, on the former, Larraín *et al.* (1997); on the latter, Calvo (1998).

<sup>14/</sup> For a more extensive analysis, see Ocampo (2000a). Keynes’ concept of a “beauty contest” is thus much more appropriate to analyze the volatility of expectations, as Eatwell (1996) and Eatwell and Taylor (2000) have emphasized.

<sup>15/</sup> Group of 24 (1999a).

<sup>16/</sup> Group of 24 (1999b). See a more extensive discussion of this issue in IMF (1999, 2000a, 2000b).

<sup>17/</sup> See Group of 24 (1999b, 2000). See also the different points of view on this issue in Council on Foreign Relations (1999).

crises rather than booms is a serious deficiency of existing arrangements, as they underplay the preventive role that they should perform. Obviously, concerted expansionary action during crises is also essential and, as was pointed out in the introduction to this paper, moves in that direction since the Russian crisis were probably the single most important reason for the relative though incomplete normalization of capital markets in 1999.

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

### C. Emergency financing

20. The enhanced provision of emergency financing during crises is the third pillar of the system to prevent and manage financial crises. This principle may be called the principle of the "emergency financier", to differentiate it from the role that central banks play at the national level as "lenders of last resort", which is not exactly matched by the IMF. More specifically, the Fund provides exceptional financing but certainly not liquidity, a fact that is reflected in the lack of automaticity in the availability of financing during crises <sup>18/</sup>. The access to emergency financing raises, in any case, "moral hazard" issues that give rise, on the side of borrowers, to the need to define access rules and, on the side of private lenders, to the need for orderly debt workouts that guarantee that they assume a fair share of the costs of adjustment.

21. The main lessons from recent crises are: (1) that, as a preventive measure, wider use should be made of private contingency credit lines that are agreed during periods of adequate access to capital market, following the (partly successful) pioneering experiences of some "emerging" economies; (2) that large-scale official emergency funding may be required, though not all of it needs to be disbursed if support programs rapidly restore market confidence; (3) that 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. At least the last two imply significant differences with respect to the traditional IMF approach, which is based on the principle of correcting fundamental balance of payments disequilibria once they have become evident. Positive measures have been adopted in this area, including a significant expansion of IMF resources through a

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<sup>18/</sup> This important distinction is made by Helleiner (1999) and Eatwell and Taylor (2000). For a fuller discussion of this issue and its relation to IMF access to adequate resources, see Mohammed (1999).

quota increase and the New Arrangements to Borrow, which entered into effect in late 1998; the launching of a the Supplemental Reserve Facility (SRF) in December 1997 to finance exceptional borrowing requirements during crises; and the creation of the Contingency Credit Line (CCL) in April 1999 to provide financing to countries facing contagion, though under very restrictive eligibility conditions.

22. The major controversies relate to inadequate funding, conditions for access and credit terms. With respect to the first point, bilateral financing and contributions to the IMF will continue to be scarce during crises. This is a crucial issue, as the stabilizing effects of rescue packages will be absent if the market deems that the intervening authorities (the IMF plus additional bilateral support) 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, according to several recent proposals, is to allow additional issues of SDRs during episodes of world financial stress; these funds could be destroyed once financial conditions normalize <sup>19/</sup>. This procedure would create an anti-cyclical element 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 to allow the IMF to raise the resources needed in the market.

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

24. Indeed, following ideas closer to these classical criteria, some of the more radical proposals in this area involve reducing conditionality significantly and moving towards short-term credit lines, at penalty in-

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<sup>19/</sup> See United Nations Task Force (1999), Council on Foreign Relations (1999), Meltzer et al. (2000), Camdessus (2000)

terest rates <sup>20/</sup>. These alternatives are equally controversial. First of all, they also violate one of Bahegot's criteria: unlimited funding; indeed, these proposals would restrict financing severely when compared to recent IMF credit lines. Secondly, in some of those proposals, conditionality is maintained, even including conditions that have been absent in traditional IMF financing <sup>21/</sup>. Moreover, a basic assumptions of these proposals is that recent crises have been severe but short <sup>22/</sup>. The alleged fact is debatable <sup>23/</sup>. More importantly, the characteristics of recent crises --including their duration-- is certainly not independent of the rapid response of the international community in the form of larger and faster rescue packages than in the past (along the "lessons" previously inferred). During the Asian crisis, it was also associated, as indicated, to the rapid, concerted macroeconomic response of industrialized countries.

25. The recent Contingency Credit Line designed to deal with contagion have introduced similar but also some additional problems. Following, again, traditional "lending of last resort" criteria, critics have argued that such a credit line should have more onerous credit terms, but should also be automatic, based on whether countries fulfil certain ex-ante criteria, and thus be detached from traditional conditionality. The window created recently for this purpose does not fully meet these criteria: although Article IV consultations were given an enhanced role in signaling access ex-ante, access still requires negotiations prior to approval by the Board (a special "activation" review) and an explicit standby agreement. Moreover, countries with current access to IMF financing were not considered eligible. A more important difficulty is the fact that ex-ante signalling transforms, in effect, the IMF into a credit rating agency, a fact that could generate severe destabilizing effects on countries when downgraded. Moreover, performance indicators that are appropriate before crises may cease to be so once crises strike.

26. This discussion highlights how complex it is for an "emergency financier" (rather than a true "lender of last resort") to find the appropriate mix of conditionality, limited funding and more onerous credit

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<sup>20/</sup> See, in particular, Meltzer et al. (2000), but also Council on Foreign Relations (1999).

<sup>21/</sup> Thus, Meltzer et al. (2000) would require borrowing countries, as conditions for access, fiscal soundness, minimum prudential regulation, transparent data on debt and its structure, and freedom of operation for foreign financial institutions. The latter is absent, not only in current conditionality but in other proposals related to IMF financing.

<sup>22/</sup> Council on Foreign Relations (1999), ch. III.

<sup>23/</sup> As a matter of fact, commercial bank lending did not normalize in Latin America in the 1990s, despite the boom in such financing to East and South-East Asia. Moreover, the recovery of bond financing after the Asian crises and the successive shocks that followed were accompanied by a worsening of credit conditions (particularly higher spreads but also shorter maturities during the early recovery phase and call options that effectively further shorten maturities). More broadly, flows experienced a depression of more than two years (so far).

terms. The adequate solution would require: (1) large up-front financing; (2) no prequalifications but a fast review process during periods of strong contagion; and (3) reduced conditionality in general, but particularly for those credit lines subject to harsher terms <sup>24/</sup>.

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

27. Debt standstills and orderly workouts procedures are an essential mechanism to avoid the coordination problems implicit in chaotic capital flight, to guarantee an appropriate sharing of adjustments by private lenders and, thus, to avoid “moral hazard” issues associated with emergency financing. Broad consensus on the need to create arrangements of this sort exists <sup>25/</sup> but little action has followed. This reflects private sector opposition to non-voluntary arrangements in industrialized countries, but also the practical difficulties involved in drafting general rules in this area <sup>26/</sup>. A preference to a “case by case” approach has followed, but this approach is also clearly inadequate.

28. Due to the effects that the use of this mechanism could have on their credit standing, borrowing countries are unlikely to abuse it. Nonetheless, to avoid “moral hazard” issues on the side of borrowers, it must be subject to international control, by allowing countries to call a standstill unilaterally but then requiring that they submit it for approval by an independent international panel or an agreed international authority, whose authorization would give it legitimacy <sup>27/</sup>. An alternative could be to draft ex ante rules under which debt service would be automatically suspended or reduced if certain macroeconomic shocks were experienced; such rules have sometimes been incorporated into debt renegotiation agreements.

29. The active use of these mechanisms has four implications. Firstly, to avoid both free riding and discrimination against countries or group of countries that adopt them, they require the universal adoption by borrowing countries of “collective action clauses”, as indeed British rules already require. The G-7 countries should actually lead the process, as they suggested in October 1998 <sup>28/</sup>, for otherwise it may become an additional source of discrimination against “emerging markets”. Secondly, “bailing in” should be encouraged by giving seniority to lending that is extended to countries during the period in which the standstill is in effect and during a later phase of “normalization” of capital flows. IMF “lending into arrears” should be considered as part of “bailing in” operations. Thirdly, the phase of voluntary debt renegotiations under this framework must have a short, strictly-defined time horizon,

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<sup>24/</sup> See a discussion along these lines in Ahluwalia (1999).

<sup>25/</sup> See the references quoted in footnote 8.

<sup>26/</sup> See a review of some of the controversies involved in IMF (1999, 2000a, 2000b), Boorman and Allen (2000) and Fischer (1999).

<sup>27/</sup> UNCTAD (1998), Part I, Chapter IV; United Nations Task Force (1999).

<sup>28/</sup> Group of Seven (1998).

beyond which the country in arrears could request the independent panel or international authority to intervene in the negotiations or even to determine the terms of rescheduling. Indeed, the basic deficiency of voluntary case-by-case solutions is that the negotiation periods could become extremely long, generating large costs to developing countries, as the experience of Latin America in the 1980s indicates. Finally, to avoid repeated renegotiations –another troublesome feature of voluntary arrangements in recent decades-- aside from the portion that is written off (or refinanced in highly concessional terms), the service of another portion should be subject to the fulfilment of certain contingent macroeconomic conditions that determine debt service capacity (e.g., terms of trade, normalization of lending, domestic economic activity, etc.).

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



## IV. Development Finance

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

32. Equally important, however, is the acceleration of the growth of multilateral lending. Moreover, due to the high concentration of private flows in a few “emerging” economies, multilateral lending will continue to play an essential role even with respect to middle-income nations. More broadly, multilateral lending will continue to play a central role in at least four areas: (1) to channel funds to low-income countries; (2) to correct market failures associated to overpricing of risks, which may lead to inadequate access to long-term financing by middle income countries with insufficiently high credit rating and, consequently, to inadequate debt profiles that increase risks, thus generating “self-fulfilling” low-level equilibria; (3) to act as a counter-cyclical balance to fluctuations in private capital market financing; and (4) to facilitate the transition to private financing by supporting some innovations in long-term financing to developing countries and signalling creditworthiness. To these we should add the traditional “value added” of multilateral financing: lending-associated technical assistance <sup>29/</sup>.

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<sup>29/</sup> See, on this, Gilbert, Powell and Vines (1999) who, nonetheless, reject the idea that market failures are an argument for development lending to middle-income countries. The idea suggested by these authors that there is some kind of “natural monopoly” in some types of development economics research does not seem, however, a sensible defense of the World Bank. The parallel idea that global public goods should be provided is certainly valid, but it justifies the existence of many types of international

33. The first of these functions underscores the central role that financing from IBRD-IDA and the regional and subregional development banks will continue to play in the immediate future. It has received widespread support in recent debates. The second and third functions emphasize the role that official development financing will continue to play even for middle-income countries. Some authors reject, nonetheless, the validity of these arguments <sup>30/</sup>. The high interest rates that have characterized private lending to developing countries in the 1990s, and the much shorter maturities of private vs. official financing to middle-income countries, may indicate that, on average, risk may have been overestimated (see Table 3) <sup>31/</sup>.

**Table 3**  
**DEVELOPING COUNTRIES: AVERAGE TERMS OF NEW COMMITMENTS**

|                                 | 1990        | 1991        | 1992        | 1993        | 1994        | 1995        | 1996        | 1997        | 1998        |
|---------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <b>Average maturity (years)</b> |             |             |             |             |             |             |             |             |             |
| Official                        |             |             |             |             |             |             |             |             |             |
| All developing countries        | <b>22.2</b> | <b>20.9</b> | <b>21.1</b> | <b>21.4</b> | <b>22.1</b> | <b>19.2</b> | <b>21.2</b> | <b>20.1</b> | <b>18.5</b> |
| 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        | <b>13.9</b> | <b>10.2</b> | <b>10.0</b> | <b>9.4</b>  | <b>8.9</b>  | <b>7.4</b>  | <b>8.3</b>  | <b>10.0</b> | <b>8.8</b>  |
| 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         |
| <b>Average interest (%)</b>     |             |             |             |             |             |             |             |             |             |
| Official                        |             |             |             |             |             |             |             |             |             |
| All developing countries        | <b>5.5</b>  | <b>5.5</b>  | <b>5.3</b>  | <b>4.8</b>  | <b>4.9</b>  | <b>5.8</b>  | <b>4.8</b>  | <b>5.4</b>  | <b>5.2</b>  |
| 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        | <b>8.5</b>  | <b>7.8</b>  | <b>6.8</b>  | <b>6.3</b>  | <b>6.3</b>  | <b>6.4</b>  | <b>7.3</b>  | <b>7.3</b>  | <b>7.9</b>  |
| Income groups                   |             |             |             |             |             |             |             |             |             |
| Low income                      | 7.9         | 7.5         | 6.7         | 6.0         | 5.7         | 6.4         | 6.6         | 6.4         | 6.9         |
| Middle income                   | 8.8         | 7.8         | 6.9         | 6.4         | 6.5         | 6.4         | 7.5         | 7.5         | 8.0         |

Source: World Bank (2000).

34. It must be stressed, however, that the anti-cyclical provision of funds should not be confused with the provision of emergency balance

institutions, not development banks per se.

<sup>30/</sup> 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.

<sup>31/</sup> Indeed, it is peculiar that Meltzer *et al.* (2000) estimate the subsidies of development financing in the 1990s by assuming that it is equivalent to only half of spreads in capital markets.

of payments financing, which is essentially a task of the IMF. However, to the extent that anti-cyclical fiscal policies are a necessary element in counter-cyclical macroeconomic management in general, there may be an argument for development financing during crisis as a counterpart to pure balance of payments financing <sup>32/</sup>. An alternative would be to allow IMF financing –or the latitude it offers for domestic credit creation– for fiscal purposes, but this step would be suboptimal. In any case, the large-scale requirements for counter-cyclical financing to middle-income countries during crises may crowd out financing to poor countries, a point which has been made by the President of the World Bank <sup>33/</sup>. Thus, if multilateral development financing is not significantly expanded, its role as a counter-cyclical device will necessarily be very limited, and it would certainly be of secondary importance relative to its first two roles, particularly the provision of long-term development financing to poor countries. This is underscored by the data from Table 2, which indicate that multilateral financing in 1992-1998 represented only 15% of that provided by the private sector, excluding FDI, and only 8% in the case of middle-income countries. Thus, a useful counter-cyclical function would certainly require a significant increase in resources available to multilateral development banks or a more active use of cofinancing and credit guarantees by these institutions (see below).

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

36. Recent analyses have come to some basic conclusions about these programs. Firstly, safety nets must be part of permanent social protection schemes, as only a permanent scheme guarantees that the program coverage will respond without lags to the demand for protection of vulnerable sectors during crises <sup>34/</sup>. Secondly, given the heterogeneity of labor markets in developing countries, a combination of several pro-

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<sup>32/</sup> Such financing could be tied to broader forms of anti-cyclical management, on the basis of counterpart savings in the countries accumulated during the previous boom or repayment conditions that would require acceleration of amortizations if fiscal revenues experience a strong recovery during a subsequent boom.

<sup>33/</sup> Wolfensohn (1998).

<sup>34/</sup> Cornia (1999).

grams, with different target groups, is necessary <sup>35/</sup>. Thirdly, these programs must be adequately financed and should not crowd out resources from long-term investment in human capital. This, it must be said, leads to a fourth conclusion: that the effective functioning of social safety nets requires that public-sector expenditure should include anti-cyclical components. This would be impossible, without generating inefficiencies in the rest of public-sector expenditure, if fiscal policy as a whole is not counter-cyclical. In the absence of this anti-cyclical fiscal pattern, external financing from development banks during crises to safety nets will be unnecessary, as overall net fiscal financing requirements will actually decrease despite the increased spending associated to such safety nets.

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

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<sup>35/</sup> Márquez (1999). Different groups would be supported by unemployment insurance, emergency employment or emergency labor-intensive public works programs, income-support schemes in conjunction with training, and special targeted subsidies (such as some nutrition programs, subsidies to households with school-age children that are tied to school attendance, and various support programs aimed at ensuring that households with an unemployed head of household do not lose their home during crises, etc.).

## V. Conditionality VS. "Ownership"

The most controversial issue behind international emergency and development financing is certainly conditionality. In the case of the IMF, this issue has long been a central area of contention.

However, in recent years –and even decades– the issue has become increasingly troublesome for three different reasons. Firstly, the scope of conditionality has been gradually expanded to include not only the realms of other international organizations –quite often, for example, that of the WTO and the development banks– but also of domestic economic and social development strategies and institutions which, as the United Nations Task Force has indicated, “by their very nature should be decided by legitimate national authorities, based on broad social consensus”<sup>36/</sup>. The broadening of conditionality to social policy, governance issues and private sector involvement in crisis resolution has been criticized by developing countries in the Group of 24<sup>37/</sup>. The need to restrict conditionality to macroeconomic policy and financial sector issues is shared by a broad group of analysts with quite different persuasions as to the future role of the IMF<sup>38/</sup>. A similar view was expressed in the external evaluation of surveillance activities of the Fund<sup>39/</sup>.

39. Secondly, whereas the legitimacy of conditionality is indisputable when domestic policies are the source of macroeconomic disequilibria that lead to financial difficulties, as well as being necessary to avert “moral hazard” issues, it is unclear how this principle applies when such difficulties are generated by international crises and, particularly, by contagion effects. Thirdly, as has already been pointed out, it is even less clear why conditionality should be mixed with adverse credit terms. Finally, many observers have criticized overkill in some IMF programs, a fact which has led the Fund to allow some room for anti-cyclical fiscal policies in its adjustment programs<sup>40/</sup>.

40. Even if the legitimacy of the principle of conditionality –or, as it is sometimes stated, “support in exchange for reforms”– is accepted, there are thus reasons to review the characteristics of such conditionality. Indeed, the perception that conditionality has been carried beyond what may actually be necessary in order for the Fund to perform its functions properly may be helping to undermine its legitimacy. Thus, a strong argument can be made that the way to restore full confidence in the principle of conditionality is by reaching a renewed international agreement on how it should be used.

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<sup>36/</sup> United Nations Task Force (1999), Section 5.

<sup>37/</sup> Group of 24 (1999b).

<sup>38/</sup> Council on Foreign Relations (1999), Meltzer *et al.* (2000), Collier and Gunning (1999), Feldstein (1998), Helleiner (2000b) and Rodrik (1999b).

<sup>39/</sup> Crow, Arriazu and Thygeseb (1999).

<sup>40/</sup> Fischer (1998).

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

42. It must be emphasized that similar issues have been raised in relation to development finance. With respect to this issue, a recent World Bank report which analyses the success of structural lending, according to its own evaluation, comes to the conclusion that conditionality does not influence the success or failure of such programs at all <sup>41/</sup>. Nonetheless, according to the same report, aid effectiveness is not independent of the economic policies that countries follow. In particular, the growth effects of aid are higher for countries that adopt “good” policies, which, according to their definition, include stable macroeconomic environments, open trade regimes, adequate protection of property rights and efficient public bureaucracies that can deliver good-quality social services. In the context of good policies, there is an additional positive effect of aid that is manifested through the “crowding in” of private financing. Neither of these effects are present, however, in countries following “wrong” policies. In terms that are now familiar in the aid literature, the ownership of adequate economic policies, i.e., the commitment of national authorities to them, is what really matters. Conditionality has no additional contribution to make in these cases, and it is obviously ineffective in the case of countries that do not follow good policies.

43. Curiously enough, on the basis of this study the World Bank draws the conclusion that conditionality is good after all. Hence, it claims that “Conditional lending is worthwhile where reforms have serious domestic support” <sup>42/</sup> and, in particular, that it “still has a role –to allow gov-

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<sup>41/</sup> See World Bank (1998b), Chapter 2 and Appendix 2. See also Gilbert, Powell and Vines (1999) and Stiglitz (1999).

<sup>42/</sup> World Bank (1998b), p. 48.

ernment to commit to reform and to signal the seriousness of reform—but to be effective in this it must focus on a small number of truly important measures”.<sup>43/</sup> This statement is certainly paradoxical if the conclusions of the report are taken at face value. Rather, this study raises serious doubts about the rationality of conditionality itself, a fact that is, indeed, implicit in the idea that policies are only effective when they are rooted in broad national consensus, the essential idea that has been captured in the concept of “ownership”<sup>44/</sup>. Indeed, the President of the World Bank has made the strongest statement in this regard: “We must never stop reminding ourselves that it is up to the governments and its people to decide what their priorities should be. We must never stop reminding ourselves that we cannot and should not impose development by fiat from above –or from abroad”<sup>45/</sup>.

44. A recent analysis by Rodrik has come to complementary conclusions which are extensive to short-term macroeconomic policies<sup>46/</sup>. Aside from arguing that international arrangements should allow for diversity in national development strategies (different “brands of capitalism”), this author makes a strong argument that adequate institutions of conflict management, which can only be guaranteed by national democratic processes, are crucial for macroeconomic stability and that this, in turn, is vital for economic growth. To borrow the term, the “ownership” of adjustment programs is also essential to guarantee their political sustainability.

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

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<sup>43/</sup> World Bank (1998b), p. 19.

<sup>44/</sup> See a full discussion of these issues in Helleiner (1999).

<sup>45/</sup> Wolfensohn (1998).

<sup>46/</sup> Rodrik (1999a).

## VI. The Role of Regional Institutions

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

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

48. Thirdly, for smaller countries, the access to a broader menu of alternatives to manage a crisis or to finance development is relatively more important than the "global public goods" that the largest international organizations provide (e.g., global macroeconomic stability) and



upon which they will assume they have little or no influence (i.e., they have the attitude of “free riders”). Due to their small size, their negotiation power vis-à-vis large organizations would be very limited, and their most important defense is therefore competition in the provision of financial services from such institutions.

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

50. This implies that the International Monetary Fund of the future should not be viewed as a single, global institution, but rather as the apex of a network of regional and subregional reserve funds and swap arrangements. To encourage the development of the latter, incentives could be created by which common reserve funds could have automatic access to IMF financing and/or a share in the allocation of SDRs proportional to their paid-in resources –in other words, contributions to common reserve funds would be treated as equivalent to IMF quotas <sup>47/</sup>. As noted, regional reserve funds or swap arrangements could provide most of the exceptional financing for smaller countries within a region, but also part of the financing for larger countries, and they could also serve to deter, at least partly, would-be speculators from attacking the currencies of individual countries.

51. This model should be extended to the provision of macroeconomic consultation and surveillance, as well as to coordination and surveillance of national systems of prudential regulation and supervision. Thus, regional and subregional systems, including peer review mechanisms, should be designed to internalize the externalities that macroeconomic policies generate on neighbours. This would complement, rather than substitute for, regular IMF surveillance. In the area of prudential regulation and supervision, more elaborate systems of regional information and consultation, including the design of specific regional “minimum standards”, can also play a positive role. Again, peer reviews

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<sup>47/</sup> United Nations Task Force (1999), Section 9; Ocampo (2000a).

should be part of this system. Aside from other functions considered in Section III, subregional development banks can play a significant role as a mechanism to pool the risks of groups of developing countries, thus allowing them to make a more aggressive use of opportunities provided by private capital markets.

52. As it is well known, Western Europe provides the best example of regional financial cooperation in the post-war period. The U.S., through the Marshall Plan, catalysed the initial phases of this process, which underwent a dynamic deepening from the design of the European Payments Union to a series of arrangements for macroeconomic coordination and cooperation, that eventually led to the current monetary union of most of its members. No similar schemes have been devised in the rest of the world, although some proposals have been made, the most ambitious of which was the Japanese suggestion to create an Asian Monetary Fund. The most interesting development in recent years has been the swap arrangement among thirteen Asian countries agreed in May 2000 <sup>48/</sup> and initiatives to strengthen the Latin American (previously Andean) Reserve Fund <sup>49/</sup>.

53. An institutional framework such as that suggested would have two positive features. First of all, it may help to bring more stability to the world economy by providing essential services that can hardly be provided by a few international institutions, particularly in the face of a dynamic process of open regionalism. Secondly, from the point of view of the equilibrium of world relations, it would be more balanced than a system based on a few world organizations. This would increase the commitment of less powerful players to abide by rules that contribute to world and regional stability.

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<sup>48/</sup> Park and Wang (2000).

<sup>49/</sup> Agosin (2000) and ECLAC (2000b, ch. 2).

## VII. The Realms of National Autonomy

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

55. 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 <sup>50/</sup>. Despite the traditional emphasis on crisis management, the focus of the authorities should instead be the management of booms, since it is in the periods of euphoria of capital inflows, trade expansion and terms-of-trade improvements that crises are incubated. Crisis prevention is thus, essentially, an issue of the adequate management of periods of euphoria.

56. In this regard, regulations on capital inflows may be essential to avoid unsustainable exchange rate appreciation during booms. Although some appreciation may be inevitable and even an efficient way to absorb the increased supply of foreign exchange, an excessive revaluation may also generate irreversible “Dutch disease” effects. The regulation of capital inflows thus plays an essential role in open developing economies as a mechanism for monetary and domestic credit restraint and for the avoidance of unsustainable exchange rate appreciation during booms. The nature of such regulations will be considered below. Regulations governing outflows may also play a role as a way to avoid overshooting interest or exchange rates during crises, which may have adverse macroeconomic dynamics, including the greater risk of domestic financial crises; they are also essential to put in place debt standstill and orderly debt workout procedures. It is essential, of course, that capital account regulations be used as a complement and not a substitute for fundamental macroeconomic adjustment.

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<sup>50/</sup> The literature on national policies is extensive. See, among recent contributions, ECLAC (2000a, ch. 8); World Bank (1998a), Chapter 3; Ffrench-Davis (1999); Hel-leiner (1997); and Ocampo (1999, 2000b).

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

58. The experience of many developing countries indicates that crises are associated not only with high debt ratios but also with inadequate debt profiles<sup>51/</sup>. The basic reason for that is that, under uncertainty, financial markets respond to gross –rather than only to net– financing requirements, or in other words, the rollover 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 between good external and internal debt profiles. Hence, excessive short-term domestic borrowing may force a Government that is trying to rollover 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.

59. In the case of the public sector, direct controls by the Ministry of Finance are an appropriate instrument of a liability policy. Exchange

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<sup>51/</sup> See an excellent recent treatment of this issue in Rodrik and Velasco (1999).

rate flexibility may deter some short-term private flows and may thus partly operate as a “liability policy”, but its effects are limited in this regard, as it is unlikely to smooth out medium-term financial cycles, which will be reflected in a parallel cycle of nominal and real exchange rates. Direct controls on inflows may also be an appropriate instrument to achieve a better private debt profile. An interesting, indirect price-based policy tool is reserve requirements on capital inflows, such as those used by Chile and Colombia in the 1990s. These requirements are a particular type of Tobin tax, but the equivalent tax rate (3% in the case of Chile for one-year loans and 10% or more in Colombia during the boom) is much higher than that proposed for an international Tobin tax. A flat tax has positive effects on the debt profile, as it induces longer-term borrowing, for which the tax can be spread over a longer time period, and is easier to administer. 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 –or, what is equivalent, interest arbitrage conditions– should also be affected <sup>52/</sup>. A basic advantage of this instrument is that it is targeted at capital inflows and is thus a preventive policy tool. It also has specific advantages over prudential regulations that could have similar effects: it affects both financial and non-financial agents, and it uses a non-discriminatory price instrument, whereas prudential regulations affect only financial intermediaries, are usually quantitative in nature and supervision is essentially discretionary in its operation <sup>53/</sup>.

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

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<sup>52/</sup> Agosin (1998), Agosin and Ffrench-Davis (2000), Le Fort and Lehman (2000), Ocampo and Tovar (1998, 1999), and Villar and Rincón (2000).

<sup>53/</sup> 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.

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

62. There are actually no strong arguments in favour of moving towards capital account convertibility<sup>54/</sup>. There is no evidence that capital mobility leads to an efficient smoothing of expenditures in developing countries through the business cycle and, on the contrary, strong evidence that in these countries the volatility of capital flows is an additional source of instability. There is also no evidence of an association between capital account liberalization and economic growth, and there are some indications that point in the opposite direction<sup>55/</sup>. A simple way to pose the issue is to argue that, even if it were true that freer capital flows, through their effects on a more efficient savings-investment allocation process, have positive effects on growth, the additional volatility associated with freer capital markets has the opposite effect. The absence of an adequate international financial safety net is an equally important argument in this connection. Why should developing countries give up this degree of freedom if they do not have access to adequate amount of contingency financing with well-defined conditionality rules, and no internationally agreed standstills and debt workout procedures? This is a crucial issue for countries without significant power in the international arena, for whom renouncing any possible means of crisis management is a costly alternative. Indeed, there are strong similarities between today's international financial world and the era of "free banking" at the national level: in the absence of central banks as lenders of last resort and officially managed bank rescue schemes, inconvertibility of private bank notes was a necessary legal alternative in the face of bank runs.

63. Similar arguments could be used to claim that there are no grounds for limiting the autonomy of developing countries to choose their exchange rate regime. There are certainly virtues to the argument that, in the current globalized world, only convertibility regimes or totally free-floating exchange rate regimes can generate sufficient credibility in the eyes of private agents. However, any international rules in this area would be unfortunate. The advantages and disadvantages of

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<sup>54/</sup> For a more extensive analysis of this subject, see United Nations Task Force (1999), UNCTAD (1998), Part One, Chapter IV, ECLAC (1998), Part III, IMF (1999), Eichengreen (1999), Griffith-Jones (1998), Grilli and Milesi-Ferreti (1995), Krugman (1998a, 1998b), Ocampo (2000a) and Rodrik (1998).

<sup>55/</sup> See, in particular, Eatwell (1996), Eatwell and Taylor (2000), Rodrik (1998) and, for Latin America, Ocampo (1999).

these extremes, as well as of interventionist regimes in between the two, have been subject to extensive historical debate (and, of course, experience) <sup>56/</sup>. In practice, countries almost invariably choose intermediate regimes, a fact that can probably be traced back not only to the deficiencies of the extremes, but also to the many additional demands that authorities face <sup>57/</sup>. The choice of the exchange rate regime has, nonetheless, major implications for economic policy that must be recognized in macroeconomic surveillance. Particularly, as we have noticed, domestic prudential regulations must take into account the specific macroeconomic risks that financial intermediaries face under each particular regime.

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<sup>56/</sup> Velasco (2000) provides a recent survey of the issues involved.

<sup>57/</sup> The best conclusion on this subject is, thus, that reached by the IMF (2000a): “No single regime is appropriate for all countries or in all circumstances”. See also ECLAC (2000b, ch. 2) and, for a recent defense of intermediate regimes, Williamson (2000).

## VIII. Conclusions

This paper has argued that the agenda for international financial reform must be broadened in at least two senses. First of all, it should go beyond the issues of financial prevention and resolution, on which the recent debate has focused, to those associated with development finance for poor and small countries, to overcome the strong concentration of private and even official financing in a few large “emerging” economies, and to the “ownership” of economic and development policies by countries. Secondly, it should consider, in a systematic fashion, not only the role of world institutions but also of regional arrangements and the explicit definition of areas where national autonomy should be maintained. These issues should be tabled in a representative, balanced negotiation process.

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

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



national autonomy, particularly capital account regulations and the choice of exchange rate regimes. Regional institutions and national autonomy are particularly important for the smaller players in the international arena, which will gain significantly from competition in the services provided to them and from the maintenance of freedom of action in a context of imperfect supply of global public goods.

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