

International financial *reform: the* broad agenda

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This paper argues 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 crisis prevention and resolution, to those associated with development finance for poor and small countries and to the “ownership” of economic and development policies by countries. Secondly, it should consider 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 capable of overcoming some of the adverse political economy features that characterize the current debate. After some initial considerations of the nature of the problems that the current system faces and some political economy aspects, the author addresses the following issues: i) the reforms relating to the prevention and resolution of financial crises; ii) the role of development finance, including the use of multilateral development finance to support increased participation of low-income and small middle-income countries in private capital markets and the financing of social safety nets during crises; iii) the need to reach a renewed international agreement on the limits of conditionality and full recognition of the central role of the “ownership” of development and macroeconomic policies by developing countries; iv) the role of regional and subregional institutions in increasing the supply of “global public goods” and other services in the area of international finance; and v) the need to maintain several realms of national autonomy, including capital account regulation and the choice of exchange rate regimes. The author argues that regional institutions and national autonomy are particularly important for the smaller players in the international arena, who would 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.

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 financial crises and improve their management when they occur. The crisis led, indeed, to the recognition that there is an enormous discrepancy between the sophisticated and dynamic financial world and the institutions that regulate it, and that “existing institutions are inadequate to deal with financial globalization”.¹

The crisis gave rise to some positive responses: a concerted expansionary effort led by the United States, 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 International Monetary Fund (IMF) resources; the recognition that incentives must be created to induce more suitable debt profiles in developing countries; a special boost for international efforts to establish minimum standards of prudential regulation and supervision, as well as of information; the partial acceptance by the IMF that fiscal overkill is inappropriate in adjustment programmes; the improvement of the Highly Indebted Poor Countries (HIPC) Initiative; and the greater emphasis given to the design of adequate so-

cial safety nets in developing countries. Some responses were positive but do not seem to be leading in any clear direction (or even seem to be leading in the wrong one). This is the case of the adoption of collective action clauses in issues of external debt securities, as an essential step to facilitate internationally agreed debt standstills and workout procedures. In some cases, the responses were insufficient or clearly inadequate: IMF conditionality was further extended; the issues associated with 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 undeservedly strong opposition that led to its rapid dismissal; more generally, the role that regional institutions can play in an appropriate international financial arrangement was not given adequate attention; and no steps were taken to ensure the fair representation of developing countries in the discussions on reform or in a revised international architecture.

The fairly rapid normalization of capital markets seems to be giving way to a sense of complacency that could slow down the reform effort. Moreover, it may lead efforts in the wrong direction, as for example in giving new impetus to discussions on capital account convertibility. On the other hand, the calmer environment could be taken as an opportunity to broaden the agenda and to set in motion a representative, balanced negotiation process. 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)² to include those associated with development finance and the “ownership” by the countries of economic and, particularly, development policies; secondly, it should consider, in a systematic fashion, not only the role of world institutions, but also that of regional arrangements and

□ This article is partly based on the Report of the Task Force of the Executive Committee on Economic and Social Affairs of the United Nations (United Nations, Task Force, 1999a), of which the author was Coordinator, as well as on two later studies (Ocampo, 1999a and 1999b) and a study carried out jointly with Stephany Griffith-Jones (Griffith-Jones and Ocampo, 1999), with the support of the Ministry of Foreign Affairs of Sweden. The discussions at the meeting organized by the International Development Research Centre (IDRC) in Ottawa, Canada, in preparation for a large-scale project on international financial reform, were very useful in clarifying some of the issues addressed in this paper. The author wishes to thank Oscar Altimir, Reynaldo Bajraj, Nicolás Eyzaguirre, Günther Held, Gerald K. Helleiner and the participants in a workshop on the World Financial Authority held at the New School for Social Research in New York for their comments on a previous draft of this study, and Guillermo Mundt and Camilo Tovar for their elaboration of the data included in section II.

¹ United Nations, Report of the Task Force of the Executive Committee on Economic and Social Affairs (1999a, section I).

² Ocampo (1999a).

the areas where national autonomy should be maintained. This is the focus of this paper. The following two sections present brief introductory reflections on the nature of the problems that the system faces and the political economy of the reform effort. The paper

then goes on to deal with crisis prevention and management, development finance, the issue of conditionality versus “ownership” of policies, which concerns both sides, the role of regional institutions, and national regulations and autonomy.

II

The nature of the problems facing the system

International capital flows to developing countries have exhibited four outstanding features in the 1990s.³ First of all, official and private flows have shown 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 world level. Finally, the instability of private financial flows has required the design of major emergency rescue packages, of unprecedented size, which have concentrated funds in a few large “emerging” economies.

The first two patterns are shown in table 1. Both foreign direct investment (FDI) and all types of private financial flows have registered 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 fallen in real terms throughout the decade, and in 1998 it is estimated to have amounted to only 0.22% of the GDP of industrialized countries: a significant fall with respect to the 0.35% of GDP reached in the mid-1980s.⁴ The reduction in bilateral aid has been strongest in the case of the largest industrialized countries, though 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 pro-cyclical and, indeed, some components of it – particularly balance of payments support but also multilateral development finance – have displayed counter-cyclical behaviour.

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, which was to be expected, but it is also lower than their share in developing countries’ GDP. This situation is particularly striking in the case of bond financing, commercial banking and portfolio flows, if India is excluded in the latter case. In all these cases, private financing to poor countries is minimal. 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, on the contrary, receives a smaller proportion of financial flows. The high concentration of the most volatile flows in middle-income countries, excluding China, has meant in turn that questions of financial volatility and contagion have become particularly important for them.

Low-income countries have thus been marginalized from private flows and have continued to depend on declining official resource flows. More specifically, they have 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

³ For a full evaluation of these trends, see UNCTAD (1999, chapters III and V) and World Bank (1999).

⁴ World Bank, 1999, chap. 4, p. 70.

TABLE 1

Net long-term resource flows to developing countries,^a 1990-1998
(Billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998 ^b
<i>Net long-term resource flows</i>	100.8	123.1	152.3	220.2	223.6	254.9	308.1	338.1	275.0
Official	56.9	62.6	54.0	53.3	45.5	53.4	32.2	39.1	47.9
Private	43.9	60.5	98.3	167.0	178.1	201.5	275.9	299.0	227.1
From international capital markets	19.4	26.2	52.2	100.0	89.6	96.1	149.5	135.5	72.1
Private debt flows	15.7	18.6	38.1	49.0	54.4	60.0	100.3	105.3	58.0
Commercial banks	3.2	4.8	16.3	3.3	13.9	32.4	43.7	60.1	25.1
Bonds	1.2	10.8	11.1	37.0	36.7	26.6	53.5	42.6	30.2
Other	11.4	3.0	10.7	8.6	3.7	1.0	3.0	2.6	2.7
Portfolio equity flows	3.7	7.6	14.1	51.0	35.2	36.1	49.2	30.2	14.1
Foreign direct investment	24.5	34.4	46.1	67.0	88.5	105.4	126.4	163.4	155.0

Source: World Bank, *Global Development Finance 1999*.

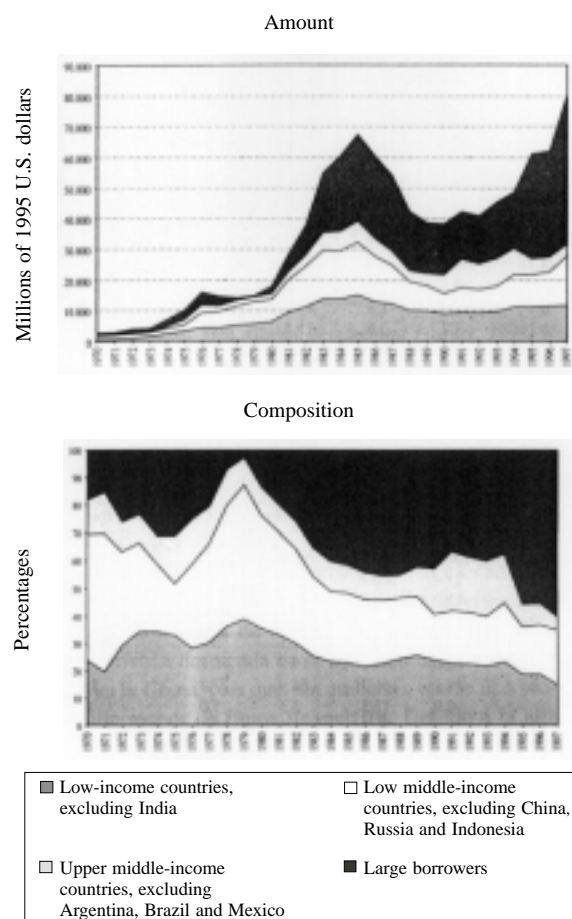
^a Net long-term resource flows are defined as net liability transactions of original maturity greater than one year. Although the Republic of Korea is a high-income country, it is included in the developing country aggregate since it is a borrower from the World Bank.

^b Preliminary.

developing countries' GDP but also in population. This is also true of multilateral financing, excluding the IMF.

The volatility of private financial flows, on the one hand, and their 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 Enhanced Structural Adjustment Facility) financing has exhibited strong counter-cyclical behaviour compared with private flows but has been concentrated 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. This 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, the Russian Federation and Mexico) have in fact exceeded by a small margin the total net real flows from the Fund in 1995-1997. As a result, the share of IMF financing going to large borrowers⁵ has displayed a strong upward trend over the past two

FIGURE 1
Use of IMF credit, 1970-1997



⁵ This group includes Argentina, Brazil, China, Indonesia, India, Republic of Korea, Mexico and the Russian Federation.

TABLE 2

Net flow of resources, 1992-1997
(Annual averages, billions of 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
<i>Developing countries</i>	99.0	100.0	35.7	100.0	29.7	100.0	2.9	100.0	13.7	100.0
Excluding China	66.8	67.5	31.7	88.9	29.4	99.0	0.5	19.0	11.6	84.5
<i>Low-income countries</i>	6.7	6.8	3.4	9.5	15.8	53.2	0.8	27.1	5.9	43.4
India	1.6	1.6	2.5	6.9	0.6	1.9	-0.3	-11.3	1.0	7.4
Other countries	5.1	5.2	0.9	2.6	15.2	51.3	1.1	38.4	4.9	36.0
<i>China</i> ^a	32.1	32.5	3.9	11.1	0.3	1.0	2.3	81.0	2.1	15.5
<i>Middle-income countries</i>	60.1	60.8	28.3	79.4	13.7	46.1	-0.2	-8.1	5.6	41.1
Argentina	4.4	4.5	1.7	4.9	-	0.1	-0.1	-3.2	0.9	6.6
Brazil	7.7	7.7	4.1	11.5	0.1	0.2	-1.3	-43.4	-0.1	-0.6
Russian Federation	1.9	1.9	1.1	3.1	1.1	3.7	0.6	21.4	0.9	6.2
Indonesia	3.5	3.6	2.4	6.8	0.2	0.8	1.2	41.7	0.1	0.9
Republic of Korea ^b	1.5	1.5	3.1	8.8	-	-	-0.2	-5.4	0.6	4.1
Mexico	8.1	8.2	5.1	14.3	-	0.1	-0.6	-21.4	0.3	2.2
Other countries	33.0	33.3	10.7	30.1	12.2	41.2	0.1	2.2	3.0	21.7

	Bonds		Commercial bank loans		Other loans		Total		Memo:	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	GDP	Population
<i>Developing countries</i>	34.6	100.0	28.3	100.0	4.9	100.0	248.7	100.0	100.0	100.0
Excluding China	32.9	95.2	26.6	94.0	1.1	21.4	200.7	80.7	89.2	74.8
<i>Low-income countries</i>	0.5	1.5	0.9	3.3	0.4	7.2	34.5	13.9	11.4	41.0
India	0.4	1.1	0.8	2.8	0.4	8.9	6.9	2.8	5.6	19.3
Other countries	0.2	0.4	0.2	0.6	-0.1	-1.7	27.6	11.1	5.8	21.7
<i>China</i> ^a	1.7	4.8	1.7	6.0	3.9	78.6	48.0	19.3	10.8	25.2
<i>Middle-income countries</i>	32.4	93.7	25.7	90.7	0.7	14.2	166.3	66.9	77.8	33.9
Argentina	5.5	15.9	0.8	2.9	-	-0.9	13.3	5.3	5.0	0.7
Brazil	3.1	9.0	8.2	29.0	-0.6	-11.3	21.2	8.5	10.5	3.3
Russian Federation	0.8	2.2	0.3	1.1	1.4	28.7	8.1	3.2	7.3	3.1
Indonesia	1.6	4.7	0.9	3.2	0.2	3.7	10.2	4.1	3.4	4.0
Republic of Korea ^b	4.5	12.9	4.1	14.5	-0.2	-4.8	13.4	5.4	7.3	0.9
Mexico	5.2	15.2	0.3	1.1	-0.3	-6.9	18.2	7.3	6.7	1.9
Other countries	11.7	33.8	11.0	38.9	0.3	5.6	81.9	32.9	37.6	19.8

Source: World Bank, *Global Development Finance, 1999*, Washington, D.C., March 1999 and *World Economic Indicators*, Washington, D.C., 1998 for GDP and population data.

^a The World Bank considered China as a low-income country until 1998. Since 1999 it has been classified as a middle-income country. In this table it is considered in a separate category.

^b The World Bank classifies it as a high-income country, but it is included as a middle-income country in *Global Development Finance, 1999*.

decades. Indeed, in recent years, the IMF financing data underestimate 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 figures.⁶

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 unchanged 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 finance to the medium-sized Asia-Pacific nations in recent years. In any case, IMF and counterpart bilateral liquidity financing have complemented private funds throughout 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 finance for low-income countries, the high concentration of balance of payments financing in a few large “emerging” economies raises significant concern about the overall rationality governing the distribution of global capital flows, including even official flows. It certainly raises questions about whether the problems of the largest developing countries generate specific biases in the response of the international community.

Thus, although the volatility and contagion exhibited by private capital flows, which have been at the centre of recent debates, are certainly a matter for concern, 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.

III

Some reflections on the political economy of the reform process

The nature of the current controversies regarding international financial reform reflects three features of the political economy of the globalization process which is under way. The first is the reluctance of most countries, both industrialized and developing countries alike, to give up economic sovereignty to international organizations. Under the influence of the strong market forces characteristic of globalization, which tend to weaken the nation-State, and the concomitant unilateral national liberalization processes that many countries have followed, government regulations have lost ground all over the world. Many analysts perceive this result as an advance, but it is also a source of significant distortions and risks. Indeed, the issues associated with capital flows that are discussed in section IV below are a good exam-

ple of cases where most analysts agree that inadequate regulation –both national and international– has been an essential determinant of market instability. Another good example is that of “fair trade” rules, such as antidumping and countervailing duties, which, when applied at the national level, are generally suboptimal compared with other forms of regulating competition, such as antitrust provisions, and may create distortions of their own, even if applied within World Trade Organization rules. National restrictions on labour mobility also generate distortions, and the asymmetric character of factor mobility (i.e., the greater mobility of capital and skilled labour versus unskilled labour) generates strong adverse income distribution pressures worldwide.⁷

⁶ It must be emphasized, however, that in rescue packages pledged bilateral financing tends to be disbursed in smaller proportions than the corresponding multilateral finance.

⁷ With regard to this latter point, see Rodrik (1997).

The second feature is the disorganization of the actors, particularly developing countries, in the international policy debate. This may be a reflection of the weakening of the historical mechanisms of concerted action (such as the Group of 77), but it also reflects the “policy competition” that globalization itself has generated: the great incentive that each country has to claim that it is more attractive for investment in an era of mobile capital and a decline in the importance of traditional production location factors. This has raised the costs of generating international coalitions and implies that the international agenda may tend to be even more biased than it traditionally has been towards the largest countries and best organized coalitions, which are unlikely to fully internalize the effects that their policies and agendas have on the rest of the world. It should probably be added that, although open regionalism is also a feature of globalization, and strong integration forces have been at work in many parts of the developing world (e.g., Latin America and Southeast Asia), this has not led to strong developing-country coalitions. The fact is that, the European Union aside, countries are also unwilling to give up their sovereignty even to regional institutions.

The disorganization of the actors is closely associated with a third feature of globalization: the incomplete and even lopsided character of the international policy agenda that accompanies the process, i.e., the strong thrust in some directions but, on the contrary, a disregard for others that should equally be part of a more balanced globalization process. Four issues figure predominantly in the agenda: free trade, intellectual property rights, investment protection and capital account liberalization. The latter has been subject to some reservations in the light of the recent crises: it should be gradual, emphasis should be given to longer-term flows, and strong prudential regulations and supervision should precede it. Other issues are conspicuously left aside: labour mobility, international rules on capital taxation (essential to guarantee adequate taxation of this highly mobile factor), the design of truly international rules on competition and codes of conduct for multinational firms, and compensatory financing and technology transfers to guarantee the inclusion of those countries which tend to be left behind in the globalization process.

These political economy elements have major implications for international financial reform. The

most obvious are that there are only likely to be weak pressures for substantial reform,⁸ that designing a balanced negotiation process will be a complex business, and that negotiation processes may underestimate or bypass altogether the interests of certain actors. Obviously, the ideal outcome would be for adequate fora and a broad agenda to be chosen, so as to adequately represent the interests of those actors who would otherwise not have a strong voice.⁹ These elements also imply that the international financial architecture will continue to rely essentially on a network of **national** institutions, so that its major task is the creation of adequate incentives for these institutions to internalize the externalities that they generate among themselves. This means, in turn, that national autonomy will continue to play a central role in many (if not most) policy areas and that policy instruments that are ruled out at the national level (such as certain restrictions on market activities, or unilateral debt standstills) should probably be left open as options at the international level.

A final, crucial implication is that no international financial architecture is neutral in terms of the balance of international relations. It will be strongly argued in this paper that an international system that relies on one or a few international institutions will be less balanced than one that relies on a network of regional institutions, and that countries with very limited power in the international arena will be better off if they have access to a broader menu of alternatives for managing a potential crisis or financing development than if they are restricted to fewer options. The first part of this proposition means, in fact, that the strongest defence mechanism for the weaker actors is competition in the supply of support to them. The second means that, in the absence of adequate international support, the “second-best” solution may be more, rather than less, national autonomy. National autonomy obviously has costs, as the greater menu of alternatives for managing crises must be traded off against the need to generate “credibility”: a factor that inclines developing countries to adopt the policy package they believe the market considers to represent best practice (a result of the “policy competition” to which we alluded earlier).

⁸ See Eichengreen (1998).

⁹ These are fundamental concerns of United Nations, Report of the Task Force of the Executive Committee on Economic and Social Affairs (1999a), the Group of 24 (1998) and Helleiner and Oyejide (1998).

IV

Financial crisis prevention and resolution

The issues associated with the prevention and resolution of financial crises have received extensive attention in recent discussions.¹⁰ The most important area of agreement relates to the need to improve the institutional framework in which financial markets operate: that is to say, to strengthen prudential regulation, supervision and accounting practices of financial systems worldwide; to adopt minimum international standards in these areas and sound principles of corporate governance; and to improve the information provided to financial markets. From the point of view of the industrialized countries, the central issues for their corresponding domestic agencies are stricter regulation and supervision of highly leveraged institutions and operations, controls on offshore centres, and the need for greater weight to be given to the risks associated with operations with countries having a high level of net indebtedness, particularly of a short-term character, in order to discourage risky financing at the source.

From the point of view of the 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 means that the level of external liabilities of these firms should also be regulated. We will return to these issues in section VIII below.

Nonetheless, substantial divergences of opinion remain. Firstly, there is no consensus as to what kind of institutions should be entrusted with enhanced responsibilities in this field. The Bank for International Settlements (BIS) should certainly play the leading role, but this requires a significant expansion of developing-country membership in that organization and of developing-country participation in the definition of all sorts of international standards and codes of conduct in general. More ambitious proposals, such as the creation of a World Financial Authority on the basis of the BIS and the International Organization of Securities Commissions, should also be considered.¹¹ Secondly, 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. Thirdly, differences exist as to the relative merits of prudential regulation and supervision versus other possible instruments in key areas. One particularly relevant issue in this regard, as we will see below, relates to capital account regulation. Fourthly, there are significant differences of opinion as to what can be expected from enhanced prudential regulation and supervision, since 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

¹⁰ See, among others, Camdessus (1998a and 1998b), IMF (1998), IMF, Interim Committee of the Board of Governors on the International Monetary System (1998), Group of Seven (1998), UNCTAD (1998, part I, chap. IV), United Nations, Report of the Task Force of the Executive Committee on Economic and Social Affairs (1999a), Miyazawa (1998), Rubin (1999), Akyüz and Cornford (1999), Eatwell and Taylor (1999), Eichengreen (1999), Griffith-Jones (1998), Griffith-Jones and Ocampo (1999), Ocampo (1999a and 1999b), White (1999) and Wyplosz (1999).

¹¹ Eatwell and Taylor (1999).

macroeconomic effects (they may be unable to prevent excessive risk-taking during booms and they may 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.

Equally important are the doubts 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 strict sense of that term (i.e., factual information). The tendency to equate opinions and expectations with “information” is one of the greatest confusions 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, to avoid generating still further instability.¹² To use modern terminology, rather than “information cascades”, what characterizes macroeconomic financial instability are “opinion and expectation cascades”, i.e., the alternate “contagion” with both optimism and pessimism through the business cycle. Even 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.¹³

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 importance of the coherence of macroeconomic policies worldwide, i.e., on appropriate mechanisms to internalize the externalities generated by national macroeconomic policies. This issue is crucial in relation to both booms and crises, but the need to strengthen the extremely weak existing arrangements is particularly vital 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 inhibit excessive private risk-taking or the adoption of pro-cyclical national policies. Indeed, one of the most serious shortcomings of the existing arrangements is that the current institutions –both national and international– focus their attention on crises rather than booms, thus underplaying 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, the moves in that direction after the Russian crisis are probably the single most important reason for the relative though incomplete normalization of capital markets in 1999. The lack of adequate representation of developing countries is another deficiency of the current arrangements. The proposals to strengthen IMF surveillance of macroeconomic policies and to transform the IMF Interim Committee into a Monetary and Financial Policy Committee are the most encouraging in this regard, though the latter should be accompanied by increased representation of developing countries on that Committee. Likewise, given its more adequate balance in the representation of developing and developed countries, the United Nations should also play an enhanced role in the normative area, either through the Economic and Social Council or an Economic Security Council.

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 automatic availability of financing when a crisis occurs.¹⁴ The “moral hazards” raised by such financing make it necessary to define access rules on the borrowers’ side and to create orderly debt workout mechanisms that guarantee that private lenders will assume a fair share of the costs of adjustment.

The main lessons from recent crises are that:
i) large-scale funding may be required, though not all

¹² See, on the former, Larraín, Reisen and von Maltzan (1997), and on the latter, Calvo (1998).

¹³ For a more extensive analysis, see Ocampo (1999a). Keynes’s concept of a “beauty contest” is thus much more appropriate for analysing the volatility of expectations, as Eatwell (1996) has emphasized.

¹⁴ This important distinction is made by Helleiner (1999a). For a fuller discussion of this issue and its relation to IMF access to adequate resources, see Mohammed (1999).

of it needs to be disbursed if support programs rapidly restore market confidence; ii) funds should be made available **before**—rather than after—international reserves reach critically low levels; and iii) because of strong contagion effects, contingency financing may be required even by countries that do not exhibit fundamental imbalances. At least the last two of these lessons imply a significant departure from 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 quota increase and the New Arrangements to Borrow, which finally entered into effect in late 1998; the launching of a new window in December 1997 to finance exceptional borrowing requirements during crises; and the creation of the Contingency Credit Line in April 1999 to provide financing to countries suffering the effects of contagion, though under very restrictive eligibility requirements.

The major controversies are over 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 not take place if the market feels 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 is to allow additional issues of Special Drawing Rights (SDRs) during episodes of world financial stress; these funds could be eliminated once financial conditions normalize.¹⁵ This procedure would bring a counter-cyclical element into 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 would be to make 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.

¹⁵ See United Nations, Report of the Task Force of the Executive Committee on Economic and Social Affairs (1999a).

The broad issues raised by conditionality will be discussed in section VI below. However, two issues must be emphasized here. First, it has been argued that contingency credit lines to deal with contagion should be automatic, provided that countries fulfil certain prior criteria, and should thus be detached from traditional conditionality. The window created recently for this purpose does not fully meet these criteria: although the consultations provided for in article IV of the IMF Articles of Association were given an enhanced role in determining access in advance, such access still requires negotiations prior to approval by the Board of Governors (a special “activation” review) and an explicit standby agreement. Moreover, countries with current access to IMF financing were not considered eligible; this is an important restriction, as it eliminates countries which have experienced a strong recovery from past crises but still have pending IMF credits. Finally, the combination of conditionality with the application of harder terms than those traditionally used in regular IMF financing for this window and for exceptional financing (i.e., higher interest rates and shorter maturities) is also controversial. This eliminates the “credit union” character of IMF financing but still falls far short of being a “market condition”.

Internationally sanctioned debt standstills and orderly workout procedures are essential mechanisms to avoid the coordination problems implicit in chaotic capital flight, to guarantee appropriate sharing of adjustment costs by private lenders and, hence, to avoid “moral hazard” issues associated with emergency financing. Due to the effects that the use of these mechanisms could have on their credit standing, borrowing countries are unlikely to abuse them. Nonetheless, to avoid “moral hazard” issues on the borrowers’ side, such arrangements must be subject to international control, either by requiring prior IMF approval or by allowing countries to call a standstill unilaterally but then requiring that they submit it for approval by an independent international panel, whose authorization would give it legitimacy.¹⁶ A third alternative could be to draft *ex-ante* rules under which debt service would be automatically suspended or reduced if certain macroeconomic shocks

¹⁶ UNCTAD (1998), Part I, chapter IV; United Nations, Report of the Task Force of the Executive Committee on Economic and Social Affairs (1999a).

were experienced; such rules have already been incorporated in some debt renegotiation agreements.

The use of these mechanisms has four implications. Firstly, to avoid both free riding and discrimination against countries or groups of countries that adopt them, they require the universal adoption of “collective action clauses” in international lending. The G-7 countries should take the lead in this process, as they suggested in October 1998,¹⁷ for otherwise it could become an additional source of discrimination against “emerging markets”. Secondly, aiding countries in this way (“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. Thirdly, debt renegotiations under this framework must have a short, strictly-defined time horizon beyond which the IMF or the independent panel would have the authority to determine the terms of rescheduling. Finally, to avoid repeated renegotiations—one of the most troublesome features of debt rescheduling operations in recent years—except for the portion that is written off or refinanced on highly concessional terms the service of the remaining portion should be subject to certain contingent macroeconomic conditions that determine debt service capacity (e.g., terms of trade, normalization of lending, domestic economic activity, etc.).

The most problematic of all rescheduling processes in recent decades have been those associated with heavily indebted poor countries (HIPC). The HIPC Initiative has been slow in its implementation due to the complexity of the process for determining

eligibility (and, obviously, the conditionality attached to it) and the lack of adequate funding.¹⁸ The recent Cologne Debt Initiative may serve to overcome some of these problems, providing “faster, deeper and broader debt relief”.¹⁹ It is essential, of course, that aside from eligibility criteria and the implementation of the most generous terms, additional funding should effectively become available. In particular, in an environment of scarcity of official development assistance (ODA) funds, it is essential that the funds allocated to HIPC debt relief should not crowd out fresh ODA. This would be regrettable, as new financing is a necessary complement to debt relief and the latter is unlikely, by itself, to accelerate economic growth in heavily indebted poor countries. Moreover, the lack of adequate funding has generated additional demands that must be met from the net income (profits) of development banks, which has led some of them, including the World Bank, to increase spreads and thus lending rates. This means, paradoxically, that other developing debtor countries will end up paying part of the costs of debt relief. Financing problems are particularly acute in the case of regional and subregional development banks: a fact which may severely disrupt some of their activities if the trust funds provided for under the HIPC Initiative do not adequately cover the cost of debt relief.

The definition of international rules on capital account regulation and exchange rate regimes has not been addressed in this section because, under the current incomplete world financial arrangements, national autonomy should continue to prevail in these areas, as analysed in section VIII below.

V

Development finance

As indicated in section II, although adequate financing from the IMF 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 create 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

¹⁷ Group of Seven (1998).

¹⁸ United Nations (1999b).

¹⁹ Group of Seven (1999).

largest industrialized economies, is certainly the most important issue. As we already pointed out, it is important that efforts to accelerate implementation of the HIPC Initiative should not crowd out new ODA financing in the budgetary processes of the industrialized countries. Indeed, in addition to 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 effective "ownership" of policies by developing countries: a process that calls for less direction from abroad and more emphasis on the role of national development institutions. The latter objective requires, in turn, respect for the central role that the parliaments and governments of aid-receiving nations should have in the global allocation of aid through their budgetary processes and the vital role that the governments of those countries should have in directing traditional areas of public policy (such as social policy and infrastructure), even when civil society is given a major role in the execution of those policies.

Equally important, however, is the need to speed up the growth of multilateral lending. Due to the high concentration of private flows in a few "emerging" economies, such lending will continue to play an essential role even with respect to middle-income nations. More broadly, multilateral lending will continue to play a very important role in at least four areas: i) channeling funds to low-income countries; ii) providing long-term finance to middle-income and small countries which, because they do not have a sufficiently high credit rating or because of the fixed costs involved (e.g., in bond financing), do not have adequate access to private funds; iii) acting as a counter-cyclical means of compensating for fluctuations in private capital market finance; and iv) facilitating the transition to new forms of private financing. To these we should also add the traditional "value added" of multilateral financing: lending-associated technical assistance.

The first of these functions underscores the central role that financing from the World Bank, the International Development Association and the regional and subregional development banks will continue to play in the immediate future. The second and third functions emphasize the role that official development assistance will continue to play even for

middle-income countries. It must be stressed, however, that the counter-cyclical provision of funds should not be confused with the provision of emergency balance of payments financing, which is essentially a task of the IMF. However, 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.²⁰ Thus, if multilateral development financing is not significantly expanded, its role as a counter-cyclical device will necessarily be very limited and will 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 1992-1997 represented only 13% of that provided by the private sector, excluding FDI, and only 6% in the case of middle-income countries. Consequently, if it is to carry out a useful counter-cyclical function, this will certainly require a significant increase in resources.

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 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 could also be used to support developing countries' efforts to return to markets during crises and, even more importantly, to support initial bond issues by developing (and particularly poor developing) countries seeking to enter private capital markets. Co-financing or guarantee schemes could be used for this purpose. It must be emphasized, however, that the full development of these schemes would require a radical change in the management of guarantees by development banks because, under current practices, guarantees are treated as if they were equivalent to loans: a practice 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

²⁰ Wolfensohn (1998).

risk-taking by these institutions. Nonetheless, in a world that will probably be dominated by private financing, this may be absolutely essential in order to prevent low-income countries from being left out of major developments in the capital markets, and it should therefore receive priority attention in the current discussions.

In the recent debates on these matters, due emphasis has also been placed on the role that multilateral development banks should play in financing social safety nets in developing countries. Strong social safety nets are, indeed, essential for managing the social repercussions of financial vulnerability in the developing world. The concept itself is subject to some confusion, however, as it is 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 social protection mechanisms. Although multilateral banks have been involved in the former for a long time and have also accumulated some experience with the latter, the preferred mechanism since the late 1980s has been social emergency funds (later transformed in many countries into more stable social investment funds). Although they have introduced some innovations in social policy, such as competitive mechanisms to allocate resources and participation by civil society in social policies, their effects have been rather limited, their targeting has not always been effective, and they may have crowded out resources from long-term social policies.²¹ Other instruments have also been used in the past by developing countries, including various types of unemployment insurance (the main instrument used for this purpose in the industrialized world), emergency employment or emergency labour-intensive

public works programmes, income-support schemes in conjunction with training, and some nutrition programmes. The recent crisis seems to have led to the design of new instruments: special subsidies for households with school-age children (tied to school attendance), and various support programmes designed to ensure that households with an unemployed head do not lose their homes during crises.

Recent analyses have drawn some basic conclusions about these programmes. Firstly, safety nets must be part of **permanent** social protection schemes, as only a permanent scheme guarantees that the programmes will respond without delay to vulnerable sectors' needs for protection during crises.²² This means, in turn, that financing must be fundamentally of a domestic character, with only a very limited proportion of external financing, which may contribute only marginally, if at all, during crises (see below). Secondly, given the heterogeneity of labour markets in developing countries, a combination of several programmes, with different target groups, is necessary.²³ Thirdly, these programmes must be adequately financed and should not crowd out resources from long-term investment in human capital. This leads in turn to a fourth conclusion: that the effective functioning of social safety nets requires that public-sector expenditure should include counter-cyclical components. This would be impossible –without generating inefficiencies in the rest of public-sector expenditure– unless fiscal policy as a whole is counter-cyclical: a point that has not been sufficiently emphasized in current discussions. In the absence of this counter-cyclical fiscal pattern, external financing from development banks during crises would be unnecessary or, at best, illusory, as overall net fiscal financing requirements will actually decrease despite the increased spending associated with social safety nets.

²¹ See in particular Cornia (1999), and also ECLAC (1998a, chap. VI), Graham (1994) and Lustig (1997).

²² This issue is highlighted in the best available analysis of the subject (Cornia, 1999), which also emphasizes the need for adequate financing.

²³ Márquez (1999).

VI

Conditionality versus “ownership” of economic policies

The most controversial aspect of international emergency and development financing is undoubtedly conditionality. In the case of the IMF, this issue has long been a central area of contention, but 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 World Trade Organization and the development banks– but also those of domestic economic and social development strategies and institutions which, as the United Nations Task Force has noted, “by their very nature should be decided by legitimate national authorities, based on broad social consensus”.²⁴ Secondly, whereas the legitimacy of conditionality is indisputable when domestic policies are the source of macroeconomic imbalances 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. As already noted, it is even less clear why conditionality should be combined in such cases with adverse credit terms. Finally, many observers have criticized the over-adjustment (“overkill”) implicit in some IMF programmes: a fact which has led the Fund to allow some room for counter-cyclical fiscal policies in its adjustment programmes.

Even if the legitimacy of the principle of conditionality –or, as it is sometimes defined, “support in exchange for reforms”– is accepted, there are good reasons for reviewing its characteristics. Indeed, the perception that conditionality has been carried beyond what may really be necessary in order for the Fund to perform its functions properly may be helping to undermine its legitimacy. A strong argument

can therefore 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.

Several principles can be advanced in this regard. Firstly, conditionality should be restricted to the macroeconomic policies that were its purview in the past, and it should only be used when expansionary policies are clearly associated with the generation of macroeconomic imbalances. 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 (an issue which is still controversial, as we have seen). Secondly, a suitable volume of low-conditionality funds should be available when the source of the imbalance is an international shock. This principle should be fully recognized in the new contingency credit line available to countries suffering the effects of contagion. Over and above the pre-set limit for these funds, however, access to Fund resources could also be subject to macroeconomic conditionality on the traditional terms. Thirdly, as we already noted, more stringent credit terms should not be used as a complement to conditionality. Fourthly, when signing an agreement with the Fund automatic rules should be agreed upon by common consent whereby the restrictiveness of the adjustment programme would be eased should evidence of overkill become clear. Finally, regular official evaluation of IMF programmes, either by an autonomous division of the Fund (as in the World Bank) or by outside analysts, should be introduced and the main conclusions of these evaluations, after review by the Board of Governors, should be explicitly incorporated into regular Fund practice.

Similar issues have arisen in relation to development finance. With respect to this matter, 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 programmes

²⁴ United Nations, Report of the Task Force of the Executive Committee on Economic and Social Affairs (1999a, section 5). See also Group of 24 (1999), Feldstein (1998) and Rodrik (1999b).

at all.²⁵ Nonetheless, according to the same report, the effectiveness of aid 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 the Bank’s (certainly debatable) definition, include a stable macroeconomic environment, open trade regimes, adequate protection of property rights and efficient public bureaucracies that can deliver good-quality social services. With regard to the effectiveness of aid, good policies have an additional positive effect in the form of the “crowding-in” of private financing. Neither of these effects are present, however, in countries following “wrong” policies. Expressed in terms that are now familiar in the aid literature, the “ownership” of good 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.

Curiously enough, on the basis of this study the World Bank draws the conclusion that conditionality is good after all, claiming that “Conditional lending is worthwhile where reforms have serious domestic support”²⁶ and, in particular, that it “still has a role –to allow government 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”.²⁷ 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 which is, indeed, implicit in the idea that “ownership” of economic policies is, after all, the essential issue.²⁸

A recent analysis by Rodrik comes to complementary conclusions which are extensive to short-term macroeconomic policies.²⁹ Thus, 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 for conflict management, which can only be guaranteed by national democratic processes, are crucial for macroeconomic stability, which, in turn, is vital for economic growth. To borrow the term already used above in another context, the “ownership” of macroeconomic adjustment programmes is also essential to guarantee their political sustainability.

The issue of conditionality versus a country’s ownership of economic policies 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 sought. Both these elements may not only be relatively ineffective but will also lack political sustainability if this role is appropriated by international institutions or the aid agencies of the industrialized countries.

VII

The role of regional institutions

There are at least three arguments in support of a strong role for regional institutions in the new financial order. The first one is that, as we have noted, globalization also entails open regionalism. The growth of intraregional flows of trade and direct investment is a striking feature of the ongoing globalization process. This factor increases macroeconomic linkages and thus the demand for certain services provided by the interna-

tional financial system which we have analysed in previous sections: macroeconomic surveillance and internalization of the externalities that national macroeconomic policies have on neighbouring countries, mutual surveillance of each other’s mechanisms for the prudential regulation and supervision of the financial system, and the regional effects of potential debt standstills and workout procedures.

²⁵ See World Bank (1998b), chap. 2 and appendix 2.

²⁶ *Ibid.*, p. 48.

²⁷ *Ibid.*, p. 49.

²⁸ For a fuller discussion of these issues, see Helleiner (1999b).

²⁹ Rodrik (1999a).

Secondly, some of these services may be subject to diseconomies of scale and it is unclear whether others have economies of scale which are strong enough to justify single international institutions in specific areas (i.e., the existence of 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 not help 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 prudential regulation and supervision of the financial sectors, and even the definition of specific minimum standards in this area, could 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 the regional and subregional levels that could not be performed at the international level. Also, although the danger of regional and international contagion means 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 can also play a useful role even in the most serious crises (as shown by the Latin American Reserve Fund, formerly the Andean Reserve Fund) and, if expanded, could even provide full support to the small and medium-sized countries in some regions. Also, as the increasing concentration of balance of payments support in a few countries indicates (see section II above), there may be biases in the response of the international community according to the size of the country involved: a fact which would justify a division of labour between world and regional organizations in the provision of such services.

The third argument was already put forward in section III: for smaller countries, access to a broader menu of alternatives for managing a crisis or financing development is relatively more important than the “global public goods” (such as global macroeconomic stability) provided by the largest international organizations, but in whose provision they assume that they have little or no influence (i.e., they have

the attitude of “free riders”). Due to their small size, their negotiating power *vis-à-vis* large organizations is very limited, and their most important defence is therefore the existence of competition in the provision of financial services from such institutions to them.

There may be a fourth argument, of a political economy nature: countries are likely to take quite different attitudes to the analyses made by international and by regional organizations (and to the attached conditionality). To use the term employed in the previous section, they are probably more likely to have a sense of “ownership” of the latter, as they feel they have a stronger voice in the analyses made by regional organizations: a fact that will improve rather than reduce their effectiveness. The fear that this may lead to lax arrangements is unwarranted, as the proposal to create and strengthen regional financial institutions entails financial commitments by the developing countries to provide the capital for the corresponding reserve funds and development banks, so that the countries will tend to closely monitor the soundness of their activities. In reality, the supply of capital is the single most important restriction on the growth of these regional financial networks. The fact that many of them will raise money in the market will provide an additional means of control over their operations.

The current discussions have underscored the inadequate supply of some services provided by international financial institutions, including some “global public goods”. However, it would be wrong to conclude from this statement that an increase in that supply should come from a few world organizations. Rather, the organizational structure should consist, in some cases, of networks of institutions that provide the services required on a complementary basis, and in others of a system of competing 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). However, the purity of the model’s structure is probably not the most important feature: it is desirable that in some cases parts of networks should compete with each other (e.g., regional reserve funds versus the IMF in the provision of emergency financing), while in other cases competing organizations should cooperate.

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. In order to encourage the development of the latter, incentives could be created whereby 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.³⁰ As already noted, regional reserve funds could not only 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, at least partly, to deter would-be speculators from attacking the currencies of individual countries.

This model should be extended to cover macroeconomic consultation and surveillance, as well as the 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”, could also play a positive role. Again, peer reviews should be part of this system. In the case of debt standstills and workouts, regional mechanisms should at least play a role in assessing the specific regional impacts that they may have.

It is important to emphasize that, aside from other functions considered in section V, 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 more aggressive use of opportunities provided by private capital markets. In Latin America, an interesting experience in this regard is that of the Andean Development

Bank (Corporación Andina de Fomento, CAF), an institution owned in its entirety by developing countries. The fact that the credit ratings of this institution have exceeded those of Colombia (the only Andean country that has been classified as “investment grade” in the 1990s and has thus been able to issue debt obligations on favourable terms) indicates that such a risk-pooling policy can be very effective.

As it is well known, Western Europe provides the best example of regional financial cooperation in the post-war period. The United States, 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. The history of many institutions, including the Bank for International Settlements, is associated with these cooperation efforts. At different stages, they demonstrated the essential contribution that regional schemes can make to the stability of the world economy. 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.

On a much more limited scale, there are institutions which have likewise played a useful role in the developing world, particularly in the area of development finance. In Latin America and the Caribbean, for example, the Inter-American Development Bank far outweighs the World Bank in development finance to the region. The Andean Development Bank likewise outweighs the IDB in financing to the Andean region countries in recent years. The Andean (now Latin American) Reserve Fund has played a limited but constructive role in balance of payments support to the Andean countries over the past two decades. Under the existing integration schemes, some dialogues have also taken place on macroeconomic coordination, but progress has been rather limited in this area. At all events, the call for stronger macroeconomic coordination mechanisms has been a common theme during the recent crisis.

An institutional framework such as that suggested would have two positive features. First of all, it could 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

³⁰ United Nations, Report of the Task Force of the Executive Committee on Economic and Social Affairs (1999a, section 9) and Ocampo (1999a).

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, and this would increase the commitment of less powerful players to abide by rules that contribute to world and regional stability.

VIII

The realms of national autonomy

Whatever new 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 in any support scheme. This raises the question of the national policies necessary to guarantee financial stability and the areas where national autonomy should be maintained. We consider that the international system should continue to maintain national autonomy—at least in the case of developing countries—in two critical areas: management of the capital account and choice of the exchange rate regime. The choice of development strategies is obviously another essential realm in which national autonomy should prevail, as we emphasized in section VI.

The experience of the developing countries indicates that the management of capital account volatility requires: i) consistent and flexible macroeconomic management; ii) strong prudential regulation and supervision of domestic financial systems, and iii) equally strong “liability policies”, aimed at inducing good public and private external and domestic debt profiles.³¹ Traditionally, the emphasis has been on crisis management, but the authorities should focus their attention rather on the management of **booms**, since it is in the periods of euphoria of capital inflows, trade expansion and terms-of-trade improvements that crises are incubated. Crisis prevention is thus very closely linked with the proper management of boom periods.

The nature of the policies to be used will naturally vary according to the structural peculiarities of different economies, as well as their macroeconomic

traditions and levels of development. In the macroeconomic area, the two main objectives should be to avoid the accumulation of unsustainable levels of indebtedness by either public or private agents during booms and to avoid imbalances in major prices, particularly the exchange rate and domestic asset prices. In the fiscal area, the focus should be the sustainability of public-sector debt ratios **throughout the cycle**, which requires fiscal strengthening during the upswing in order to give the authorities sufficient freedom to permit some fiscal loosening during the subsequent downswing in order to avoid an excessive contraction of economic activity. In contrast, as is well known, in open economies authorities face major difficulties in applying contractionary monetary and domestic credit policies during boom years, in the absence of adequate regulation of capital inflows. Sterilized foreign-exchange reserve accumulation is a first alternative, but experience indicates that this may be self-defeating unless there is adequate restraint on capital inflows, due to interest-rate arbitrage. A second possibility is direct control of the growth of credit from domestic financial intermediaries, but this alternative may actually induce additional external borrowing in the absence of adequate controls and tends to protect inefficient intermediaries. A third alternative is the use of increased reserve or liquidity requirements in respect of the liabilities of the domestic financial system, but this may also generate incentives for non-financial agents to borrow abroad.

Regulations on capital inflows may also be essential to avoid unsustainable exchange rate appreciation during booms. Although some appreciation may be inevitable and even an efficient way of absorbing 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 un-

³¹ The literature on national policies is extensive. See, among recent contributions, ECLAC (1995 and 1998b), World Bank (1998a, chap. 3), French-Davis (1999), Helleiner (1997), and Ocampo (1999b).

sustainable exchange rate appreciation during booms. The macroeconomic effects of the regulation of inflows have, unfortunately, received much less attention in the past than the question of the regulation of outflows during crises. The nature of such regulations will be considered below. Regulations governing outflows may nevertheless also play a role as a way to avoid excessive increases in interest or exchange rates, which may have adverse effects on macroeconomic dynamics, including a greater risk of domestic financial crises. Such regulations are also an essential element when applying debt standstill and orderly debt workout procedures. It is essential, of course, that they be used as a complement and not a substitute for fundamental macroeconomic adjustment.

As we pointed out in section IV, 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 type of operation, higher capital requirements, matching liquidity requirements or caps on the valuation of assets should be established. Moreover, given these macroeconomic links, prudential regulation should be strengthened during periods of financial euphoria to take into account the increasing risks being incurred by financial intermediaries. These links also mean 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 a necessary complement to stricter prudential regulation and supervision. Moreover, due to the important externalities which large non-financial firms can generate for the domestic financial sector, particularly in the context of exchange rate depreciation, the external liability exposure of these firms should also be subject to some regulation. 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.

The experience of many developing countries indicates that crises are associated not only with high debt ratios but also with inadequate debt **profiles**. The basic reason for this is that, in conditions of 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 means that “liability policies” aimed at improving debt profiles play an essential role. Although improving the external debt profile should be the central role of such policies, there is a strong complementary relationship between good external and internal debt profiles. Thus, excessive short-term domestic borrowing may force a government that is trying to roll over debt during a crisis to raise interest rates in order to avoid capital flight by investors in government bonds. Also, excessively high short-term private liabilities increase the risks perceived by foreign lenders during crises: a fact that may induce a stronger contraction of external lending.

In the case of the public sector, direct controls by the Ministry of Finance are an appropriate instrument of a liability policy. In the private sector, exchange rate flexibility may also deter some short-term 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 then be reflected in a parallel cycle of nominal and real exchange rates. Direct controls on capital inflows may also be an appropriate instrument for achieving a better private debt profile, but a more 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 boom periods) 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 heated controversy. At all events, since tax evasion is costly and short- and long-term borrowing are not perfect substitutes, the magnitude of flows should also be af-

fected.³² 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, as it affects both financial and non-financial agents and it uses a non-discriminatory price instrument, whereas prudential regulation only affects financial intermediaries, is usually of a quantitative nature, and the supervision is essentially discretionary.³³

Simple rules are preferable to complex ones, particularly in underdeveloped regulatory systems. In this sense, quantitative controls, such as flat prohibitions on certain activities or operations, may actually be preferable to sophisticated price-based signals, but simple price rules, such as those used by Chile and Colombia, can also be effective. Any regulatory system must also meet the additional requirement of having adequate institutional backing. A **permanent** system of capital account regulations, which can be strengthened or loosened in the course of the business cycles, is therefore 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, since the administrative machinery to make it effective will not be 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: the need to avoid over-borrowing during booms and thus focus attention primarily on capital inflows rather than outflows.

This indicates that capital account regulation may be an essential instrument for crisis prevention and management in a context of strong volatility of capital flows and weak international financial safety nets. It may be complementary to other desirable policies in the macroeconomic and financial regulatory areas, and in some cases it may actually be preferable to other alternatives. The foregoing analysis also suggests the desirability of using capital account regulation as a **permanent** policy instrument. Of course, none of these mechanisms is foolproof, and

some developing countries may prefer to use policy mixes that avoid their use (e.g., more active use of fiscal and exchange rate policies, as well as of prudential regulation) or may prefer a less interventionist approach, even at the cost of greater GDP volatility. Thus, the most compelling argument is for maintaining the autonomy of developing countries to manage their capital accounts.

There are actually no strong arguments in favour of moving towards capital account convertibility.³⁴ There is no evidence that capital mobility leads to efficient smoothing of expenditures in developing countries throughout the business cycle, and on the contrary there is strong evidence that in these countries the volatility of capital flows is an additional source of expenditure instability. There is also no evidence of an association between capital account liberalization and economic growth, but there are some indications that point in the opposite direction.³⁵ In simple terms, the argument is 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. As already noted, 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 amounts of contingency financing with well-defined conditionality rules and there are no internationally agreed standstill and debt workout procedures? As we pointed out in section III, this is a crucial issue for countries without significant power in the international arena, for whom renouncing a possible means of crisis management is a costly alternative. In reality, there are strong similarities between today's international financial world and the era of "free banking" at the national level, when, 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.

³² Agosin (1997), Agosin and Ffrench-Davis (forthcoming), and Ocampo and Tovar (1997 and 1999).

³³ Ocampo (1999a). 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 Morgan (1998), p. 23.

³⁴ For a more extensive analysis of this subject, see United Nations, Report of the Task Force of the Executive Committee on Economic and Social Affairs (1999a); UNCTAD (1998), part I, chap. IV; ECLAC (1995, Part Three); Eichengreen (1999); Griffith-Jones (1998); Grilli and Milesi-Ferretti (1995); Krugman (1998a, 1998b); Ocampo (1999a), and Rodrik (1998).
³⁵ See in particular Eatwell (1996), Rodrik (1998) and, for Latin America, Ocampo (1999b).

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 some virtues in 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, the imposition of any international rules in this area would be unfortunate. The advantages and disadvantages of these extreme positions, as well as of interventionist regimes in between the two, have been subject to extensive debate and, of course,

have given rise to a considerable store of experience. In practice, countries almost invariably choose intermediate regimes: a fact that is probably explained not only by the deficiencies of the extremes, but also by the many other demands that the authorities face. The choice of the exchange rate regime has, nonetheless, major implications for economic policy that must be recognized in macroeconomic surveillance. Also, as already noted, domestic prudential regulations must take into account the specific macroeconomic risks that financial intermediaries face under each particular regime.

IX

Conclusions

In this paper it has been 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 crisis prevention and resolution, on which the recent debate has been focused, to cover also those associated with development finance for poor and small countries, measures to overcome the strong concentration of private and even official financing in a few large “emerging” economies, and the importance of 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 dealt with in a representative, balanced negotiation process capable of overcoming some of the adverse political economy features that characterize the current debate.

In the area of financial crisis prevention and resolution, a balance must be struck between, on the one hand, the current emphasis on the need to improve the institutional framework in which financial markets operate, and on the other 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, em-

phasis 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 the financing of social safety nets during crises should 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 full recognition of the central role of the “ownership” of development and macroeconomic policies by developing countries.

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 take the form 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.), while in others (particularly in development finance) it should consist rather of a system of competitive organizations. The fact that any new order will continue to form only an incomplete “financial safety net” means both that national policies will continue to play a disproportionately large role in crisis prevention and that certain areas should con-

tinue 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, who would

gain significantly from competition in the services provided to them and from greater freedom of action in a context of imperfect supply of global public goods.

(Original: English)

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