
temas de coyuntura

Reforming the
international financial architecture:
consensus and divergence

José Antonio Ocampo



NACIONES UNIDAS



Santiago, Chile

April 1999

LC/L.1192

April 1999

This document has not undergone formal editing, but has been checked for correct terminology and references.

Index

I. Four essential propositions(assumptions) for a relevant reform	9
II. Areas of growing consensus	13
A. The first two areas of consensus: the need for expansionary policies in industrialized countries and for contingency financing for countries in difficulties.....	13
B. The need to improve the institutional framework in which financial markets operate	14
C. The need for appropriate mechanisms to internalize the externalities generated by national macroeconomic policies	17
D. Internationally sanctioned standstill provisions to guarantee an adequate sharing of the burdens of adjustment.....	18
III. Areas of disagreement	21
A. The provision of adequate liquidity	21
B. IMF conditionality	22
C. Preservation of the autonomy of developing countries to manage the capital account.....	23
D. Freedom to choose the exchange rate regime should continue.....	25
E. The role of regional institutions in the new architecture	26
IV. Complementary issues	29
References	31
Publications related to this series	33

Abstract

This paper reviews the current controversy on the reform of the international financial architecture. The paper first identifies some basic assumptions that must be taken into account in any meaningful reform. Then it identifies basic areas of consensus among different analysts: the need to maintain expansionary policies in industrialized countries as long as the current uncertainty prevails; to develop adequate contingency financing for countries in difficulties; to improve the institutional framework in which financial markets operate; to create appropriate mechanisms to internalize the externalities generated by national macroeconomic policies; and to design internationally sanctioned standstill provisions to ensure appropriate sharing of the burdens of adjustment. Next, it identifies certain areas of divergence and presents some proposals to overcome them: the need to use SDRs more actively as a financing mechanism during crises; to reach agreements on the coverage of IMF conditionality, restricting it to the macroeconomic policies that were its purview in the past; to preserve the autonomy of developing countries to manage the capital account; to maintain the freedom of countries to choose the exchange rate regime; and to strengthen regional institutions. It ends with a brief look at some complementary issues associated with the prevention and management of financial crises, which is the main focus of the paper.

Reforming the international financial architecture: consensus and divergence

José Antonio Ocampo*

The Asian crisis and its rapid spread to Russia and Latin America has given rise to a broad consensus on the need to reform the international financial architecture to face the inherent instability that the current system exhibits. Volatility and contagion have been common terms in the analysis of the current situation by academic and private financial analysts, governments, intergovernmental bodies and international organizations alike. The ongoing controversy has given rise to some areas of consensus on reforms in some areas, but also to divergence in many others. This paper critically reviews the current debate from the perspective of developing countries. Section I takes a brief look at four basic propositions that must underlie any relevant reform of the current system. This serves as

* Executive Secretary, United Nations Economic Commission for Latin America and the Caribbean, ECLAC. The author coordinated the elaboration of the Report of the Task Force of the Executive Committee on Economic and Social Affairs of the United Nations, which was issued in January 1999. Thus, some parts of this paper draw considerably from that report, which we will refer to as United Nations Task Force (1999). I am grateful to the Managing Director of the IMF, Michel Camdessus, who provided me with detailed comments on this report, and helped me to understand the areas of consensus (and divergence). I am also particularly grateful to Manuel Agosin, Yilmaz Akyüz, Guillermo Calvo, Nitin Desai, Nicolás Eyzaguirre, Ricardo Ffrench-Davis, Enrique Ganuza, Stephany Griffith-Jones, Isabelle Grunberg, Gunther Held, Gerald Helleiner, Barry Herman, Daniel Heyman, Jan Kregel, Omar Noman, Rubens Ricupero, Martin Santiago, Barbara Stallings, Joseph Stiglitz, Camilo Tovar, Andrés Velasco, René Villarreal and Rocío de Villarreal, with whom I have discussed some of the issues dealt with in the paper in recent months.

the basis for a closer look at the current controversy in sections II and III. These sections, like the paper as a whole, focus on those reforms required to prevent and manage financial crises and the required reforms in what may be called the “narrow” financial architecture. A broader and related set of issues are dealt with briefly in Section IV.

I. Four essential propositions (assumptions) for a relevant reform

Any meaningful reform of the international financial architecture must be based on four basic propositions (assumptions). The first one is that the instability of the system reflects “information problems” that are largely unsolvable, as financial market behaviour is determined as much by **opinions** and **expectations** as by information, in the precise meaning of that term.

The central role that imperfect information plays in generating market failures in the financial sector is well known ^{1/}. Improved information is thus central to a better market performance. However, we have seen in recent years how sophisticated and increasingly informed financial markets have continued to be extremely (and even increasingly) volatile. There are many reasons for that. The most important is probably the fact that much of the relevant information to which the market reacts comes only with a significant lag, and depends on macroeconomic conditions that are not entirely known in advance. Thus, for example, some investment decisions made before the Latin American debt crisis of the 1980s or before the 1997 Asian crisis may have been unsound to start with, but the magnitude of the losses associated with them were determined even more by the major macroeconomic shocks that these regions experienced, which were probably unpredictable –certainly with respect to their magnitude- and indeed were unpredicted by even the best observers. The increasing information that is relevant for improving microeconomic market efficiency may thus do very little to reduce **macroeconomic** volatility.

¹ See, for instance, the classic paper by Stiglitz and Weiss (1981).

The economic decisions that determine such macroeconomic volatility are, thus, central to financial market performance. We should mention first, in this regard, using the terms of classical keynesian theory, that historical time (to borrow Joan Robinson's concept) involves **uncertainty**. Thus, the investment and savings decisions that determine macroeconomic behaviour and performance are based on opinions and expectations on the uncertain evolution of economic variables rather than on risk probability distributions that can be known ex-ante. In a word, markets are necessarily imperfect when time is involved, as the information necessary to correct such "market imperfection" will never be available.

The way information is processed to form such opinions and expectations poses additional problems. A fundamental microeconomic factor in this regard is the fact that processing of information for individual decisions is subject to sharply increasing marginal costs, particularly when it involves financial actors that concentrate complex decisions. Thus, a board of directors of a financial institution faced with a decision to invest in a particular country (or sector), or even to invest at all, will not be able to take into account the rich information that the direct market operators of that institution may have on strengths and weaknesses of all specific firms in that country (or sector). Much simpler information and even rules of thumb would be necessarily used, and the tendency to conform to the "average opinion" that may exist in the market at that time would be very strong.^{2/} Regardless of the rationality involved in forming such an "average opinion" (or the lack of it), it is clear that the changes that it may experience will have major effects on markets. Indeed, the interrelation of the "information" that financial actors manage at any particular time –i.e., the "information cascades"- or, rather, of the opinions and expectations that are formed from such information, is central to the rich contemporary literature on self-fulfilling booms and busts.

Changes in opinions through time indicate that the **same** information may be interpreted in a totally different way at different times. Moreover, the mix between the simple way opinions and expectations are formed with today's sophisticated markets imply that markets may actually become **more** volatile in the face of changed expectations. This is the opinion of the Chairman of the Federal Reserve Board, who has argued that the "size of the breakdowns and required official finance to counter them is of a different order of magnitude than in the past".³ Indeed, certain characteristics of sophisticated markets may enhance instability. This is, first of all, an effect of improved communications and 24-hour trading around the world, which increases market reactions to any additional "information". Specialized information in today's markets may have the same result. In the case of emerging markets, for example, there is strong evidence that grading agencies may have increased rather than reduced volatility.⁴ Also, changes in the opinions of those investors that are considered to be "informed" may lead to overreactions by non-informed ones, who rely on the former to make their decisions.^{5/} It is also generally accepted that the unbundling of risks through derivative operations and the corresponding concentration of certain risks in specific agents imply that, even if improved regulation and supervision of these operations were designed, a breakdown in that corner of the market would have amplified implications.

The second proposition is that, as in any other case, self-insurance is a costly option in the area of international finance. This would sound self-evident and should probably be left aside from the discussion altogether, were it not for the fact that many proposals, particularly those involving developing countries, imply that, in the current order, a degree of self-insurance is inevitable. Indeed, the line that divides national policies aimed at preventing crises from self-insurance is a fuzzy one. Thus,

² This idea was captured by Keynes' concept of the "beauty contest", in which each actor tries to best interpret what the average opinion in the market is. See Eatwell (1996).

³ Greenspan (1998).

⁴ Larrain, Reisen and von Maltzan (1997).

⁵ Calvo (1998).

high levels of international reserves, building stronger credibility through the introduction of deflationary biases in macroeconomic policy, the adoption of prudential regulations stronger than those recommended by the Basle Committee, and discouraging excessive short-term external borrowing through price-based or quantitative capital controls, i.e., the whole array of national policies recommended to developing countries in a world of volatile capital flows (with the particular preference depending on the author), all have elements of self-insurance attached to them.

All these exclusively national options are costly. Thus, although the prevention of excessive risks is an essential element in the design of any insurance system, the basic architecture of the international financial system could not rely only or even fundamentally on strengthening these forms of “self-insurance”. Rather, it should aim at devising appropriate institutional mechanisms at the international level that reduce the costs involved in relying exclusively on national policies and in choosing the less costly among them. In the case of developing countries, the greater volatility associated with capital flows and/or terms of trade fluctuations imply that exclusive reliance on a high level of international reserves or deflationary policies to manage downside macroeconomic risks may be very costly. As we will argue below, stringent domestic regulations to manage financial risks may be necessary, but they are also costly. Thus, a well-designed international system must complement those policies with institutional mechanisms that allow these costs to be minimized. We will argue below that, from the perspective of national policies, the advantages of discouraging short-term external borrowing lies precisely in the fact that it reduces (though it certainly does not eliminate) the need to rely on other, more costly alternatives.

The third proposition that is essential to the analysis of international financial reform is the recognition that nations, particularly the industrialized but also many developing countries, are only willing to give up their economic sovereignty very partially, if at all --or, in the case of some countries in the European Union, only to a regional organization under their control.⁶ The positive and negative sides of this fact can be extensively argued over, but any viable reform must take it into account. This indicates that the “financial safety nets” that have been developed at the national level to manage market instability cannot be replicated in the international system, or can only be copied in a partial and imperfect way. This is true of central banks, prudential regulation and supervision, deposit and credit insurance, and bankruptcy procedures. This implies, in turn, that an essential task in the design of the international financial architecture is to guarantee that a system which will continue to rely essentially on a network of **national** institutions (regional in the case of some EU ones) takes adequate account of their international linkages --i.e., it internalizes at least some of the externalities that they generate among themselves. It also implies that options that are closed at the national level (such as strong restrictions on certain market activities, or even unilateral standstills on debts) should probably be left as open options at the international level.

The fourth proposition is that no international financial design is neutral in terms of the equilibrium in international relations. Thus, the particular balance that each alternative involves, as well as the **procedures** by which reforms are discussed and decided upon, should be a central concern for developing and small countries⁷. It will be strongly argued in this paper that an international system that relies on one or a few international institutions is less neutral than one that relies on a network of regional institutions and on peer review among national institutions. More democratic forums are superior to closed ones, in terms of generating stable consensus by all players, powerful or not. A broad agenda, in which all relevant issues are placed on the table, is also preferable to a limited one. Finally, but not least important, a country with very limited power in the international arena will be better off if it has access to a broader menu of alternatives to manage a potential crisis than if it is restricted to a few options.

⁶ See Rodrik (1998a).

⁷ These are fundamental concerns of the United Nations Task Force (1999), the Group of 24 (1998) and Helleiner and Oyejide (1998).

The combination of these four propositions (assumptions) is what makes the desired system and routes to it so complex. It will be argued here that only an integral system, which includes both the areas of consensus and those on which no agreement has yet been reached, is desirable. In a sense, the desired system is complex largely because it includes many “second best” or even “third” or “n-best” alternative routes, as no optimal solution is available. Moreover, it is unclear that even if an agreement were reached to replicate national solutions to financial instability at the international level –i.e., if a world central bank could be created, together with a world financial superintendence, deposit and credit insurance, and international courts to manage bankruptcy procedures involving cross-border transactions--, it is unclear whether that system would be desirable to smaller international players, given the nature of world relations. The route is also made more complex by the fact that some major players do not perceive themselves to be facing fundamental problems, and by the additional fact that the simpler decision-making system that characterized the design of the Bretton Woods system, in which the two dominant powers and victors in the Second World War negotiated between themselves, would be unacceptable today. I should probably add, that this is also the reason why some perceive that only a limited reform is viable,⁸ and why any viable alternatives should build on existing institutions rather than relying on the creation of new ones.

⁸ See, in particular, Eichengreen (1998a).

II. Areas of growing consensus

A. The first two areas of consensus: the need for expansionary policies in industrialized countries and for contingency financing for countries in difficulties

A clear consensus has been building up in several areas, though in some cases it is only partial, reflecting differences in interpretation or in the emphasis given to a particular component of the reform. Taking into account first the shorter-term measures, there is a growing consensus that the international financial crisis faced by a large set of developing countries requires expansionary policies in the industrialized world. This is an essential difference between the current crisis (as well as the “tequila” episode of 1994) and the Latin American debt crisis of the early 1980s, when high interest rates induced by contractionary monetary policies in the United States clearly increased the severity of the contraction.⁹ Curiously, the generalized shift towards this recent consensus has only built up since mid-1998 –i.e., a year after the onset of the Asian crisis—and has only led to agreement on the **direction** of monetary policy and on the need for a fiscal stimulus in Japan. The **magnitude** of the monetary impulse and the need to coordinate it with fiscal stimulus in a broader set of countries is still a matter of debate.

⁹ See, on this, the classical essay by Díaz-Alejandro (1988), ch. 15.

Moreover, and probably more importantly, although such a policy shift was able to turn around the strong unfavourable uncertainties that characterized world financial markets in the aftermath of the Russian moratoria, its “trickling down” to the developing world has been only partial, either because the net trade stimulus which the latter receives is limited –and poses a threat of protectionism in the industrialized countries—and/or because falling interest rates in the industrialized countries have only limited effects on restoring confidence in emerging markets, i.e., it compensates only partly for growing spreads. Indeed, due to strong dependence on the United States as the only engine of world economic growth, “trickling down” is even more limited, and may be partially or totally compensated in the medium and long run by the growing risks that are being incurred through feeding what increasingly looks as an unsustainable stock exchange and consumption boom in that country.

The limited “trickling down”, as well as the strong evidence of contagion during international crises are basic reasons for the growing consensus on a second area of reform: the need to increase the supply of liquidity in times of crisis and, particularly, contingency financing for countries in difficulties that is made available **before** international reserves are depleted. This is a major advance, not only with respect to the principles of intervention adopted in Bretton Woods, based on the concept of a “fundamental disequilibrium” in the balance of payments, but also with respect to the experience accumulated since the 1994 Mexican and the 1997 Asian crises, when contingency funds were approved only after the crisis had been unleashed. Still, the effectiveness of the new type of contingency financing may be limited, as the recent Brazilian episode indicates, for several reasons: (a) because it may serve to postpone adjustment which is judged inevitable; (b) because the negotiation process is too cumbersome; and, probably more importantly, (c) because the market judges that the intervening authorities (the IMF, supported by some development banks and a few industrialized countries) are unable or unwilling to supply funds in the quantities required to stabilize speculative pressures. These difficulties are compounded by controversies over the nature of conditionality involved in the use of funds. We will return to these issues in Section III below.

B. The need to improve the institutional framework in which financial markets operate

A third area of consensus relates to the need to improve the information provided to financial markets, to adopt common minimum standards in prudential regulation, supervision and financial accounting, codes of conduct in fiscal, monetary and financial policies, and principles of sound corporate governance, i.e., to improve the institutional framework in which financial markets operate. There is, in particular, a broad agreement on the important role that information plays for adequate microeconomic performance in financial markets, and on the need for strong regulation and supervision to guarantee financial stability.¹⁰ Let us emphasize, however, that aside from their effect on market efficiency and stability, these reforms are part of a laudable process of creating greater transparency in public policies worldwide and many of them could even be defended on these grounds alone. Disagreement remains, however, on what authorities would be given broader responsibilities in the area of prudential regulation and supervision, on what types of additional regulation would be required to reduce volatility and on how much additional information, regulation and supervision would contribute to stability.

On the first of these topics, although it has been agreed that IMF surveillance of macroeconomic policies should be extended to take a closer look at domestic financial sector issues and capital flows,¹¹ there is probably agreement that the IMF should not become the international authority in the area of

¹⁰ See, in particular, Camdessus (1998a, 1998b), IMF (1998), IMF Interim Committee (1998), Group of Seven (1998), United Nations Task Force (1999), Jospin (1998), Miyazawa (1998), Eichengreen (1999) and Griffith-Jones (1998), among others.

¹¹ IMF Interim Committee (1998).

prudential regulation and supervision. Bolder reform recommendations in this area include the proposal to create a World Financial Authority responsible for regulatory practices and effective risk management procedures, overseeing the development of credible guarantor and lender of last resort functions and the accountability of the IMF and the World Bank ^{12/}. Less ambitious suggestions are based on strengthening the BIS (including the Basle Committee) and IOSCO activities in the areas of domestic regulation and supervision, which would require extended membership by developing countries in these organizations. An interesting suggestion in the October 1998 Group of Seven Communiqué is the possibility of using peer review more extensively in this area. Indeed, a strong argument can be made in this case for designing an international system based on a network of regional and subregional organizations, which use peer review as their basic mechanisms of operation, with a World Financial Authority designed on the basis of BIS and IOSCO as a coordinator of this network of institutions.

There is now a broad agreement, which includes the authorities in developed countries, to extend prudential regulation and supervision to high leveraged institutions and offshore centers ^{13/}. But clearly reforms should go beyond that. In the case of industrialized countries, prudential regulation of financial institutions --including mutual and hedge funds-- should clearly give greater weight to the high risk associated with operations with countries incurring large net borrowing, particularly of a short-term character. This would discourage this type of lending at the source. On the borrowing side, Basle standards and the corresponding domestic regulation should include or give greater weight to risks related to the growth of credit, to currency mismatches of assets and liabilities, to the accumulation of short-term liabilities in foreign currencies by financial intermediaries and to the valuation of fixed assets as collateral during episodes of asset inflation. Depending on the operation, higher capital standards, matching liquidity requirements or caps on valuation of assets should be established.¹⁴ This would discourage not only risky investments but also risky ways of financing them.¹⁵

Also, due account should be taken of the links between domestic financial risk and changes in key macroeconomic policy instruments, notably exchange and interest rates. This indicates that prudential regulations should be stricter in developing countries, where such links are more important, and that they should be strengthened in periods of financial euphoria to take into account the increasing risks which financial agents are incurring. Indeed, otherwise the application of strict prudential standards may become a pro-cyclical element of economic policy since, although they would reduce excessive risk taking during the upswing, this effect could be even more stringent during the downswing, when provisioning standards and their effects on capital requirements affect the capacity to extend credit. Moreover, due to the important externalities which large non-financial firms could generate on the domestic financial sector, particularly in the context of an exchange rate depreciation, the unhedged external liability exposures of these firms should also be subject to some regulation.¹⁶

The information problems which regulation and supervision face should not be underestimated, however.¹⁷ Regulation will almost necessarily lag behind innovations, and indeed regulations will induce innovations. Moreover, since regulation always focus on the services provided by financial intermediaries rather than on activities as such, an important form of innovation is the creation of new, unregulated agents that provide the same services. Supervisors can only review a limited amount of individual operations of financial intermediaries, and that information will be necessarily partial and will come with a lag. Indeed, the experience of supervision worldwide is that many high risks are only really known by the authorities too late to avoid some (even large) insolvencies from occurring. Moreover, this information comes as a significant surprise even to the (profit motivated) financial and non-financial

¹² Eatwell and Taylor (1998).

¹³ Group of Seven (1998).

¹⁴ United Nations Task Force (1999) and ECLAC (1998b).

¹⁵ Eichengreen (1998b).

¹⁶ United Nations Task Force (1999) and ECLAC (1998b).

¹⁷ See, for example, UNCTAD (1998), Part One, Ch. IV.

private firms involved, a fact that places significant doubts on whether the decisions that underlie such high risks could have been avoided in the first place. This is largely associated to the fact that unprofitable and loss-making investment decisions (and, thus, their real riskiness) are only known years after they have been made and, as we have pointed out, depend on macroeconomic as well as microeconomic factors, many of which are only known (and can only be known) ex post.

On the other hand, although an essential role of prudential regulation and supervision is to make financial intermediaries more risk conscious, there are clear limits to the appropriateness of discouraging private risk undertaking. After all, this is the basic role of private entrepreneurship and the engine of growth in modern economies, and an essential role of financial systems is to facilitate the undertaking of such risky ventures. Some classic roles of regulation may also become useless under major macroeconomic shocks: diversification of risks at the national level will turn out to be an inadequate safeguard under these conditions, attempts to avoid this problem by diversifying into assets and liabilities in foreign currencies generate new risks associated to currency mismatches, and capital requirements necessary to avoid such (hopefully) unusual circumstances may be so high as to entirely discourage important financial activities.

Moreover, though prudential regulation and supervision are essential activities, the first involves some price signals (e.g., higher capital requirements as a counterpart to riskier assets, and higher liquidity requirements for short-term liabilities), but also a whole array of quantitative restrictions (e.g., outright prohibitions or explicit limits on certain types of operations, such as matching requirements between certain assets and liabilities and limits on credits to related parties); the second is necessarily a discretionary public sector intervention; these are the two types of intervention that are generally viewed today as subject to important “government failures”. As a matter of fact, some of the major “moral hazard” issues are closely associated to the discretionary character of financial supervision. Indeed, a peculiar paradox in the recent literature is that authors who are unwilling to accept that quantitative restrictions and discretionary government intervention and even public sector intervention at all are good in other areas of economic policy (e.g., trade policy or capital account regulations) are so fervent in the defence of quantitative controls and discretionary policies in this particular case.

Although the argument in favor of stricter financial regulation and supervision is a compelling one, there are limits to what these instruments can do in terms of avoiding financial crises, and there are increasing costs to stricter regulation that cannot be ignored. The lags in regulatory practices and the limits to what supervisors can do are, on the other hand, strong arguments to emphasize the **internal** regulation system that banks and other financial intermediaries develop, and to focus an important part of supervisory activities on analysing the functioning of such internal regulations.

Similar comments can be made about information. As we have argued in Section I, improved information may enhance microeconomic efficiency but 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. Thus, although strong financial regulation and supervision and better information **are** essential components of any reform, there are limits to what reforms in these areas can do. Moreover, in the absence of adequate funding in times of crisis, market discipline may generate a strong deflationary bias in macroeconomic policy, and thus a more procyclical performance of economic activity, as authorities try to build credibility in volatile markets¹⁸ –particularly if, as we have indicated, markets do not believe that contingency financing would be available anyway in the required amounts. Under these conditions, stronger mechanisms for the authorities to “lean against the wind” in times of financial euphoria may be necessary, as well as alternatives to manage the crisis –in particular, regulation of capital flows and standstill provisions.

¹⁸ Eatwell (1996).

C. The need for appropriate mechanisms to internalize the externalities generated by national macroeconomic policies

Given that economic sovereignty would be given away only in a very partial way, stronger mechanisms to guarantee that the externalities generated by macroeconomic events --i.e., the contagion effects of both booms and busts—are adequately dealt with would be necessary in the new order. In the case of industrialized countries, this is essential to guarantee the global consistency of their macroeconomic policies, i.e., their collective ability to avoid both world inflationary and deflationary pressures. In the case of developing countries, evidence of contagion calls for similar mechanisms to internalize at least partially the regional effects of macroeconomic policies.

The three essential problems are the weaknesses of current arrangements, the lack of adequate representation of developing countries, and the considerable asymmetry between the two phases of the business cycle. With respect to the first of these problems, the Group of Seven is a weak mechanism of consultation, IMF Article IV reviews can be ignored rather easily by countries that do not require Fund financing, and there are no mechanisms of consultation (less so of surveillance or coordination) at the regional level in the developing world. In relation to the second problem, developing countries and the smaller industrialized countries obviously have no voice in the Group of Seven, and their representation on the IMF Interim Committee is less than it should be. The asymmetry between the two faces of the business cycle is reflected in the fact that, whereas the combination of market discipline and IMF conditionality are a very strong mechanism in the downswing --indeed, probably too strong, as we have argued above with respect to market discipline and will argue below with respect to conditionality--, there are no similar mechanisms in the upswing, when most of the risks that are later reflected in the crisis are incurred. In a word, crisis prevention is essentially the role of policies adopted to manage booms, when “market discipline” is perverse, as it rather encourages “irrational exuberance” (to use, again, Alan Greenspan’s term),¹⁹ and there are no constraints on the adoption of national procyclical policies.

Broad consensus on the need to reinforce consultations and surveillance of macroeconomic policies is not reflected, however, in a similar agreement on the adequate institutions. The French proposal to broaden the mandates of the IMF Interim Committee to make it a strong policy organ is the most promising one, certainly more than proposals to expand the Group of Seven, although it would certainly require improved representation of developing countries on the Committee. This should go together with strong emphasis on the critical role that Article IV consultations should play in the new order. Given its unique character as a global forum, certainly the most democratic of its kind, the United Nations should play a role in this area, through an improved Economic and Social Council or the Economic Security Council recommended by the 1995 Commission on Global Governance, the mandates of which would obviously cover a broader set of economic, social and environmental issues. At the regional level in the developing world, similar consultation mechanisms should be designed, using peer review, as it has also been recommended above with respect to regional surveillance of domestic financial regulation and supervision.

Moreover, it is crucial that all these surveillance and consultative mechanisms give greater weight to the management of booms, when financial crises are incubated. This change of emphasis has also been suggested for domestic policies in developing countries.²⁰

¹⁹ Greenspan (1996).

²⁰ ECLAC (1998b) and Ocampo (1998).

D. Internationally sanctioned standstill provisions to guarantee an adequate sharing of the burdens of adjustment

Through its chaotic effects on exchange and interest rates and on domestic economic activity, disorderly capital flight generates significant damage for debtor countries, and considerably increases the probability that illiquidity may turn into insolvency. It is also bad for creditors, as it reduces the probability that many of them would be repaid. Under these conditions, the unilateral suspension of debt servicing also generates significant damage. It destroys the credibility of national authorities and thus may worsen, rather than improve, conditions in the short term. The experience of many developing countries indicates that it leads to a repeated exercise of debt rescheduling, which interrupts investment and growth for protracted periods. On the other hand, under these conditions, the provision of additional liquidity by international institutions and official sources may serve to bail out many private creditors, raising moral hazard issues and serious concerns over the distribution of the burden of adjustment.

These considerations are the basis for the growing consensus on the need to create internationally sanctioned standstill provisions (also referred to as orderly debt workouts) in the area of international finance. These provisions would play the same role as national bankruptcy procedures play in domestic affairs. The preventive suspensions of debt service and agreed rescheduling under an internationally agreed procedure would serve to solve the coordination problems implicit in chaotic capital flight, and thus to avoid some of its worst effects. If, aside from illiquidity, there are problems with the debt burden of the country concerned, this mechanism would also serve to distribute more equitably the costs of adjustment and, particularly, to force private creditors to pay –also in an equitable way among themselves—part of the burden.

Due to the effects that the use of this mechanism may have on their credit reputation and its collateral effects on trade financing, borrowing countries are unlikely to use these provisions, except under severe difficulties. However, to avoid abusing their use –i.e., moral hazard on the side of borrowers--, they must be subject to some control. According to UNCTAD, which has provided probably the most forceful defense of this mechanism, there could be two alternatives to make it work.²¹ The first would be to explicitly give the IMF the power to sanction such standstills, to lead the renegotiations and to facilitate “lending into arrears” only in these cases. The second would be to allow countries to unilaterally call the standstill, but then to submit it for approval to an independent international panel, whose sanction would then give it legitimacy. An interesting third, complementary possibility would be to draft *ex-ante* rules under which debt service would be automatically suspended or reduced if certain macroeconomic shocks are experienced. These rules have sometimes been incorporated into debt renegotiation agreements. Although it can be argued that any of these alternatives could increase the perceived country risks, it may be argued on the contrary that it is only a mechanism to legally recognize default risks that already exist, and that it would actually reduce the default risks for **individual** operations (something that is provided for today only partially in cross-default provisions).

We should emphasize that this mechanism has four implications. First, to avoid free riding, it requires the generalized adoption of “collective action clauses” in international lending. Secondly, “bailing in” should be encouraged, by giving preference to lending that is given to the country involved throughout the period during which the standstill is in effect and a later phase of “normalization” of capital flows. Thirdly, debt renegotiations under this framework must have a strictly agreed, short time horizon, beyond which the IMF or the international panel would have the authority to determine the terms of reschedulings. To avoid repeated renegotiations, which have been one of the most troublesome features of debt reschedulings over the past two decades, the renegotiation should aim at being a definite settlement, i.e., one in which the debt burden is sustainable. The external debt, public and private, should

²¹ UNCTAD (1998), Part One, Ch. IV.. These recommendations are also incorporated into the United Nations Task Force (1999).

thus be classified in three portions: (a) a first one that would be subject to normal servicing, which would include the “bailing in” operations; (b) a contingent portion that would be paid totally or partially depending on certain external and domestic conditions (e.g., terms of trade and normalization of borrowing, in the first case; economic activity or unemployment, in the second); and (c) a third portion that would be written off. Finally, the use of this mechanism would necessarily require the use of explicit controls on capital flows, which must extend for some time beyond the successful conclusion of renegotiations to avoid ex post “free riding” (for example, private agreements to cancel the debt that was written off).

III. Areas of disagreement

A. The provision of adequate liquidity

As we have pointed out, the agreed principle that contingency financing should be available has not been matched by a clear agreement on how to make funds available in adequate quantities to make contingency financing really effective. The current principles of IMF intervention were summarized in the April 1998 Interim Committee Communiqué: “The Fund cannot be expected to be able to finance whatever large balance of payments deficit. Its role is essential to catalyze other sources of financing, and, when needed, to coordinate support from other sources”. This statement is certainly appropriate for “normal” times, but under crisis conditions, its “catalytic” and “coordination” roles would be largely ineffective if the market judges that the intervening authorities (i.e., including bilateral sources) are unable or unwilling to supply funds in the quantities required. Thus, insufficient resources may turn two correct principles –contingency financing and the catalytic role of the Fund—into a largely dead letter.

Contingency windows should thus be adequately financed. In other words, even if no true “lender of last resort” were devised (as we assume it will not), a well-funded “contingency financier” would certainly be required. This must be for developing countries a *sine qua non* of any reform effort. As bilateral financing and contributions to the IMF will continue to be very scarce, the best solution is certainly to allow additional issues of SDRs under critical financial conditions, to create the additional liquidity required.

These funds could be destroyed once financial conditions normalize. This procedure would, by the way, create an anticyclical element in world liquidity management and would give SDRs an increasing role in

world finance, a principle that developing countries advocated in the past and should continue to do. A second best alternative would be to allow the IMF to raise in the market the resources needed to guarantee adequate funds for contingency financing.

B. IMF conditionality

IMF conditionality has long been an area of contention. However, in recent years –and even decades–, the issue has become increasingly troublesome for three different reasons. First, 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 development banks–, but also on 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”.²² Indeed, although not referred explicitly to IMF conditionality, this point has been recently made in strong terms by the President of the World Bank: “We must never stop reminding ourselves that it is up to the government 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”.²³

Secondly, whereas the legitimacy of conditionality is indisputable when domestic policies are the source of macroeconomic disequilibria that lead to financial difficulties, it is unclear how this principle applies when such difficulties are generated by contagion. Moreover, it is even less clear why conditionality should be mixed in this case with adverse credit conditions (higher interest rates and shorter maturities), as has been advocated by the Group of Seven and agreed to in the case of contingency financing.

Finally, evidence of overkill in some IMF programmes has accumulated and has led to mounting criticisms on the specific macroeconomic analysis implicit in the programmes. Due to this fact, the IMF itself has agreed to facilitate countercyclical fiscal management in the depressed Asian economies.²⁴

Even if the legitimacy of the principle of conditionality is accepted –or, as it is sometimes alternatively stated, “support in exchange for reforms”–, these are reasons that should lead to a major revision of the characteristics of such conditionality. Indeed, the perception that conditionality has gone too far in practice may undermine its legitimacy, and weaken the international consensus on which the IMF itself is built. 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.

Several principles can be advanced in this regard. (1) Conditionality should be restricted to the macroeconomic policies that were its purview in the past. It should be used when expansionary policies are clearly associated with the generation of macroeconomic imbalances, or when a country needs to draw Fund resources beyond some automatic low-conditionality facilities if the source of the imbalance is an international shock. Reforms of domestic financial regulation and supervision may also be required, but parallel agreements should be made with the corresponding international authorities (a still controversial issue, however, as it was pointed out in Section II.B). (2) Low conditionality facilities should be available in adequate quantities when the source of the imbalance is an international shock. This principle has been recognized in the Compensatory and Contingency Financing Facility but should be extended to the case of contagion. In this case, ex-ante criteria could be used to determine eligibility

²² See United Nations Task Force (1999), Section 5. Actually, the strongest statement in this regard has come from a conservative critic of the Fund, Feldstein (1998).

²³ Wolfensohn (1998).

²⁴ Fischer (1998).

for the available windows. It is interesting to point out that these principles are those used to make “lender of last resort” funds available to financial institutions at the national level. (3) More stringent credit conditions should not be used as a complement to conditionality. It could be argued that they should be a substitute (i.e., a characteristic of some low-conditionality funds), but this is also controversial, as it undermines the “credit union” character of the IMF without really approaching “market conditions” that, under such circumstances, would be very stringent.²⁵ (4) Automatic rules should be agreed when signing an agreement with the Fund, by which the restrictiveness of policies would be eased should evidence of “overkill” become clear. In practice, as we have noticed, such easing has been granted *ex-post* to some Asian countries, but the negotiation process was too cumbersome and easing only came with a significant lag, when the contractionary effects of policies had surpassed by significant amounts that which had been assumed in the program. (5) Finally, regular official evaluation of IMF programs, either by an autonomous division in the Fund (as it is done in the World Bank) or by outside analysts, should be introduced and the major conclusions of these evaluations, when reviewed by the Board, should be explicitly introduced into regular Fund practice.

C. Preservation of the autonomy of developing countries to manage the capital account

Massive evidence of capital account liberalizations that ended up in major external and domestic financial crises in many countries have led to several agreements in this area²⁶. It is now generally agreed that such liberalizations should be gradual, should emphasize longer-term flows and be extremely cautious with shorter term and volatile funds (such as short-term credits and portfolio flows), and should be preceded by the development of strong financial regulation and supervision and consistent macroeconomic policies. Moreover, it is also accepted that any international agreement in this area should include safeguard mechanisms that would allow a temporary use of controls under certain, critical conditions. The consensus stops at this point. A strong argument has been made by some analysts to place well-managed capital account liberalization as the final objective of policy, on the basis that freer capital markets are inherently good for growth. If these assertions were correct, the use of capital controls should be essentially a temporary device. These are the arguments that underlie the current discussion on the introduction of capital account convertibility into the Articles of Agreement of the IMF. A strong argument can be made, however, on the advantages of maintaining the autonomy of developing countries to manage the capital account, on at least four grounds.²⁷

First of all, some of the fundamental assumptions that underlie full capital account liberalization are wrong. There is no evidence that capital mobility allows an efficient smoothing out of expenditure in developing countries through the economic cycle. On the contrary, in these countries the volatility of capital flows is clearly an additional source of instability. There is also no evidence of an association between capital account liberalization and economic growth, and some in the opposite direction²⁸. A simple way to pose the issue is to argue that, even if it is true that freer capital markets, through their effect on a more efficient savings-investment allocation, has positive effects on growth, the additional volatility associated with freer capital markets has the opposite effect.

Secondly, capital account regulations are obviously costly, but so are the alternatives. Thus, although they can be abused by using them as substitutes for appropriate macroeconomic management, the additional degrees of freedom that they provide to economic policy are important. Indeed, they may

²⁵ I am grateful to the General Manager of the IMF, Michel Camdessus, for making this point clear to me.

²⁶ For a recent survey, see Williamson and Mahar (1998).

²⁷ For a more extensive analysis of these issues, see United Nations Task Force (1999), UNCTAD (1998), Part One, Ch. IV, ECLAC/CEPAL (1998a), Part III, Eichengreen (1998b, 1999), Griffith-Jones (1998), Grilli and Milesi-Ferretti (1995), Krugman (1998) and Rodrik (1998b).

²⁸ See, in particular, Eatwell (1996) and Rodrik (1998b).

be a necessary complement to other desirable policies. During financial booms, some form of tax or control on inflows provides additional mechanisms to “lean against the wind” and thus avoid excessive borrowing, particularly of a short-term character, thereby acting as an effective mechanism to prevent financial crises. In countries that use some form of managed exchange rate flexibility, they also help to avoid an excessive appreciation of the domestic currency in the face of favourable terms of trade or capital account shocks, avoiding the generation of current account positions that become unsustainable once these favourable shocks cease. In terms of our discussion in Section I, they may thus be one of the least costly forms of “self-insurance” that a country may choose. It is certainly preferable to allowing the economy to boom without restrictions, accumulating excessive risks, and may be better than sterilized reserve accumulation, a policy that has been found to be self-defeating in many developing countries. During crises, controls on outflows provide additional “room for manoeuvre”, if they are not used as a substitute for fundamental macroeconomic adjustment. As we have argued, they are also a necessary complement to debt standstills, generally viewed as an important ingredient of a necessary financial architecture.²⁹

Thirdly, it can be argued that some capital account regulation on inflows that has been used by some developing countries during boom years may be not only more effective but actually preferable to alternative prudential regulation and supervision. Indeed, the boundary between some forms of capital controls and prudential regulation is a thin one. This is associated to the fact that capital account regulations have both macro and microeconomic effects, and may thus serve in the latter case as a substitute for prudential regulations aimed at guaranteeing a certain structure of assets or liabilities of financial intermediaries. As we have pointed out, prudential regulations in some cases establish price signals, but also quantitative restrictions, and although financial supervision is an essential activity, it is not free from significant information problems, and to those associated with discretionary public sector interventions. Certain types of regulations of the capital account may thus be equivalent to or a close substitute for traditional quantitative financial regulations (e.g., explicit prohibition of a certain type of external borrowing, or a minimum stay period for portfolio capital) or may introduce a price signal to substitute for quantitative restrictions (such as a Tobin tax, or the system of reserve requirements on capital flows to discourage short-term indebtedness that have been extensively used by Chile and Colombia in the 1990s³⁰), reducing the need for more discretionary interventions. Equivalent practices are actually used by private agents, such as the selling fees imposed by mutual funds on investments held for a short period, in order to discourage short-term holdings.³¹ Moreover, whereas prudential regulation and supervision cover only financial intermediaries, capital account regulations have a more extensive coverage. Given the significant externalities that non-financial agents have on domestic financial stability, this is a significant advantage.

Finally, but not least important, in the absence of an adequate international financial “safety net”, it is unclear why developing countries should give away their autonomy in this area. This is a crucial point. Why should developing countries give up this degree of freedom if they do not have access to adequate contingency financing and well-defined conditionality rules? In terms of our discussion in Section I, this is a particularly crucial issue for countries without significant power in the international arena, for whom renouncing any possible means to manage a crisis is a costly alternative.

Thus, at least in the case of developing countries, a flexible approach is superior to capital account convertibility. Thus, the mandate of the IMF should not be for convertibility, but rather for analysing and spreading good practices in this area. Based on the Latin American experience, three may be pointed out: (1) Capital account regulations during booms, which have a preventive character, would be preferable to the establishment of strong quantitative controls on outflows during the ensuing crises.

²⁹ This is an essential point, made strongly by Krugman (1998).

³⁰ For an overview of the functioning of these mechanisms, see Agosin and Ffrench-Davis (1999) and Ocampo and Tovar (1998).

³¹ J. P. Morgan (1998), pp. 23-26.

(2) Price-based regulations (such as Chilean and Colombian reserve requirements) are preferable to quantitative controls, whenever viable. And (3) a permanent regulation or control regime that is tightened or loosened throughout the economic cycle is preferable to the alternation of a free capital account regime during the boom and quantitative controls on outflows during the cycle. This type of sporadic, crisis-driven controls are generally ineffective, as a tradition of regulation and supervision is necessary to make them operative.

D. Freedom to choose the exchange rate regime should continue

In the face of recent events, some authors have strongly argued that the only stable regimes in the current globalized world are either a convertibility scheme or a totally free exchange rate. According to this point of view, the IMF should stop countries from adopting exchange rate regimes that are assumed to be unstable. This argument is obviously only one step from arguing that the exchange rate regime should be subject to conditionality, a step that would certainly be unfortunate.

The free vs. floating exchange rate controversy is an old one and indicates that no optimal regime exists. Currency boards certainly introduce built-in institutional arrangements that provide for fiscal and monetary discipline. Due to this fact, they reduce the room for speculation that a fixed but adjustable exchange rate regime exhibits. However, such arrangements are not speculation-proof, as the experience of Argentina in 1994-1995 or Hong Kong in 1997 indicates. Moreover, they reduce the scope for relative price adjustments in the face of balance of payments crises, a fact that can be costly. More generally, they reduce the room for stabilizing macroeconomic policies and may thus generate strong swings in economic activity and asset prices. Finally, using currency boards reduces (or even eliminates) the possibility of using the central bank as a lender-of-last-resort for financial institutions. Indeed, the need to support domestic financial institutions in difficulty was an essential reason for the abandonment of the classical ancestor of convertibility regimes in many countries, the gold standard.³²

On the other hand, the classic arguments in favor of floating rates are that they provide a market mechanism to face both trade and capital account shocks, with the emphasis on the latter being particularly strong in recent years, and allow authorities an additional degree of freedom to manage monetary policy to respond to domestic anti-cyclical goals. However, exchange rate volatility increases the costs of trade transactions and thus reduces the benefits of international specialization. During periods of large capital account flows or good terms of trade, Dutch disease effects may also put export sectors that may be competitive in the long run out of business, a fact that may be irreversible if there are dynamic scale economies (learning processes or fixed costs of conquering markets). The existence of financial liabilities in foreign currencies generates additional difficulties, as exchange rate fluctuations generate significant capital gains and losses, that would tend to be strongly procyclical. Since the exchange rate is a crucial variable in the formation of domestic prices, it may generate a perverse inflation-exchange rate dynamic, particularly in the downswings. Probably as a result of these links between the exchange rate, financial structures and domestic prices, the essential advantage of a floating exchange rate, that of allowing authorities to determine monetary policy on the basis of domestic factors, is not always materialized. The experience of both domestic policies and IMF programs is that, contrary to that rule, under floating rates authorities tend to use monetary policy to counteract market pressures on exchange rates –i.e., to reduce interest rates when there is appreciation and to increase them when there are devaluation pressures.

In practice most countries choose intermediate regimes, such as adjustable and crawling pegs, exchange rate bands and dirty floatation. The basic argument for an intermediate, administered exchange

³² This was, indeed, a central issue in the old gold standard days. See Eichengreen (1996), Ch. Two.

rate regime is that it may counteract some of the adverse characteristics of free floating, such as the effects of exchange rate volatility on trade, Dutch-disease processes, shocks on financial structures, and perverse exchange rate-price dynamics, while maintaining the advantages of using the exchange rate as a policy tool. However, as it was indicated at the end of the previous paragraph, at several stages in the business cycle, such intermediate regimes may lead authorities to use interest rate management as a support for exchange rate management. This may be socially very costly if an inappropriate exchange rate is defended.

As long as no compelling argument exists in favor of one or a few specific alternatives, countries should be free to choose the exchange rate regime that they find preferable. National authorities and IMF surveillance and conditionality should recognize in this case, however, that other policies might have to be adjusted accordingly. In particular, domestic regulation will have to take into account the specific macroeconomic risks that financial intermediaries face under a particular regime. Equally important, complementary capital account regulations may be useful to moderate shocks in either direction. Thus, regulation or controls on inflows may be useful during the boom to avoid reducing interest rates in a procyclical way and thus feeding the expansion of aggregate domestic demand. In turn, controls on outflows during crises may be a useful alternative to high domestic interest rates, which have strong effects on aggregate demand and on the stability of the domestic financial system.

E. The role of regional institutions in the new architecture

In the post-war period, Western Europe provides the best example of regional financial cooperation. 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. The history of many institutions, including that of the Bank of 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.

At a more limited level, there are institutions that have 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. There are also several subregional institutions in this area, the most dynamic of which is the Andean Development Bank (Corporación Andina de Fomento), which in turn 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. The Centro de Estudios Monetarios Latinoamericanos (CEMLA) has provided, in turn, a forum for dialogue on many issues, including the design of prudential regulations and supervision. Under existing integration schemes, some dialogue has also taken place on macroeconomic coordination, but progress has been very limited in this area. In any case, the call for stronger mechanisms of macroeconomic coordination has been a common theme during the recent crisis.

It can be strongly argued that a network of regional and subregional institutions would play two positive roles from the point of view of international financial arrangements. First, by generating more lines of defence, it would contribute to the stability of the world economy. Macroeconomic consultation or stronger forms of coordination, including an organized system of peer review or a more elaborate mechanism of regional and subregional surveillance, could internalize, at least partly, the significant externalities that national macroeconomic management generates for neighbouring countries. In the area

of prudential regulation and supervision, more elaborate systems of regional information and consultation, and again peer reviews or some mechanism of regional or subregional surveillance, can also play a positive role. Strong regional reserve funds could also serve to deter, at least partly, would-be speculators from attacking individual countries, and can also provide additional funds in times of difficulty. On both the demand and the supply side, they would thus reduce the need for extraregional financing. A second advantage of this system is that it would be more balanced from the point of view of the equilibrium of world relations than a system based on a few world organizations. This would increase the commitment of less powerful players to abide by rules that can contribute to world and regional stability.

For these reasons, aside from strengthening existing global institutions or creating new ones, the design of an appropriate world system for financial stability should also include the design of a whole network of regional and subregional institutions which contribute to the different tasks that have been emphasized in the discussions on the new international financial architecture. Indeed, such a network is certainly more appropriate for today's world than a system that relies on a few global institutions. After all, a feature of globalization is also open regionalism, and many of the most dynamic processes that the world economy is undergoing today are associated with increased intraregional trade and investment. In Latin America and the Caribbean, this is certainly an outstanding feature.

An interesting suggestion made by the United Nations Task Force is the possibility of conceiving the International Monetary Fund of the future, not as a single, global institution, but rather as the apex of a network of regional and subregional reserve funds. 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 its paid-in resources –in other words, to treat contributions to common reserve funds as equivalent to IMF quotas.³³

³³ United Nations Task Force (1999), Section 9.

IV. Complementary issues

The issues related to international financial stability that have been the main subject of this paper –the “narrow” financial architecture, as we have called it-- are part of a broader set of issues. At least three others deserve a brief reference: the solution of outstanding debt issues, development finance and the design and financing of effective social safety nets.

Among the first, the most important are those associated with highly indebted poor countries. The main initiative aimed at significantly reducing the debt burden of these nations (the so called HIPC Initiative) has been extremely slow in its operation, due both to the lack of adequate financing and to the conditionality involved. Moreover, contributions to the corresponding Trust Fund have been crowding out other forms of ODA, including resources for new development finance for poor countries. This is unfortunate, as new ODA should be a complement, not the substitute for debt write-offs, as it is the former that would contribute to accelerating growth in the poor countries, with the latter basically eliminating an obstacle. Moreover, contributions to the Trust Fund are, strictly speaking, indirect capitalizations of the IMF, World Bank and regional development banks, which allow them to write off debts without incurring an accounting loss. In more normal operations of this kind in the financial world, the loss would be incurred first and then a fresh capitalization would replenish the net worth. Thus, as it has become clear that bolder debt relief initiatives are required, more active use of alternative financing mechanisms that do not crowd out ODA are also needed.

This issue is strongly related to those associated to international development finance. The experience of the 1990s indicates that the latter should have three main goals: (1) to channel funds to

poor countries, whose access to private financing and FDI is much more limited than that of the middle-income countries; (2) to provide long-term financing to middle income or small countries who, due to lack of an adequate credit rating or to the fixed costs involved (e.g., in bond financing) do not have access to comparable private funds; (3) to act as a counter-cyclical balance to fluctuations in private capital market financing; and (4) to facilitate the transition to new forms of private financing. To these we could add the traditional “value added” in multilateral financing: lending-associated technical assistance.

The first of these functions underscores the central role that bilateral ODA, IDA, ESAF and similar mechanisms would continue to play in the future in financing the least developed countries. The second indicates that multilateral financing in general will continue to be an important source of long-term funds for many middle income and small countries. The third emphasizes a role that tends to be underestimated in years of financial euphoria, and that has actually led many middle-income countries to design financing strategies that were not adequately balanced in terms of the proportions of market vs. multilateral financing. This role should not be confused with that of providing liquidity in times of crisis, which is essentially a task of the IMF. In any case, the large requirements of counter-cyclical financing to middle-income countries during crises may crowd out financing to poor countries.³⁴ The fourth role is of fairly recent origin, but has experienced rapid growth in recent years. It has been associated, in particular, with direct financing (by the bank or associated financial corporations) or guarantee schemes to support private infrastructure projects in developing countries. However, it has been suggested that it could also be used to support the return to markets by developing countries during crises, or eventually to support initial bond issues by developing (particularly poor) countries seeking to position themselves in private markets. The full development of these schemes would certainly require a radical change in the management of guarantees by development banks, a fact that has been criticized on the grounds that it could involve excessive risk-taking by such institutions.

Last but certainly not least, the introduction of strong social safety nets is central to any scheme for managing financial vulnerability in the developing world. Indeed, poor sectors of society in these countries benefit rather marginally from financial booms but, on the contrary, bear a substantial burden of macroeconomic adjustment during financial crises. However, social safety nets have been subject more to rhetoric than practice. The concept itself is subject to confusion, as it is used to refer both to the design of long-term social policies and to specific mechanisms to protect vulnerable sectors of society during crises. The first could obviously include systems that offer stable mechanisms of the second type, but the most common mechanism of its type in developed countries, unemployment insurance, is not a viable alternative in most of the developing world. The most commonly used mechanism in developing countries since the 1980s has been social emergency funds (later transformed into more stable social investment funds). Although they have introduced important innovations in social policy (e.g., more effective targeting and competitive mechanisms to encourage civil society participation in social policies), their effects have been rather limited and they may have crowded out resources from long term social policy.³⁵ Thus, the recent call from the Group of Seven to design “general principles of good practice in social policy” is a significant step forward,³⁶ but it should certainly not replace efforts aimed at analysing the more specific role that social safety nets --understood in the more limited sense of mechanisms to protect vulnerable sectors during crises--could play and at guaranteeing adequate financing for them.

³⁴ Wolfenshon (1998).

³⁵ See an evaluation of several experiences in Graham (1994), referred to the use of safety nets in structural reform processes.

³⁶ Group of Seven (1999).

References

- Agosin, Manuel and Ricardo Ffrench-Davis (1999), "Managing Capital Inflows in Chile", forthcoming as a book published by Oxford University Press, United Nations University/ World Institute for Development Economics Research (WIDER).
- Calvo, Guillermo (1998), "Contagion and Sudden Stops", Baltimore, University of Maryland, November, unpublished.
- Camdessus, Michel (1998a), "Opening address at the Annual Meeting of the Board of Governors of the IMF", *IMF Survey*, vol. 27, 19 October.
- ___ (1998b), "Towards an agenda for international monetary and financial reform", *Address to the World Affairs Council*, Philadelphia, 6 November.
- Díaz-Alejandro, Carlos F. (1988), *Trade, Development and the World Economy*, Selected Essays, Andrés Velasco (ed.), Oxford, Basil Blackwell.
- Eatwell, John (1996), "International Financial Liberalization: The Impact on World Development", UNDP-Office of Development Studies Discussion Paper, No. 12, United Nations Development Programme (UNDP), September.
- Eatwell, John and Lance Taylor (1998), "A Proposal for the Creation of a World Financial Authority", unpublished.
- ECLAC (Economic Commission for Latin America and the Caribbean) (1998a), *América Latina y el Caribe: políticas para mejorar la inserción en la economía mundial*, second version, revised and updated, Santiago, Chile, Fondo de Cultura Económica. An earlier English language version appeared in 1995, *Latin America and the Caribbean: Policies to Improve Linkages with the Global Economy* (LC/G.1800/Rev.1-P), Santiago, Chile. United Nations publication, Sales No. E.95.II.G.6.
- ___ (1998b), "Preventing and handling financial crises", *The International Financial Crisis: An ECLAC Perspective* (LC/G.2040), Santiago, Chile, October.
- Eichengreen, Barry (1999), *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*, Washington, Institute for International Economics.

- ___ (1998a), "The Only Game in Town", University of California-Berkeley, November, unpublished.
- ___ (1998b), "Capital Controls: Capital Idea or Capital Folly", University of California-Berkeley, November, unpublished.
- ___ (1996), *Globalizing Capital: A History of the International Monetary System*, Princeton, Princeton University Press.
- Feldstein, Martin (1998), "Refocusing the IMF", *Foreign Affairs*, vol. 77, No. 2, March/April.
- Fischer, Stanley (1998), "Reforming world finance: lessons from a crisis", *IMF Survey*, Special Supplement, 19 October.
- Graham, Carol (1994), *Safety Nets, Politics, and the Poor*, Washington, The Brookings Institution.
- Greenspan, Alan (1998), "The structure of the international financial system", *Remarks at the Annual Meeting of the Securities Industry Association*, Boca Raton, Florida, 5 November.
- ___ (1996), "The challenge of central banking in a democratic society", *Remarks at the Annual Dinner and Francis Boyer Lecture of The American Institute for Public Policy Research*, Washington, 5 December.
- Griffith-Jones, Stephany (1998), *Global Capital Flows-Should They Be Regulated?*, London, Macmillan.
- Grilli, Vittorio and Gian Maria Milesi-Ferretti (1995), "Economic Effects and Structural Determinants of Capital Controls", *IMF Staff Papers*, vol. 42, No. 3, September.
- Group of Seven (1999), *Communiqué of the G-7 Finance Ministers and Central Bank Governors*, Petersburg, Bonn.
- ___ (1998), *Declaration of G-7 Finance Ministers and Central Bank Governors*, 30 October.
- Group of 24 (1998), *Communiqué*, 3 October.
- Helleiner, Gerry and Ademola Oyejide (1998), "Global Economic Governance, Global Negotiations and the Developing Countries", Background Paper for the *Human Development Report 1999*, December.
- IMF (International Monetary Fund) (1998), *Toward a Framework for Financial Stability*, Washington, D.C.
- IMF (International Monetary Fund), Interim Committee (1998), *Statement*, Washington, D.C., 16 April.
- Jospin, Lionel (1998), "La crise mondiale et nous", *Le nouvel observateur*, 10 September.
- Krugman, Paul (1998), "The Eternal Triangle", Cambridge, Massachusetts Institute of Technology (MIT), unpublished.
- Larraín, Guillermo, Helmut Reisen and Julia von Maltzan (1997), "Emerging Market Risk and Sovereign Credit Ratings", OECD Development Centre Technical Paper, No. 124, April.
- Miyazawa, Kiichi (1998), "Towards a New International Financial Architecture", *Speech at the Foreign Correspondents Club of Japan*, 15 December.
- Morgan, J. P. (1998), *World Financial Markets*, New York, 7 October.
- Ocampo, José Antonio (1998), "Beyond the Washington Consensus: a view from ECLAC", *CEPAL Review*, No. 66, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC).
- Ocampo, José Antonio and Camilo Tovar (1998), "Capital Flows, Savings and Investment in Colombia, 1960-96", *Capital Flows and Investment Performance: Lessons from Latin America*, R. Ffrench-Davis and H. Reisen (eds.), Economic Commission for Latin America and the Caribbean (ECLAC)/OECD Development Centre, Paris and Santiago.
- Rodrik, Dani (1998a), "Rethinking the World Economy", Boston, Harvard University, Unpublished.
- ___ (1998b), "Who Needs Capital-Account Convertibility?", Harvard University, February, Unpublished.
- Stiglitz, Joseph and Andrew Weiss (1981), "Credit Rationing in Markets with Imperfect Information", *American Economic Review*, June.
- UNCTAD (United Nations Conference on Trade and Development) (1998), *Trade and Development Report*, Geneva.
- United Nations, Task Force of the Executive Committee on Economic and Social Affairs (1999), *Towards a New International Financial Architecture. Report of the Task Force of the Executive Committee on Economic and Social Affairs (LC/G.2054)*, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), March.
- Williamson, John and Molly Mahar (1998), "A Survey of Financial Liberalization", *Essays in International Finance*, No. 211, November.
- Wolfensohn, James D. (1998), "The Other Crisis", *Address to the Board of Governors*, Washington, 6 October.



NACIONES UNIDAS



Serie

temas de coyuntura

Publications related to this series

- "Impact of the Asian Crisis on Latin America". www
- "Impacto de la crisis asiática en América Latina" (LC/G.2026), mayo de 1998. www
- "La crisis financiera internacional: una visión desde la CEPAL/The International Financial Crisis: An ECLAC Perspective" (LC/G.2040), Octubre/October 1998. www
- "Towards a New International Financial Architecture. Report of the Task Force of the Executive Committee on Economic and Social Affairs of the United Nations/Hacia una nueva arquitectura financiera internacional. Informe del Grupo de Trabajo del Comité Ejecutivo de Asuntos Económicos y Sociales de las Naciones Unidas" (LC/G.2054), March/Marzo 1999. www

-
- Readers wishing to obtain the above publications can do so by writing to the following address: ECLAC Secretariat, Casilla 179-D, Santiago de Chile.
Please use this page as a form, indicating your choice by checking the corresponding box.

Name:

Address:

Postal code and city:

Country:

Tel.: Fax: E.mail address:

- www : These publications are also available on the Internet: <http://www.eclac.cl>