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International financial reform: the broad agenda

José Antonio Ocampo

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Abstract

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 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, in a systematic fashion, not only the role of world institutions but also of regional arrangements and the explicit definition of areas where national autonomy should be maintained. These issues should be tabled in a representative, balanced negotiation process, which should overcome 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 political economy issues, it considers: (1) the reforms associated to financial crisis prevention and resolution; (2) 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; (3) the need to reach a renewed international agreement on the limits of conditionality and a full recognition of the central role of the "ownership" of development and macroeconomic policies by developing countries; (4) 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 (5) the need to maintain several realms of national autonomy, including capital account regulations and the choice of exchange rate regimes. The paper argues that regional institutions and national autonomy are particularly important for the smaller players in the international arena, which will gain significantly from competition in the services provided to them and from the maintenance of freedom of action in a context of imperfect supply of global public goods.

International financial reform: the broad agenda

José Antonio Ocampo*

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

The crisis set in motion 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 IMF resources; the recognition that incentives must

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* Executive Secretary, United Nations Economic Commission for Latin America and the Caribbean (ECLAC). The paper partly draws upon parallel work by the author, as coordinator of the Task Force of the United Nations Executive Committee on Economic and Social Affairs (United Nations Task Force, 1999a), as well as from Ocampo (1999a, 1999b) and joint work with Stephany Griffith-Jones (Griffith-Jones and Ocampo, 1999), supported by the Swedish Ministry of Foreign Affairs. Discussions in an IDRC meeting in Ottawa, in preparation for a large-scale project on international financial reform, were very useful in clarifying some of the issues discussed in this paper. I am grateful to Oscar Altimir, Reynaldo Bajraj, Nicolás Eyzaguirre, Gunther Held, Gerald Helleiner and participants in a workshop on the World Financial Authority at the New School for Social Research, New York, for comments on a previous draft, and to Guillermo Mundt and Camilo Tovar for the elaboration of the data included in Section I.

1 United Nations Task Force (1999a), Section 1.

be created to induce adequate debt profiles in developing countries; a special impetus to 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 social safety nets in developing countries. Some responses were positive but do not seem to be leading in any clear direction (or even in a wrong one). This is the case of the adoption of collective action clauses in debt issues as an essential step to facilitate internationally agreed debt standstills and workout procedures. In some cases, the responses were insufficient or clearly inadequate: IMF conditionality was overextended; 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 strong unwarranted opposition that led to its rapid dismissal; more generally, the role which regional institutions can play in an appropriate international financial arrangement was not given adequate attention; and no steps were taken to ensure a 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. One such step would be to give new impetus to discussions on capital account convertibility. The calmer environment could be taken, on the other hand, as an opportunity to broaden the agenda and to set in motion a representative, balanced negotiation process. The 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" of economic and, particularly, development policies; secondly, it should consider, in a systematic fashion, not only the role of world institutions, but also of regional arrangements and the areas where national autonomy should be maintained. This is the focus of this paper. As a background, the first two sections present brief reflections on the nature of the problems that the system faces and the political economy of the reform effort. Then the paper deals with crisis prevention and management, development finance, the issue of conditionality vs. "ownership" which concerns both of them, the role of regional institutions, and national regulations and autonomy.

[2] Ocampo (1999a).

I. The nature of the problems that the system faces

International capital flows to developing countries have exhibited four outstanding features in the 1990s.[3] First of all, official and private flows have exhibited opposite patterns: whereas the former have tended to decline, private capital flows have experienced rapid medium-term growth. Secondly, different private flows have exhibited striking differences in terms of stability. Thirdly, private flows have been concentrated in middle-income countries, with official flows playing only a very partial redistributive role at a world level. Finally, the instability of private financial flows has required the design of major emergency rescue packages, of unprecedented size, which have concentrated funds in a few large "emerging" economies.

The first two patterns are shown in table 1. Both foreign direct investment (FDI) and all types of private financial flows have experienced strong medium-term growth. However, these flows have exhibited striking differences in terms of stability: whereas FDI has been resilient in the face of crises, private financial flows have experienced strong volatility and "contagion" effects. 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 reached 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

[3] For a full evaluation of trends, see UNCTAD (1999), Chapters III and V, and World Bank (1999).
[4] World Bank (1999), Chapter 4, p. 70.

industrialized countries. This trend has been partly offset, in terms of effective resource transfers, by the increasing share of grants in official development assistance. Also, contrary to private flows, official finance has not been pro-cyclical and, indeed, some components of it —particularly balance of payments support but also multilateral development finance— has displayed anti-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, a fact that may be expected, but it is also lower than their share in developing countries' GDP. This fact is particularly striking in bond financing, commercial 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 captures, on the contrary, a smaller proportion of financial flows. The high concentration of the most volatile flows in middle-income countries, excluding China, has implied, in turn, that issues of financial volatility and contagion have become particularly relevant to them.

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

The volatility of private financial flows, on the one hand, and its strong concentration in middle-income countries, on the other, have jointly generated the need for exceptional financing on an unprecedented scale, which has been concentrated in a few "emerging" countries. As a result, IMF (including ESAF) financing has exhibited both strong anti-cyclical behaviour in relation to private flows and a concentration in a few countries. As figure 1 indicates, both patterns are closely associated, as cyclical borrowing by a few countries is the major determinant of the overall cyclical pattern. The latter feature has become even more marked in recent years. Thus, whereas India and the three largest Latin American borrowers received less than half of net real flows from the Fund in 1980-1984, net real flows to only four large borrowers (Indonesia, Republic of Korea, Russia and Mexico) have in fact exceeded by a small margin the total net real flows from the Fund in 1995-1997. As a result of this feature, the share of IMF financing going to large borrowers[5] has displayed a strong upward trend over the past two decades. Indeed, in recent years, IMF financing underestimates the magnitude of emergency financing to large borrowers, as the bilateral contributions to the rescue packages of six nations (Indonesia, Republic of Korea, Thailand, Russia, Brazil and Mexico) are not included in the data.[6]

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

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

Table 1

NET LONG-TERM RESOURCE FLOWS TO DEVELOPING COUNTRIES, 1990-1998

	1990	1991	1992	1993	1994	1995	1996	1997	1998 [a]
Net long-term resource flows	100.8	123.1	152.3	220.2	223.6	254.9	308.1	338.1	275.0
Official flows	56.9	62.6	54.0	53.3	45.5	53.4	32.2	39.1	47.9
Private flows	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: The World Bank, *Global Development Finance 1999.*

Note: 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.

[a] Preliminary.

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
Developing countries	**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
Low-income countries	**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
China [a]	**32.1**	**32.5**	**3.9**	**11.1**	**0.3**	**1.0**	**2.3**	**81.0**	**2.1**	**15.5**
Middle-income countries	**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	0.0	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	0.0	0.0	-0.2	-5.4	0.6	4.1
Mexico	8.1	8.2	5.1	14.3	0.0	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

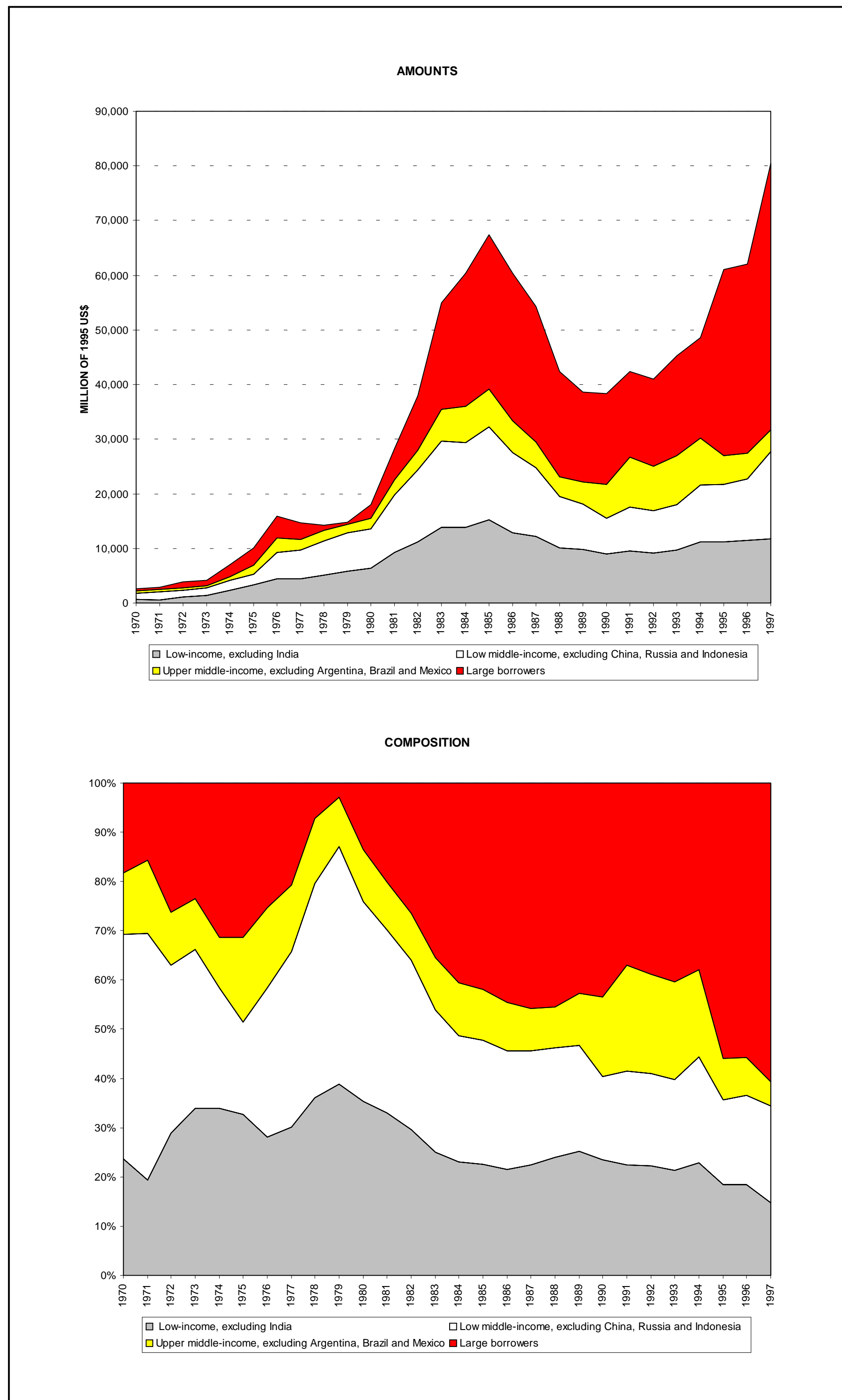
	Bonds		Commercial bank loans		Other loans		Total		**Memo:**	
									GDP	Population
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage
Developing countries	**34.6**	**100.0**	**28.3**	**100.0**	**4.9**	**100.0**	**248.7**	**100.0**	**100.0**	**100.0**
Excluding China	32.9	95.2	26.6	94.0	1.1	21.4	200.7	80.7	89.2	74.8
Low-income countries	**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
China [a]	**1.7**	**4.8**	**1.7**	**6.0**	**3.9**	**78.6**	**48.0**	**19.3**	**10.8**	**25.2**
Middle-income countries	**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	-0.0	-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: The 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 as a specific category.

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

Figure 1
USE OF IMF CREDIT



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

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

II. Some reflections on the political economy of the reform process

The nature of current controversies regarding international financial reform reflects three features of the political economy of the current globalization process. The first is the reluctance of most countries, both industrialized and developing countries alike, to give up economic sovereignty to international organizations. Under the strong market forces that characterize globalization, which tend to weaken nation states, and the unilateral national liberalization processes that have taken place simultaneously, government regulations have weakened worldwide. 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 III below are a particular case in which most analysts agree that inadequate regulation —both national and international— has been an essential determinant of market instability. Some other cases can be mentioned. It is generally agreed, for example, that "fair trade" rules, such as antidumping and countervailing duties, applied at a national level, are generally suboptimal if compared to other forms of regulating competition, such as antitrust provisions, and may create distortions of their own, even if applied within WTO 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 vs. unskilled labour) generates strong adverse income distribution pressures worldwide.[7]

[7] See, on the latter, Rodrik (1997).

The second feature is the disorganization of actors, particularly developing countries, in the international policy debate. This may be a reflection of the weakening of the historical mechanisms of concerted action (e.g., G77), but also of 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 increasing footloose production. The high costs of generating international coalitions have thus become even more important today. This implies that the international agenda would tend to be biased, more 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 a feature of globalization is also open regionalism, and strong integration forces have been at work in many parts of the developing world (e.g., Latin America and South-East Asia), this has not led to strong developing-country coalitions. Indeed, the European Union aside, countries are also unwilling to give up their sovereignty even to regional institutions.

The disorganization of 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 push in some directions and, on the contrary, the 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 qualifications during 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 competition rules and codes of conduct for multinational firms, and compensatory financing and technology transfers to guarantee inclusion of those countries which tend to be left behind in the globalization process.

These political economy features have major implications for international financial reform. The most obvious are that only weak pressures for substantial reform would be present,[8] that any balanced negotiation process would be cumbersome, and that negotiation processes may underestimate or bypass altogether the interests of certain actors. Obviously, the desirable outcome would be for adequate fora and a broad agenda to be chosen, so as to adequately represent the interests of those actors which would otherwise not have a strong voice.[9] These features also imply that the international financial architecture would continue to rely essentially on a network of *national* institutions, and thus 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 would continue to play the central role in many (if not most) policy areas and that policy instruments that are closed at a national level (such as certain restrictions on market activities, or unilateral standstills on debts) should probably be left as open options at the international level.

A final, crucial implication is that no international financial architecture is neutral in terms of the equilibrium 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 to manage a potential crisis or to finance development than if they are restricted to fewer options. The first part of this proposition indicates, in fact, that the strongest defense for weaker actors is competition in the supply of support to them. The second is that, in the absence of adequate

[8] See Eichengreen (1998).

[9] These are fundamental concerns of the United Nations Task Force (1999a), the Group of 24 (1998) and Helleiner and Oyeijde (1998).

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 best practice, a result of the “policy competition” to which we have alluded.

III. Financial crisis prevention and resolution

The issues associated with financial crisis prevention and resolution 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: 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 industrialized countries, the central issues for the corresponding domestic agencies are stricter regulation and supervision of highly leveraged institutions and operations, controls on offshore centres, and the greater weight that should be given to the risks associated with operations with countries engaging in large-scale net borrowing, particularly of a short-term character, to discourage risky financing at the source.

From the point of view of borrowing economies, greater weight should be given by domestic regulators to the accumulation of short-term liabilities in foreign currencies, to risks associated with the rapid growth of credit, to currency mismatches of assets and liabilities, and to the valuation of fixed assets as collateral during episodes of asset inflation. Most importantly, due account should be taken of the links

[10] See, among others, Camdessus (1998a, 1998b), IMF (1998), IMF Interim Committee (1998), Group of Seven (1998), UNCTAD (1998), Part One, Chapter IV, United Nations Task Force (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, 1999b), White (1999) and Wyploz (1999).

between domestic financial risks and changes in key macroeconomic policy instruments, notably exchange and interest rates. This indicates that prudential standards should be stricter in developing countries, where such links are more important, and that they should be strengthened during periods of financial euphoria to take into account the increasing risks being incurred by financial intermediaries. Due account should also be taken of the important externalities which large non-financial firms could generate for the domestic financial sector, which implies that the external liabilities exposure of these firms should also be regulated. We will return to these issues in Section VII below.

Nonetheless, a substantial divergence of opinion remains. Firstly, there is no consensus as to which institutions should be entrusted with enhanced responsibilities in this field. The BIS should certainly play the leading role, but this requires a significant expansion of developing-country membership in this organization, and of developing-country participation in the definition of all sorts of international standards and codes of conduct, in general. The more ambitious proposal to create a World Financial Authority on the basis of BIS and OIOS 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 regulations and supervision vs. alternative instruments in key areas. One particularly relevant issue in this regard, as we will see below, relates to capital account regulations. Fourthly, there are significant differences of opinion as to what can be expected from enhanced prudential regulation and supervision, given their inherent limitations. Regulations will tend to lag behind financial innovations, supervisors are likely to face significant information problems, and macroeconomic events may overwhelm even well-regulated systems. Finally, traditional prudential regulation and supervision tend to have pro-cyclical macroeconomic effects (they may be unable to avoid excessive risk-taking during the booms and 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, there is some doubt as to what can be expected from better information. Indeed, although improved information enhances microeconomic efficiency, it may not improve macroeconomic stability, which is dominated by the evolution of opinions and expectations rather than information, in the correct sense of that term (i.e., factual information). Indeed, 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, the additional instability which they may generate.[12] To use modern terminology, more than “information cascades”, what characterizes macroeconomic financial instability are “opinion and expectation cascades”, i.e., the alternate “contagion” of both optimism and pessimism through the business cycle. The best information system will be unable to correct this “market failure”, as the whims of expectations involve “information” about the future, which will never be available.[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 role played by 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 crucial

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[11] Eatwell and Taylor (1999).

[12] See, on the former, Larraín et al. (1997); on the latter, Calvo (1998).

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

during booms, when IMF surveillance is perceived by national authorities as an academic exercise, consultative mechanisms seem less necessary and "market discipline" has perverse effects, as it does not constrain excessive private risk-taking or the adoption of national pro-cyclical policies. Indeed, the focus of current institutions —both national and international— on crises rather than booms is a serious deficiency of existing arrangements, as they underplay the preventive role that they should perform. Obviously, concerted expansionary action during crises is also essential and, as was pointed out in the introduction to this paper, moves in that direction since the Russian crisis 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 current arrangements. Proposals to strengthen IMF surveillance of macroeconomic policies and to transform the IMF Interim Committee into a policy organ are the most encouraging in this regard, though the latter has not received adequate support; this should certainly be accompanied by an increased representation of developing countries. Also, given the 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 an improved Economic and Social Council or Economic Security Council.

The enhanced provision of emergency financing during crises is the third pillar of the system to prevent and manage financial crises. This principle may be called the principle of the "emergency financier", to differentiate it from the role that central banks play at the national level as "lenders of last resort", which is not exactly matched by the IMF. More specifically, the Fund provides exceptional financing but certainly not *liquidity*, a fact that is reflected in the lack of automaticity in the availability of financing during crises.[14] The access to emergency financing raises, in any case, "moral hazard" issues that give rise, on the side of borrowers, to the need to define access rules and, on the side of private lenders, to the need for orderly debt workouts that guarantee that they assume a fair share of the costs of adjustment.

The main lessons from recent crises are: (1) that large-scale funding may be required, though not all of it needs to be disbursed if support programs rapidly restore market confidence; (2) that funds should be made available *before* —rather than after— international reserves reach critically low levels; and (3) that, due to strong contagion effects, contingency financing may be required even by countries that do not exhibit fundamental disequilibria. At least the last two imply significant differences with respect to the traditional IMF approach, which is based on the principle of correcting fundamental balance of payments disequilibria once they have become evident. Positive measures have been adopted in this area, including a significant expansion of IMF resources through a 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 facing contagion, though under very restrictive eligibility requirements.

The major controversies relate to inadequate funding, conditions for access and credit terms. With respect to the first point, bilateral financing and contributions to the IMF will continue to be scarce during crises. This is a crucial issue, as the stabilizing effects of rescue packages will be absent if the market deems that the intervening authorities (the IMF plus additional bilateral support) are unable or unwilling to supply funds in the quantities required. As bilateral financing and contributions to the IMF will continue to be scarce and unreliable in crises, the best solution is to allow additional issues of SDRs during episodes of world financial stress; these funds could be destroyed once financial conditions normalize.[15] This procedure would create an anti-cyclical

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[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).

[15] See United Nations Task Force (1999a).

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

The broad issues raised by conditionality will be discussed in Section V below. However, two issues must be emphasized here. First, it has been argued that contingency credit lines to deal with contagion should be automatic, based on whether countries fulfil certain *ex-ante* criteria, and should thus be detached from traditional conditionality. The window created recently for this purpose does not fully meet these criteria: although Article IV consultations were given an enhanced role in signaling access *ex-ante*, access still requires negotiations prior to approval by the Board (a special "activation" review) and an explicit standby agreement. Moreover, countries with current access to IMF financing were not considered eligible; 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 harder terms than those traditionally used in regular IMF financing for this window and in 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".

Debt standstills and orderly workouts procedures are an essential mechanism to avoid the coordination problems implicit in chaotic capital flight, to guarantee an appropriate sharing of adjustments by private lenders and, thus, to avoid "moral hazard" issues associated with emergency financing. Due to the effects that the use of this mechanism could have on their credit standing, borrowing countries are unlikely to abuse it. Nonetheless, to avoid "moral hazard" issues on the side of borrowers, it must be subject to international control, 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 were experienced; such rules have sometimes been incorporated into debt renegotiation agreements.

The active use of these mechanisms has four implications. Firstly, to avoid both free riding and discrimination against countries or group of countries that adopt them, they require the *universal* adoption of "collective action clauses" in international lending. The G-7 countries should actually lead the process, as they suggested in October 1998, for otherwise it may become an additional source of discrimination against "emerging markets".[17] Secondly, "bailing in" should be encouraged by giving seniority to lending that is extended to countries during the period in which the standstill is in effect and during a later phase of "normalization" of capital flows. 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 —the most troublesome features of debt reschedulings in recent years— aside from the portion that is written off (or refinanced in highly concessional terms), the service of another portion should be subject to the fulfilment of certain contingent macroeconomic conditions that determine debt service capacity (e.g., terms of trade, normalization of lending, domestic economic activity, etc.).

The most problematic of all rescheduling processes in recent decades have been those associated with highly indebted poor countries (HIPC). The HIPC Initiative has been slow in its operation due to the complexity of the process required to determine eligibility (and, obviously, the conditionality attached to it), the inadequate definition of debt sustainability levels, and the lack of

[16] UNCTAD (1998), Part I, Chapter IV; United Nations Task Force (1999a).
[17] Group of Seven (1998).

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 become effectively available. In particular, in an environment of scarcity of ODA funds, it is essential that the funds allocated to HIPC 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 highly indebted poor countries. Moreover, the lack of adequate funding has generated an additional demand on 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 implies, paradoxically, that other debtor developing countries will pay part of the 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 trust funds do not adequately finance the costs of debt relief.

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

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18 United Nations Task Force (1999b).
19 Group of Seven (1999).

IV. Development finance

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

Equally important, however, is the acceleration of the growth of multilateral lending, which, at least in the case of IBRD-IDA, has experienced a slowdown in the 1990s as a whole. Moreover, due to

the high concentration of private flows in a few “emerging” economies, multilateral lending will continue to play an essential role even with respect to middle-income nations. More broadly, multilateral lending will continue to play a central role in at least four areas: (1) to channel funds to low-income countries; (2) to provide long-term financing to middle-income and small countries which, due to the lack of a sufficiently high credit rating or to the fixed costs involved (e.g., in bond financing), do not have adequate access to private funds; (3) to act as a counter-cyclical balance to fluctuations in private capital market financing; and (4) to facilitate the transition to new forms of private financing. To these we should add the traditional “value added” of multilateral financing: lending-associated technical assistance.

The first of these functions underscores the central role that financing from IBRD-IDA and the regional and subregional development banks will continue to play in the immediate future. The second and third functions emphasize the role that official development financing will continue to play even for middle-income countries. It must be stressed, however, that the anti-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. In any case, the large-scale requirements for counter-cyclical financing to middle-income countries during crises may crowd out financing to poor countries, a point which has been made by the President of the World Bank.[20] Thus, if multilateral development financing is not significantly expanded, its role as a counter-cyclical device will necessarily be very limited, and it should 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. Thus, a useful counter-cyclical function would 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 (particularly poor) countries seeking to position themselves in private capital markets. Cofinancing or guarantee schemes could be used for that 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, as, under current practices, guarantees are treated as if they were equivalent to lending, a fact which severely restricts the banks’ ability to extend them. Such an expansion of the role of development banks in guaranteeing private financing has been criticized on the grounds that it could involve excessive risk-taking by these institutions. Nonetheless, in a world that will probably be dominated by private financing, it may be absolutely essential to prevent low-income countries from being left out of major developments in capital markets. It should thus receive priority attention in current discussions.

In recent debates, a correct 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 in managing the social repercussions of financial vulnerability in the developing world. The concept itself is subject to some confusion, 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 a stable mechanism of social protection. Multilateral banks have been involved in the former for a long time and have also accumulated some experience with the latter. However, the preferred mechanism since the late 1980s has been

[20] Wolfensohn (1998).

social emergency funds (later transformed in many countries into more stable social investment funds). Although they have introduced some innovations in social policy (e.g., competitive mechanisms to allocate resources and civil-society participation in social policies), their effects have been rather limited, their targeting has not always been effective and they may have crowded out resources from long-term social policies.[21] Other instruments have also been used in the past by developing countries, including some types of unemployment insurance (the major instrument of its kind in the 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 to households with school-age children that are tied to school attendance, and various support programmes aimed at ensuring that households with an unemployed head of household do not lose their home during crises.

Recent analyses have come to some basic conclusions about these programmes. Firstly, safety nets must be part of *permanent* social protection schemes, as only a permanent scheme guarantees that the programme coverage will respond without lags to the demand for protection of vulnerable sectors during crises.[22] This implies, in turn, that financing must be fundamentally of a domestic character, with external financing contributing 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, it must be said, leads to a fourth conclusion: that the effective functioning of social safety nets requires that public-sector expenditure should include anti-cyclical components. This would be impossible —without generating inefficiencies in the rest of public-sector expenditure— 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 anti-cyclical fiscal pattern, external financing from development banks during crises will be unnecessary or, at best, illusory, as overall net fiscal financing requirements will actually decrease despite the increased spending associated with social safety nets.

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[21] See, in particular, Cornia (1999). See also ECLAC (1998b), Chapter 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).

V. Conditionality vs. "ownership"

The most controversial issue behind international emergency and development financing is certainly conditionality. In the case of the IMF, this issue has long been a central area of contention. However, in recent years —and even decades— the issue has become increasingly troublesome for three different reasons. Firstly, the scope of conditionality has been gradually expanded to include not only the realms of other international organizations —quite often, for example, that of the WTO and the development banks— but also of domestic economic and social development strategies and institutions which, as the United Nations Task Force has indicated, "by their very nature should be decided by legitimate national authorities, based on broad social consensus".[24] Secondly, whereas the legitimacy of conditionality is indisputable when domestic policies are the source of macroeconomic disequilibria that lead to financial difficulties, as well as being necessary to avert "moral hazard" issues, it is unclear how this principle applies when such difficulties are generated by international crises and, particularly, by contagion effects. As is pointed out, it is even less clear why conditionality should be mixed in this case with adverse credit terms. Finally, many observers have criticized overkill in some IMF programmes, a fact which has led the Fund to allow some room for anti-cyclical fiscal policies in its adjustment programmes, as indicated earlier.

Even if the legitimacy of the principle of conditionality —or, as it is sometimes stated, "support in exchange for reforms"—is accepted, there is reason to review the characteristics of such conditionality.

[24] United Nations Task Force (1999a), Section 5. See also Feldstein (1998) and Rodrik (1999b).

Indeed, the perception that conditionality has been carried beyond what may actually be necessary in order for the Fund to perform its functions properly may be helping to undermine its legitimacy. Thus, a strong argument can be made that the way to restore full confidence in the principle of conditionality is by reaching a renewed international agreement on how it should be used.

Several principles can be advanced in this regard. Firstly, 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 above and beyond some automatic level of low-conditionality facilities, if the source of the imbalance is an international shock. Reforms of domestic prudential regulation and supervision may also be required, but in this case parallel agreements should be made with the corresponding international authorities (a still controversial issue, as we have seen). Secondly, low-conditionality facilities should be available in adequate quantities when the source of the imbalance is an international shock. This principle should be fully recognized in the new contingency credit line available to countries facing contagion. Thirdly, as we have also noted, more stringent credit terms should not be used as a complement to conditionality. Fourthly, automatic rules should be agreed upon when signing an agreement with the Fund under which the restrictiveness of the adjustment 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 is done in the World Bank) or by outside analysts, should be introduced and the major conclusions of these evaluations, following their review by the Board, should be explicitly incorporated into regular Fund practices.

It must be emphasized that similar issues have been raised in relation to development finance. With respect to this issue, a recent World Bank report which analyses the success of structural lending, according to its own evaluation, comes to the conclusion that conditionality does not influence the success or failure of such programmes at all.[25] Nonetheless, according to the same report, aid effectiveness is not independent of the economic policies that countries follow. In particular, the growth effects of aid are higher for countries that adopt "good" policies, which, according to their (certainly debatable) definition, include stable macroeconomic environments, open trade regimes, adequate protection of property rights and efficient public bureaucracies that can deliver good-quality social services. In the context of good policies, there is an additional positive effect of aid that is manifested through the "crowding in" of private financing. Neither of these effects are present, however, in countries following "wrong" policies. In terms that are now familiar in the aid literature, the *ownership* of adequate economic policies, i.e., the commitment of national authorities to them, is what really matters. Conditionality has *no* additional contribution to make in these cases, and it is obviously ineffective in the case of countries that do not follow good policies.

Curiously enough, on the basis of this study the World Bank draws the conclusion that conditionality is good after all. Hence, it claims that "Conditional lending is worthwhile where reforms have serious domestic support"[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]

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[25] See World Bank (1998b), Chapter 2 and Appendix 2.
[26] Ibid., p. 48.
[27] Ibid., p. 19.
[28] See a full discussion of these issues in Helleiner (1999b).

A recent analysis by Rodrik has come 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 study makes a strong argument that adequate institutions of conflict management, which can only be guaranteed by national democratic processes, are crucial for macroeconomic stability and that this, in turn, is vital for economic growth. To borrow the term, the “ownership” of adjustment programmes is also essential to guarantee their political sustainability.

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

[29] Rodrik (1999a).

VI. 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 trade and direct investment flows are, indeed, striking features of the ongoing globalization process. This factor increases macroeconomic linkages and thus the demands for certain services provided by the international financial system which we have analysed in previous sections: macroeconomic surveillance and internalization of the externalities that national macroeconomic policies have on neighbouring countries, mutual surveillance of each other's mechanisms for the prudential regulation and supervision of the financial system, and regional effects of potential debt standstills and workout procedures.

Secondly, some of these services may be subject to diseconomies of scale and it is unclear whether others have strong scale economies to justify single international institutions in specific areas (i.e., natural monopolies). Traditional issues of subsidiarity are thus raised. For example, macroeconomic consultation and surveillance at the world level may be necessary to guarantee policy coherence among major industrialized countries, but it would certainly be inefficient to manage the externalities generated by macroeconomic policies on neighbours in the developing world (or even within Europe). Due to differences in legal traditions and the sheer scale of the diseconomies involved, surveillance of national systems for the prudential regulation and supervision of financial sectors, and even the definition of specific minimum standards in this area, may be dealt

with more appropriately with the support of regional institutions. Development finance can operate effectively at different scales and, as we will see, can perform certain functions at regional and subregional levels that could not be performed at the international level. Also, although regional and international contagion implies that the management of the largest balance of payments crises should be assigned to a single world institution, it is unclear how far we should push this assertion. Strong regional institutions can serve as regional buffers; as the post-war Western European experience indicates. Regional reserve funds can also play a useful role in the developing world and, if expanded, could even provide full support to the small and medium-size countries within some regions. Also, as the rising concentration of balance of payments support in a few countries indicates (see Section I), there may be biases in the response of the international community according to the size of the country, a fact which would argue for a division of labour in the provision of services in this area between world and regional organizations.

The third argument was already put forward in Section II: for smaller countries, the access to a broader menu of alternatives to manage a crisis or to finance development is relatively more important than the "global public goods" that the largest international organizations provide (e.g., global macroeconomic stability) and upon which they will assume they have little or no influence (i.e., they have the attitude of "free riders"). Due to their small size, their negotiation power vis-à-vis large organizations would be very limited, and their most important defense is therefore competition in the provision of financial services from such institutions to them.

There may be a fourth, political economy argument: countries are likely to take quite different attitudes to the analyses made by international and regional organizations (and in the attached conditionality). In terms of the previous section, they are probably more likely to "own" 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 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 developing countries to provide the capital for the corresponding reserve funds and development banks, a fact that will lead the countries to closely monitor the soundness of their activities. Indeed, the supply of capital will be the single most important restriction to the growth of these regional financial networks. The fact that many of these institutions will raise money in the market will provide an additional means of control over their operations.

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

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. To encourage the development of the latter, incentives could be created by which common reserve funds could have automatic access to IMF financing and/or a share in the allocation of SDRs proportional to their paid-in resources —in other words, contributions to common reserve

funds would be treated as equivalent to IMF quotas.[30] As noted, regional reserve funds could provide most of the exceptional financing for smaller countries within a region, but also part of the financing for larger countries, and they could also serve to deter, at least partly, would-be speculators from attacking the currencies of individual countries.

This model should be extended to the provision of macroeconomic consultation and surveillance, as well as to coordination and surveillance of national systems of prudential regulation and supervision. Thus, regional and subregional systems, including peer review mechanisms, should be designed to internalize the externalities that macroeconomic policies generate on neighbours. This would complement, rather than substitute for, regular IMF surveillance. In the area of prudential regulation and supervision, more elaborate systems of regional information and consultation, including the design of specific regional "minimum standards", can also play a positive role. Again, peer reviews 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 IV, subregional development banks can play a significant role as a mechanism to pool the risks of groups of developing countries, thus allowing them to make a more aggressive use of opportunities provided by private capital markets. 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 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. The Andean Development Bank 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. 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.

An institutional framework such as that suggested would have two positive features. First of all, it may help to bring more stability to the world economy by providing essential services that can hardly be provided by a few international institutions, particularly in the face of a dynamic process of open regionalism. Secondly, from the point of view of the equilibrium of world relations, it

[30] United Nations Task Force (1999a), Section 9; Ocampo (1999a).

would be more balanced than a system based on a few world organizations. This would increase the commitment of less powerful players to abide by rules that contribute to world and regional stability.

VII. The realms of national autonomy

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

The experience of developing countries indicates that the management of capital account volatility requires: (1) consistent and flexible macroeconomic management; (2) strong prudential regulation and supervision of domestic financial systems; and (3) equally strong "liability policies", aimed at inducing good public and private external and domestic debt profiles. [31] Despite the traditional emphasis on crisis management, the focus of the authorities should instead be the management of *booms*, since it is in the periods of euphoria of capital inflows, trade expansion and terms-of-trade improvements that crises are incubated. Crisis prevention is thus, essentially, an issue of the adequate management of boom periods.

[31] The literature on national policies is extensive. See, among recent contributions, ECLAC (1998a, 1998c); World Bank (1998a), Chapter 3; Ffrench-Davis (1999); Helleiner (1997); and Ocampo (1999b).

The nature of the policies to be used will certainly 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 major objectives should be to avoid the accumulation of unsustainable levels of indebtedness by either public or private agents during booms and to avoid disequilibria 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, which gives the authorities enough degrees of 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 restraints in terms of the adoption of 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 it may be self-defeating in the absence of adequate restraint on capital inflows due to interest 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 for 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 to absorb the increased supply of foreign exchange, an excessive revaluation may also generate irreversible "Dutch disease" effects. The regulation of capital *inflows* thus plays an essential role in open developing economies as a mechanism for monetary and domestic credit restraint and for the avoidance of unsustainable exchange rate appreciation during booms. The macroeconomic effects of the regulation of inflows have, unfortunately, received much less attention in the past than the issue of the regulation of outflows during crises. The nature of such regulations will be considered below. Regulations governing outflows may, nonetheless, also play a role as a way to avoid overshooting interest or exchange rates, which may have adverse macroeconomic dynamics, including the greater risk of domestic financial crises, and are essential to put in place 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 III, prudential regulation and supervision must take into account not only the micro- but also the macroeconomic risks typical of developing countries. In particular, due account should be taken of the links between domestic financial risk and changes in key macroeconomic policy instruments, notably exchange and interest rates. The risks associated with the rapid growth of domestic credit, currency mismatches between assets and liabilities, the accumulation of short-term liabilities in foreign currencies by financial intermediaries and the valuation of fixed assets used as collateral during episodes of asset inflation must also be adequately taken into account. Depending on the operation, higher capital adequacy requirements, matching liquidity requirements or caps on the valuation of assets should be established. Moreover, given these macroeconomic links, prudential regulations should be strengthened during years of financial euphoria to take into account the increasing risks being incurred by financial intermediaries. These links also imply that the application of contractionary monetary or credit policies during booms (e.g., higher reserve requirements or ceilings on the growth of domestic credit) may be highly complementary to stricter prudential regulation and supervision. Moreover, due to the important externalities which large non-financial firms could generate 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 that is that, under uncertainty, financial markets respond to gross —rather than only to net— financing requirements, or in other words, the rollover of short-term debts is not neutral in financial terms. This gives an essential role to "liability policies" aimed at improving debt profiles. Although improving the external debt profile should be the central role of such policies, there is a strong complementary relationship between good external and internal debt profiles. Hence, excessive short-term domestic borrowing may force a Government that is trying to rollover debt during a crisis to raise interest rates in order to avoid capital flight by investors in government bonds. Also, excessively high short-term private liabilities increase the risks perceived by foreign lenders during crises, a fact that may induce a stronger contraction of external lending.

In the case of the public sector, direct controls by the Ministry of Finance are an appropriate instrument of a liability policy. 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 inflows may also be an appropriate instrument to achieve a better private debt profile. An interesting, indirect price-based policy tool is reserve requirements on capital inflows, such as those used by Chile and Colombia in the 1990s. These requirements are a particular type of Tobin tax, but the equivalent tax rate (3% in the case of Chile for one-year loans and 10% or more in Colombia during the boom) is much higher than that proposed for an international Tobin tax. A flat tax has positive effects on the debt profile, as it induces longer-term borrowing, for which the tax can be spread over a longer time period, and is easier to administer. The effects of this system on the magnitude of flows have been the subject of a heated controversy. In any case, since tax avoidance is costly and short- and long-term borrowing are not perfect substitutes, the magnitude of flows should also be affected.[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: it affects both financial and non-financial agents, and it uses a non-discriminatory price instrument, whereas prudential regulations affect only financial intermediaries, are usually quantitative in nature and supervision is essentially discretionary in its operation.[33]

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

What the former analysis indicates is that capital account regulations may be an essential instrument for crisis prevention and management in the face of strong volatility of capital flows and

[32] Agosin (1998), Agosin and Ffrench-Davis (1999), and Ocampo and Tovar (1998, 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 J.P. Morgan (1998), p. 23.

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

There are actually no strong arguments in favour of moving towards capital account convertibility.[34] There is no evidence that capital mobility leads to an efficient smoothing of expenditures in developing countries through the business cycle and, on the contrary, strong evidence that in these countries the volatility of capital flows is an additional source of instability. There is also no evidence of an association between capital account liberalization and economic growth, and there are some indications that point in the opposite direction.[35] A simple way to pose the issue is to argue that, even if it were true that freer capital flows, through their effects on a more efficient savings-investment allocation process, have positive effects on growth, the additional volatility associated with freer capital markets has the opposite effect. As was already pointed out, the absence of an adequate international financial safety net is an equally important argument in this connection. Why should developing countries give up this degree of freedom if they do not have access to adequate amount of contingency financing with well-defined conditionality rules, and no internationally agreed standstills and debt workout procedures? In the case of our discussion in Section II, this is a crucial issue for countries without significant power in the international arena, for whom renouncing any possible means of crisis management is a costly alternative. Indeed, there are strong similarities between today's international financial world and the era of "free banking" at the national level: in the absence of central banks as lenders of last resort and officially managed bank rescue schemes, inconvertibility of private bank notes was a necessary legal alternative in the face of bank runs.

Similar arguments could be used to claim that there are no grounds for limiting the autonomy of developing countries to choose their exchange rate regime. There are certainly virtues to the argument that, in the current globalized world, only convertibility regimes or totally free-floating exchange rate regimes can generate sufficient credibility in the eyes of private agents. However, any international rules in this area would be unfortunate. The advantages and disadvantages of these extremes, as well as of interventionist regimes in between the two, have been subject to extensive historical debate (and, of course, experience). In practice, countries almost invariably choose intermediate regimes, a fact that can probably be traced back not only to the deficiencies of the extremes, but also to the many additional demands that authorities face. The choice of the exchange rate regime has, nonetheless, major implications for economic policy that must be recognized in macroeconomic surveillance. Also, as we have noticed, domestic prudential regulations must take into account the specific macroeconomic risks that financial intermediaries face under each particular regime.

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

[35] See, in particular, Eatwell (1996), Rodrik (1998) and, for Latin America, Ocampo (1999b).

VIII. Conclusions

This paper has argued that the agenda for international financial reform must be broadened in at least two senses. First of all, it should go beyond the issues of financial prevention and resolution, on which the recent debate has focused, to those associated with development finance for poor and small countries, to overcome the strong concentration of private and even official financing in a few large "emerging" economies, and to the "ownership" of economic and development policies by countries. Secondly, it should consider, in a systematic fashion, not only the role of world institutions but also of regional arrangements and the explicit definition of areas where national autonomy should be maintained. These issues should be tabled in a representative, balanced negotiation process, which should overcome 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 the current emphasis on the need to improve the institutional framework in which financial markets operate and the still insufficient attention to or action on the design of appropriate schemes to guarantee the coherence of macroeconomic policies worldwide, the enhanced provision of emergency financing during crises, and the creation of adequate debt standstill and orderly debt workout procedures. In the area of development finance, emphasis should be given to the need to increase funding to low-income countries, including the use of multilateral development finance to support increased participation of low-income and small middle-income countries in private capital markets. The role of

multilateral development banks in the financing of social safety nets during crises must also be emphasized. The enhanced provision of emergency and development financing should be accompanied by a renewed international agreement on the limits of conditionality and a full recognition of the central role of the "ownership" of development and macroeconomic policies by developing countries.

It has also been argued that regional and subregional institutions should play an essential role in increasing the supply of "global public goods" and other services in the area of international finance. The required financial architecture should in some cases have the nature of a network of institutions that provide the services required in a complementary fashion (in the areas of emergency financing, surveillance of macroeconomic policies, prudential regulation and supervision of domestic financial systems, etc.), and in others (particularly in development finance) should exhibit the characteristics of a system of competitive organizations. The fact that any new order would continue to have the characteristics of an incomplete "financial safety net" implies both that national policies would continue to play a disproportionate role in crisis prevention and that certain areas should continue to be realms of national autonomy (particularly capital account regulations and the choice of exchange rate regimes). Regional institutions and national autonomy are particularly important for the smaller players in the international arena, which will gain significantly from competition in the services provided to them and from the maintenance of freedom of action in a context of imperfect supply of global public goods.

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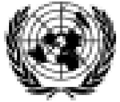

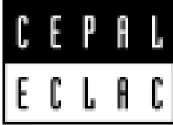

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