THE CONTEXT FOR CAPITAL ACCOUNT LIBERALISATION; WHERE GOES THE INTERNATIONAL FINANCIAL SYSTEM?

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I - Introduction

Developing countries continue to be urged to liberalise further their capital accounts. In some cases, such as the FTA negotiations of Singapore and Chile, significant pressure is exerted on developing countries to eliminate remaining, fairly modest and extremely effective capital controls. The pressure and/or persuasion exerted is applied to all developing countries, even those – like small, low income economies – where sustainable private flows are very unlikely to come.

This paper examines the context for capital account liberalisation, looking at potential risks and rewards (Stiglitz, 2002) as conditioned by the nature of the international financial system and of recent limited attempts to reform it.

For capital account liberalisation to be clearly beneficial for developing countries, three conditions would need to be met. Firstly, there would be sufficient private flows going to developing countries. Secondly, these capital flows would be long-term and thus, not easily reversible, to avoid developmentally and financially costly crises as have been so frequent in recent years. Thirdly, there would be strong enough international official mechanisms, both to assist in crisis prevention (such as sufficiently flexible and large contingent IMF credit lines) and for better crisis management (such as effective mechanisms or rules for orderly debt workouts), to make crises shorter and less costly, if unfortunately they do happen.

At the beginning and middle of the 1990's, the first condition seemed to be clearly met for a growing number of developing countries, with some hope that capital flows would increasingly spread to low-income countries (with Sub-Saharan Africa being called "the last frontier for emerging market investors"). The threat of crises and the need to prevent or manage them was a concern restricted to CEPAL and UNCTAD, as well as academics, considered by the mainstream as too pessimistic (for example, French-Davis and Griffith-Jones, 1995).

In the early 21st century, the situation has changed very drastically. Firstly, and very importantly, capital flows going to all categories of developing countries have fallen very sharply since the Asian crisis, with net flows to emerging markets becoming zero or even slightly negative in the last two years. There are important indications that at least in part (and possibly a significant part), this sharp decline is due to structural changes, which will not change easily, such as the fact that banks have crossed the border and will substitute foreign for domestic lending, and that there are not many "sufficiently large" companies left for equity investors to buy in developing countries (Griffith-Jones, 2002). To the extent that these flows are determined by cyclical factors, an important question is - how long is the relevant cycle?[1] Indeed, the sharp decline of capital flows to developing countries has already lasted for five years; in the case of Latin America, it is a major factor explaining "half a lost decade" of growth as GDP per capita in 2002 was lower than in 1998 (Ocampo, 2003).

As a result of sharp falls in net private flows, the potential rewards for developing countries of liberalising their capital account have shrunk drastically.

Secondly, the structure of capital flows has improved, in the sense that FDI has become the main source of net capital flows. FDI seems a more desirable type of flow, in that it tends to be more long-term and less easily reversible, as well as often incorporating new technology and other know-how. Nevertheless, three important caveats have to be made about the new structure of flows. A first caveat is that it is clearly not necessary for countries to fully liberalise their capital account, to attract significant FDI; indeed, countries as varied as China and Chile have attracted significant levels of FDI, with either quite restricted capital accounts (China) or specific measures to discourage short-term flows (Chile). Secondly, though the primary FDI flow is fairly stable and long term, there are other flows or transactions linked to FDI, which can imply that the net impact on countries' Balance of Payments and exchange rates of increased FDI is not as stable as normally thought. For example, foreign direct investors, in companies producing for the local market, may hedge their liability exposure in foreign currency in ways that can generate outflows and pressures on the exchange rate, precisely in difficult times (Moguillansky, 2002). They may also increase profit remittances, and/or decrease their external debt, to protect themselves from large currency depreciations, thus exacerbating pressure on the exchange rate.

A third caveat is that non-FDI capital flows to emerging markets (such as debt, portfolio equity) have not only become sharply negative, but seem to be becoming increasingly volatile, short-termist and pro-cyclical; this is due to increased use of marking to market, often on a daily basis, the adoption of similar risk models within and across different categories of lenders and investors (Persaud, 2002), increased

[1] I thank Jose Antonio Ocampo for this important point.

use of derivatives (Dodd, 2002) and other institutional factors (Griffith-Jones, op cit.). On balance therefore, the change in the structure of flows has both very positive (increasing role of FDI) but also problematic elements.

Thirdly, there has been progress on international financial architecture, to help prevent crises and manage them better; however, this progress has been insufficient and in some aspects there have even been reversals (Griffith-Jones and Ocampo, 2003). For example, as discussed below, though a Contingency Credit Line was created by the IMF to help prevention or deepening of crises, it remains unused.

Recent experiences with IMF lending offers a mixed balance; the IMF clearly made a number of mistakes in the handling of Argentina's problems. In particular, the suspension of IMF lending in December 2001 triggered, though obviously did not cause, the crisis; the unwillingness of the IMF during a long period to agree a new loan clearly significantly deepened the crisis (though other factors were obviously important). A key problem was that while for Argentina, the international community abandoned its' strategy of large IMF packages for crisis countries, it did not offer an alternative one, such as a mechanism for orderly debt work-out. On the other hand, IMF lending to Brazil in mid 2002, had a number of positive features, including its' large scale, the fact that its conditionality was not too onerous, and its backloading, so that most of the funds could be lent to the new government; it therefore contributed to stabilise market sentiment, in election time and hopefully to avoid a costly crisis in Brazil.

Fourthly, progress has been (with some honourable exceptions), particularly insufficient on measures to encourage sufficient and sufficiently sustainable private non-FDI flows, through actions to be taken by source countries or multilateral organisations. Measures, such as expanding and improving official guarantees (for trade finance and infrastructure), channelling a part of socially responsible investment assets to developing countries, and others, have not been taken on a meaningful scale, or even significantly discussed. In certain conservative circles, the very sharp fall of new non-FDI flows to developing countries is welcome, in spite of the fact that this fall, combined with high levels of debt stocks, has implied such large negative net flows, with negative impact on growth, for important parts of the developing world.

In what follows, this paper will first (section II) briefly outline major changes and trends in private capital flows going to developing countries since 1997, and especially since 2000. Secondly, (section III), the paper will synthesise and analyse recent reforms in the international financial system, especially those that most affect costs and benefits of capital account liberalisation. This will include both measures for encouraging flows, as well as to prevent and better manage crises. Less emphasis will be placed here on better crisis management, which will be explored in the Bhattacharya and Lim papers in this volume. Section IV will conclude.

II - Major changes in private capital flows since 1997

As briefly indicated above, capital flows to developing countries have suffered major changes, both in their level and structure, since the Asian crisis.

Firstly, there has been a very sharp decline of net capital flows to emerging market economies; according to IMF data, these had peaked in 1996 to almost $240 billion, halved to less than US $120 billion in 1997, and continued to fall to less than $10 billion in 2000, and continued at very low, though somewhat higher levels until 2002. Indeed in 2002, net private flows to developing countries, according to the IMF (2003), reached US $86 billion; however, if FDI was excluded, they were US-$132 billion. As the 2003 World Bank <u>Global Development Finance</u> clearly puts it, emerging economies had practically become "net exporters of capital to the developed world".

Whilst the initial decline of capital flows to emerging economies since 1997 was naturally focused initially mainly on East Asian economies, more recently flows to Latin America have declined particularly sharply. As a result, according to IADB data, net private capital flows to Latin America fell from around 5% of GDP in 1996 to around 0% of GDP in 2002. Indeed, according to ECLAC, negative net transfers at -$39 billion from Latin America in 2002 were the highest in nominal terms since statistics are available, more negative even than in the worst years of the 1980's debt crisis (as a % of the GDP they are somewhat lower).

At the time of writing (mid 2003), there was some recovery of private flows to emerging economies, especially bond flows. However, it was premature to see if these flows were sustainable.

It is important to note that private flows to low-income countries (which were never very high) have also fallen since the Asian crisis, but less sharply than flows to emerging markets (Griffith-Jones and Leape, 2002). Two comments seem relevant. Firstly, the fact that low-income countries did not experience such large surges of private flows as emerging markets, made them less vulnerable to costly sudden stops or sudden reversals. Secondly, if attracting private flows to low-income countries is an important policy objective, (for example to complement low levels of saving, particularly in Sub-Saharan Africa), then it seems the decline in private flows to emerging markets will act as a strong inhibitor to such flows to low-income countries, especially in SSA. For example, some portfolio equity investors in the mid-1990s seemed to see SSA as "the last frontier" of emerging markets; however, when risk aversion increased and more specifically appetite for investing in emerging markets fell, due to for example frequent crises in them, these investors dismissed any possibility of investing in low-income countries, even though those had not had similar crises.

As discussed briefly in the Introduction, there has also been an important change in the structure of private flows to developing countries, with a rotation from debt to equity. This shift has positive features in that FDI flows are more stable and less prone to reversals. However, the fact that an increasing proportion of FDI has recently gone into sectors such as public utilities, where sales are in local currency, makes multinational companies hedge their liability exposures, especially in times when fears of large depreciation emerge, thus putting pressure on the exchange rate in difficult times, that is in a pro-cyclical manner.

One statistical and two policy questions arise. Should FDI in companies producing mainly for home markets be registered separately from FDI for export, for policy analysis purposes? Should policy-makers in developing countries consider it as potentially having more volatile effects than FDI for exports? Could and should measures be taken to affect the level and timing of hedging by FDI for producing in the home market? If not feasible or difficult, a possible option could be that developing country governments require multinational companies investing for domestic sales to hedge their exposure at the time of entry. This seems an attractive option, even though it may pose costs for the multinational company and could be difficult to monitor. For the latter, an important requirement is for economic authorities to have the necessary data. Should developing countries consider the possibility of discouraging such FDI for sales in local currency? Here the costs of potential volatility would need to be compared with the benefits of increased efficiency and additional investment, that such FDI in public utilities brings, as well as the indirect potential benefits of the country being seen to have a favourable climate to FDI in general, which restricting certain types of FDI could possibly undermine.

The decline in non-FDI flows has been dominated by a sharp fall in external debt stocks, mainly caused by high net negative bank lending since 1997. As Hawkins (2002) puts it, in bank lending, “water is flowing upwards”. Part of this decline reportedly responds to a voluntary reduction by borrowers of short term bank debt, as several countries have, in response to recent crises, adopted guidelines to reduce such debt; this voluntary decline of short term debt is positive, in reducing countries vulnerability to crises. However, there is also an involuntary decline of foreign currency debt stocks. This is linked to international banks “crossing the border” and purchasing subsidiaries or establishing banks, from which they lend in local currency, lending which they fund with local deposits.

Indeed, bankers interviewed argue that there is a large redistribution of banks’ overall emerging market portfolios, in which banks have substituted onshore for cross-border lending. From the perspective of developing countries, this may have some advantages, e.g. of possibly stronger and more efficient banks, as well as smaller vulnerability to crisis (however, the latter point seems more doubtful after the Argentinean crisis). Foreign bank ownership also has large costs and other disadvantages. The cost, which can be very significant, is a smaller capital inflow to the developing country (with a one-off purchase via FDI of bank replacing a far larger stream of international bank lending).

Though excessive foreign currency denominated bank lending, especially short-term, both in the late seventies and in the early nineties was clearly undesirable, insufficient (and especially negative), bank lending to developing countries since 1997 is also highly problematic, as it poses a constraint on investment and growth of developing countries. Especially problematic has been the sharp decline in bank trade credit, which accompanied the crises in Argentina and Indonesia; even Brazil, though it avoided a crisis, saw a significant drying up of trade credit during the panic of 2002. This is particularly negative, as it inhibits the only positive impact of very large depreciations that typically accompany crises – on expansion of exports, expansion that is so important for post-crisis recovery. This is a relatively new phenomenon as lines of credit were mostly maintained during the 1980’s debt crisis.

Two important policy issues arise in this context. The first relates to the criteria for determining desirable levels of private flows to developing economies, and specifically to emerging markets. In particular, what levels of external debt (in relation to exports, foreign exchange reserves, and GDP) are desirable, that are sufficient to help sustain growth, but not excessive to avoid countries entering zones of vulnerability? The latter is particularly difficult to determine, as debt/GDP or debt/X ratios are often endogenously determined, by the risk premium (and their cumulative effect), as well as by the level of the exchange rate, both of which are so heavily influenced by financial market perceptions (for a very clear illustration of this for Brazil, see Williamson 2002). This problem makes it difficult to estimate the exact future evolution of these simple debt ratios, and therefore whether a country will have a level of debt considered to be sustainable.

Supposing a desirable level of different levels of private flows has been estimated, is it feasible to design policy measures in source and recipient countries to encourage flows that are sufficient and sufficiently stable in times of drought and to discourage excessive flows in times of surges? Which of these measures are more likely to be effective and cost effective? Which are more likely to be implemented? Can measures as the new proposed Basle Capital Accord, be modified in ways to avoid it further discouraging bank lending to developing countries, and especially non-investment grade ones, which includes the majority of developing economies? These are some of the key questions which developing countries would need an answer to, before they commit to further capital account liberalisation.

III – Recent reforms in the international financial system

For capital account liberalisation to be clearly beneficial for developing countries, so as to contribute to their growth and development prospects, it is necessary that an international financial and development architecture exists that a) helps prevent currency and banking crises and better manages them when they occur and b) supports the provision of sufficient net private and public flows to developing countries. As in Griffith-Jones and Ocampo, 2003 op.cit, we will evaluate progress on international reform, in relation to these goals. In this sense this paper is broader than most of the literature and the policy discussion on the subject, that rightly focuses on international and national financial stability, but tends to neglect the equally important aim of providing sufficient and sufficiently stable flows, both private and public.

In this section, we will first provide a broad overview of progress so far, stressing most recent developments. Then we will examine in more depth measures relating more to crises prevention.

a) Progress Overview

Over five years after the Asian crisis, some progress has been made, but it is clearly insufficient. The mechanisms that existed previously and the adaptations made in recent years clearly do not fully meet the needs of stability and sufficient flows.

The extensive debates in recent years and parallels with mechanisms existing at the national level, indicate that the international financial architecture must provide five different services: a) guarantee the consistency of national macroeconomic policies, with stability of global economic growth as the central objective; b) appropriate transparency and regulation of international financial loan and capital markets, as well as adequate mechanisms to encourage private flows during periods of drought; c) provision of sufficient international official liquidity during crises; d) accepted mechanisms for standstill and orderly debt workouts at the international level; and e) appropriate levels and instruments of development finance.

Progress so far has suffered four serious problems.

Firstly, there has been no agreed international reform agenda. Furthermore, the process has responded to priorities set by a few industrialised countries whose main objectives are not always to enhance development. The “Monterrey Consensus” of the International Conference on Financing for Development of the United Nations, held in March 2002 (see United Nations, 2002), provided, for the first time, an agreed comprehensive and balanced international agenda, that should be used to guide and evaluate reform efforts.

Secondly, progress made has been uneven and asymmetrical in several key aspects. The focus of reforms has been largely on strengthening macroeconomic policies and financial regulation in developing countries --i.e., on the *national* component of the architecture--, while far less progress has been made on the international and, particularly, the regional components. Indeed, there has actually been general disregard and, in some cases, open opposition to the regional dimension. These are major weaknesses, as crises have not just been caused by country problems (even though these have been obviously important) but also by imperfections in international capital markets, such as herding, that lead to rapid surges and reversals of massive private flows, and multiple equilibria, that may lead countries into self-fulfilling or deeper crises.

Another set of asymmetries related to the excessive focus of the reform effort on crisis prevention and management, mainly for middle-income countries. Important as this is, it led to neglect the equally --if not more important-- issues of appropriate liquidity and development finance, for low-income countries. Moreover, the problem of availability of development finance, especially but not only for low-income countries, has clearly moved to centre stage for all developing economies.

In this sense, it is encouraging that a new initiative has emerged, the UK proposal to create an International Financing Facility. As detailed below, this Facility would bring forward aid spending, which could ideally increase by up to $50 billion for a period up to 2015, to help meet the Millenium Development Goals, but would imply a reduction in aid flows after 2015. This is a positive initiative in the medium term, though clearly inferior to one that increased aid flows in a sustained way for a longer period; furthermore, it is yet unclear what international support it will receive.

Although some of the reforms adopted may be crucial in the future to help prevent a new wave of crises, at present, and possibly for several years, the problem is the opposite, of insufficient private flows to middle income countries. Therefore, an important task seems to be to design measures, which will both encourage higher levels of private flows (especially long-term ones), especially for middle income countries and will provide counter-cyclical official flows (both for liquidity and for development finance purposes) during the periods when private flows are insufficient.

Within the realm of crisis prevention, progress has also been uneven. Much work has been done in relation to strengthening domestic financial systems in developing countries and in drafting international codes and standards for macroeconomic and financial regulation. The review of the Basel accord on international banking regulation has also concentrated much effort, but as discussed below, many of the main concerns and possible negative impacts on developing countries have not been fully, or at all, addressed. Aside from enhanced macroeconomic surveillance of developing country policies and a few *ad hoc* episodes of macroeconomic coordination among industrialised countries, few steps have been taken to guarantee a more coherent macroeconomic policy approach at the global level. In the area of IMF financial facilities, frustration has been the characteristic of the design of the new facility to manage contagion, the Contingency Credit Line (CCL). Indeed, if it remains unused by the autumn of 2003, the CCL will be suspended. Some advance has been made in redefining IMF conditionality. The IMF quota increase and the extension of the arrangements to borrow, which became effective in 1999, has also been an advance, but several proposals made on the more active use of Special Drawing Rights (SDRs) as a mechanism of IMF financing have not led to action.

Furthermore, the IMF has been reviewing its access policy in the context of capital account crises, to "establish a stronger framework for crises resolution", which defines criteria that could pose constraints on exceptional access, and risks slowing down the granting of such loans (see IMF, March 2003, and below). It is as yet impossible to evaluate the impact of this review on future access, it is encouraging that no formal limits were put in place, even though it was discussed in the Fund Board. It is however a source of concern that IMF access limits could be reduced, especially if this allowed liquidity problems to deteriorate into solvency problems, given that proposals for the SDRM – or other comprehensive orderly debt work-out mechanisms – have been shelved (at least for the time being). Furthermore, any limit of extraordinary access as a proportion of quotas, whilst IMF quotas remain clearly insufficient to deal with the new type of crises, would be highly problematic.

Thirdly, some of these advances in the international financial architecture run the risk of reversal. There has been reluctance by developed countries to support large IMF lending (or to contribute bilateral short-term lending) to manage crises better. The main arguments given have been that these large packages lead to excessive moral hazard, and that taxpayer money from industrialised countries should not, in any case, be risked in these operations. These arguments have been vastly overstated, but have been quite influential in some recent international actions, especially in the case of Argentina, as discussed above.

Fourthly, as discussed in detail in Griffith-Jones and Ocampo, op.cit, the reform process has been characterised by an insufficient participation of developing countries in key institutions and fora. As regards the international financial institutions (especially the IMF, World Bank and BIS) more balanced representation needs to be discussed in parallel with a redefinition of their functions. It is also urgent that developing countries be represented in the Financial Stability Forum, and in standard-setting bodies, like the Basel Banking Committee, as they will be asked to implement the standards there defined, and as they are deeply affected by the actions of international banks, whose behaviour is influenced by these standards.

b) Measures for crisis prevention and for encouraging flows

Codes and Standards

As regards crisis prevention, the area where most emphasis has been placed and much activity undertaken is the development and implementation of codes and standards for macroeconomic policy and financial sector regulation in developing countries. Clearly their aims are worthy, and desirable, such as strengthening domestic financial systems. One important concern is whether implementing existing codes and standards would always be meaningful in helping to prevent crises. Indeed, it could be argued that the design of standards to be implemented by developing countries or that which will affect developing countries should more explicitly incorporate criteria for crisis prevention in developing countries. The introduction of explicit elements of counter-cyclicality into banking (and possibly other financial) regulation seems particularly relevant in this context, (see Ocampo and Chiappe, 2003; BIS 2001); this is both because financial actors seem particularly pro-cyclical in their behaviour within and towards developing economies, and because this pro-cyclicality can be particularly damaging to these more fragile economies, with fairly thin financial markets.

A concrete example of such a measure could be the introduction of obligatory forward looking provisions, along the model applied by the Central Bank of Spain. This approach estimates risk based upon past experience (to cover at least one business cycle), and creates a mechanism that provisions increase during economic expansion, provisions that are drawn down during slow downs and recessions (Ocampo and Chiappe, op. cit., Poveda 2001). Such a cycle neutral approach could be complemented by explicitly counter-cyclical mandatory provisions on rapidly increased bank lending, for example to sectors characterised by cyclical risk (such as building and real estate), or the growth of foreign currency denominated loans to non-tradable sectors (as suggested in Ocampo and Chiappe, op. cit.); the former point is suggested in the proposed new Basle Capital Accord,[2] but only on a voluntary basis. Though possibly introducing some additional elements of complexity into financial regulation, such measures could help smooth the link between pro-cyclical behaviour of financial actors and excessive macro-economic cyclicality.

More generally, the introduction of counter-cyclical or cycle neutral elements into financial regulation (both domestic and international) could create counter-vailing forces to dampen the natural tendency of financial markets to pro-cyclicality and short-termism, tendency that has been accentuated in recent times. An important area could be for regulators to have as a key objective to encourage diversity of risk-management models, that match diversity of investment objectives, as well as characteristics of lenders and investors. Regulators also should take account (and attempt to compensate for) the complex and problematic interactions between risks that pro-cyclical and herding behaviour in different actors generate. For example, a downgrade by a rating agency of a sovereign can cause investors to sell bonds immediately; simultaneously domestic counter-parties of derivatives may have to meet margin calls (Dodd, 2002) and banks may stop lending.

The tasks of attempting to carry out counter-cyclical and integrated regulation seem to be the way ahead, both within developing countries and for regulation of international actors lending and investing in developing countries. However, some aspects are technically difficult to implement. For example, the distinction between cyclical and long-term trends is sometimes very hard (Goodhart, 2002). Whilst wishing to slow down booms, regulators should not curb increases in sustained growth; this is sometimes difficult to distinguish in practice. A second problem is that most regulators do not normally regulate in a counter-cyclical manner and that such practice needs to become established. Thirdly, there will be political economy pressures, to avoid tightening of regulation in boom times. For such regulation to be effective, rules should not be changed easily, and without a clear economic justification. In spite of problems and difficulties, more integrated and counter-cyclical regulation, if effective, would seem to offer large potential gains in curbing damaging boom-bust patterns.

[2] I thank Gunther Held for this point.

Basle 2

The major regulatory change being introduced since the Asian crisis is the proposed Basle Capital Accord. Though implying improvements in some areas, the new Basle Capital Accord, however, is not being introduced to deal with the two problems affecting developing countries in terms of international bank lending going to them, which are their boom-bust pattern and their reversal since 1997. Quite the contrary! It can be feared that the impact of Basle 2 could be to increase pro-cyclicality of bank lending in general and to developing countries in particular and reduce further as well as increase the cost of bank lending to developing countries.

The proposed internal rating based (IRB) approach, to be implemented initially by large international banks, would tend to exacerbate pro-cyclical tendencies; the drive for risk weights reflecting probabilities of default (PD), estimated by banks is inherently pro-cyclical. During an upturn, PD falls, and would thus imply lower capital requirements. In a downturn, PD grows, as the same portfolio of loans is seen as more risk, raising capital requirements. As it is difficult to raise capital in a downturn, this risks a credit crunch, that could downturn into recession. This increase in pro-cyclicality goes against what is increasingly accepted as best practice and what was outlined above, the need to introduce neutral or counter-cyclical elements into regulation.

Secondly, and equally serious, the proposed IRB approach would further reduce international bank lending and increase the cost of such lending to developing countries, particularly those (the large majority) that do not have investment grade (Griffith-Jones, Spratt and Segoviano, 2003).

Recent detailed research shows clearly that the current Basle proposal would quite significantly overestimate the risk of international bank lending to developing countries; this would increase capital requirements excessively on such lending, leading to a sharp increase in the cost of bank borrowing by developing countries, as well as to an important fall in the supply of bank loans.

This is particularly serious now because, as discussed above, in the last five years bank lending to the developing world has fallen sharply. Thus, the current proposals are problematic, both in terms of the Basle Committee’s own aims (more accurate measurement of risk for determining capital adequacy) and due to their further discouragement of already insufficient bank lending to emerging markets, which damages growth of their economies. The latter impact is manifestly against one fo the aims of the G-10, which is actively to encourage private flows to developing countries and use them as an engine for stimulating and funding growth.

One of the reported major benefits of lending to – and investing in- developing countries, is their relatively low correlation with mature markets. In research quoted above, we have carefully tested this hypothesis empirically and found very strong evidence – for a variety of variables, and over a range of time periods – that correlation between developed and developing countries is significantly lower than correlation only amongst developed countries. For example, spreads on syndicated loans – which reflect risks and probability of default – tend to rise and fall together *within* developed and developing regions more than *between* developed and developing countries; similar results are obtained for the correlation of profitability to banks. Furthermore, broader macro-economic variables (such as growth of GDP, interest rates, evolution of bond prices and stock market indexes) show far more correlation within developed economies than between developed and developing ones.

Finance theory and practice tells us that the clear implication of these empirical findings is that a bank's loan portfolio that is diversified between developed and developing countries has a lower level of risk, than one focused exclusively on lending to developed economies. In order to test this more directly we simulated two loan portfolios, one with diversification only across developed economies, and another that diversified across developed and developing regions. We found that the estimated unexpected losses for the portfolio focused only on developed country borrowers was 23% higher.

Given that the capital requirements which Basel regulators determine should precisely help banks cope with unexpected losses, it is extremely unfortunate that the current Basle proposals do not incorporate explicitly the benefits of international diversification. The surprising fact that at present the Basle proposal does not do so implies that in this aspect, capital requirements will not clearly reflect risk, and thus will be both incorrectly and unfairly penalising lending to developing countries.

It therefore seems imperative that the Basle Committee in its next (and final) revision of the proposed Basel II, incorporates the benefits of international diversification, for example by explicitly reducing capital requirements, to take account of these diversification benefits.

It is encouraging that there is a clear precedent, as the Basle Committee has already made such a change (in a fairly limited way), with respect to lending to small and medium sized enterprises (SME's). After the release of the consultative document in January 2001, there was widespread concern – especially in Germany – that the increase in capital requirements would sharply reduce bank lending to SME's, with very negative effects on growth and employment. The technical case was made that the probability of a large number of SME's defaulting simultaneously was lower than for a smaller group of large borrowers. Intensive lobbying by the German authorities implied that this technical argument was recognised, and the Basel Committee agreed to lower average capital requirements by about 10% on average for smaller companies.

Our empirical research (Griffith-Jones, Segoviano and Spratt, op.cit), implies that at least as large a modification is justified with respect to international diversification, related to lending to developing countries. There are no practical, empirical or theoretical obstacles to such a change, which could potentially greatly benefit the developing world and ensure more precise measurement of risk and capital adequacy requirements. This, after all, is the main aim of the entire process.

The reason why it is difficult to persuade the Basle Committee to make changes that are technically and economically correct are related to the composition of the Basle Committee and of the dominant influences on it. Developing and transiting economies are not represented at all in the Basle Committee; the Committee is heavily influenced by the large G-10 countries' regulators, and these are influenced strongly by their international banks. The modelling "industry" also seems to have a large influence. The G-10 bank regulators are not particularly accountable democratically even in their own countries, and certainly not to the developing countries. There is here a clear problem of governance. G-10 bank regulators are concerned mainly with bank stability (clearly a legitimate and important concern), and with enhancing competitiveness of their own banks; they also wish to improve the micro-economic efficiency of allocating risk by banks and to discourage what they see as "excessively risky lending", but are insufficiently concerned with the macro-economic effect of such an approach, even in their own countries. Even less are they concerned with macro-economic effects in developing countries, even though these will have large, though indirect, effects on the G-10 economies. More broadly, important differences have arisen the time of writing (see Milne, 2003) between the US and Europe, with the former wanting to require only the very largest banks to implement the IRB approach, and the latter wishing to implement it amongst all banks and even amongst non-financial institutions. These divisions could open new opportunities for developing country bargaining, although the divisions among the G-10 may decrease any attention they are willing to place on developing country concerns.

CCL and access to IMF lending

During the 1990's, capital account liberalisation and the large scale of private flows greatly increased the need for official liquidity in times of crises. As a result of the Asian crisis, IMF resources were significantly enhanced, which facilitated the provision of fairly large financial packages that played a positive role in managing and containing crises.

Two new facilities were created, the SRF (Supplementary Reserve Facility), which has been successfully used and whose maturity has recently been slightly extended, and the preventive CCL (Contingency Credit Line), which remains unused.

The creation of the CCL was a potentially important and positive initiative, as it could significantly reduce the chances of a country entering into a crisis, by providing contingency lending agreed in advance. However, there are two very major problems. At the time of writing, no country has applied for its' use. Secondly, if a strong case is not made, and no country applies, for the CCL, it will expire in the autumn of 2003. Though precautionary stand-by agreements can, to a certain extent, play a similar function to the CCL, it seems very unfortunate if such a preventive contingency facility were eliminated rather than improved along the lines suggested below.

The key problem with the CCL has been that countries with "good" policies, and who are perceived as such, fear that there could be a stigma attached by the markets if they applied for a CCL. In particular, countries fear to be the first to apply on their own for a CCL.

To make this facility more attractive, and diminish or eliminate any potential stigma attached to it, modifications have been suggested. Particularly, it could be agreed that all countries very favourably evaluated by the IMF in their annual Article IV consultations would automatically qualify for the CCL. This would imply that quite a large number of countries --including the developed ones-- would qualify, thus eliminating the current stigma on its use. This proposal is quite similar to one that was suggested by the UK Treasury, whereby after a positive evaluation in Article IV consultations a country would automatically become eligible for the CCL; in this latter variant, the country would still have to apply for the CCL, but it would make this step far easier, because it would already know it was eligible. Countries named as eligible for the CCL by the IMF, would show strength (indicator of good policies), rather than --as currently feared-- a sign of possible future weakness. The fact that countries could have access to the CCL would hopefully diminish the likelihood of crises and therefore of the need for countries to draw on it.

Also a source of possible concern for developing countries is the IMF review of access policy in the context of capital account crises (IMF, PIN, March 2003). The stated purpose of this review is to “establish a stronger framework for crisis resolution, and provide member countries and financial markets with greater clarity and predictability …”. The source of possible concern is whether this review will not lead de facto to more restricted and slower access.

It is encouraging that no presumptive limit on cumulative exceptional access was introduced – after it was discussed and dismissed at the IMF Board – and that it was concluded in the Board discussion that “while some moral hazard is bound to be present in Fund lending, there is little evidence that the use of exceptional access in general has had large effects on moral hazard.” However, from a developing country perspective, a possible source of concern may be that tighter criteria will need to be met for exceptional access in case of capital account crises. These include some straightforward ones, like exceptional balance of payments pressures on capital account that cannot be met within normal limits, and that the policy program provides a reasonably strong prospect of success. However, two conditions are more difficult to quantify and may therefore delay or even potentially restrict, approval. High probability that debt will remain sustainable and that the country has good prospects of regaining across to private capital markets within the time. Fund resources would be outstanding; whilst both conditions are clearly sensible, they are difficult to determine ex-ante, as they depend partly on future financial markets’ perceptions of country risk and behaviour; this difficulty could potentially lead to delays in approval, that would be counter-productive, in that they could allow crises to deepen.

Furthermore, certain procedural strengthening has been introduced after the review, which while positive in providing additional safeguards and enhancing accountability, could produce delays and even decrease likelihood of packages. These procedural strengthenings include raising the burden of proof required in program documents and early consultation with IMF Board. The problem is the speed with which capital account crises can unfold and deepen, and the need to have responses from the official sector that are in a time frame that is not too much longer than that of private behaviour.

Two final issues seem relevant in a broader international financial architecture context. One is that the high percentage of quotas for IMF lending in the context of capital account crises is the result of the fact that IMF quotas seem to be insufficient, in relation to the needs of a globalised financial economy. Indeed, since the creation of IMF, quotas have grown less than GDP or than trade indicators; they have certainly not expanded, to take account sufficiently of the larger scale private flows, and their volatility and reversibility.

Secondly, though the review of access policy to IMF lending related to liquidity problems (where a combination of adjustment and financing would probably be sufficient to restore countries to a stable path), experience has shown that liquidity crises can deteriorate into solvency ones, especially if the former are mishandled. The fact that access to IMF lending may become more difficult or slower could potentially be more damaging to developing economies, because no clear international framework for orderly debt work-out resolution has been agreed (though there has begun to be progress on collective action clauses and other areas).

As the Fund Board only in early 2003 undertook the review, and no crises fortunately happened since then, it is not yet clear how much and if the new policy could affect IMF access. This needs to be monitored.

The International Financing Facility

Potentially encouraging for the international development architecture is the UK proposal to create an International Financing Facility, that would bring forward aid spending to the poorest countries by securitisation, so as to deploy a critical mass of development finance over the next 10 to 15 years, to facilitate the Millenium Development Goals to be met by 2015. The Facility would be built on a series of long term commitments from donor countries to make annual payments to the IFF. Based on these commitments, the Facility would leverage immediate additional resources for aid by issuing bonds in the international capital markets. The IFF would seek to disburse its funds through existing bilateral and multilateral channels, but would be subject to more detailed conditionality based on clear development criteria.

Amongst the reported advantages of the IFF would be its' encouragement of donor pooling and co-ordination, that could improve aid effectiveness. The key advantage would be the provision of a critical mass of aid to be linked up as a co-ordinated programme of sustained investment across health, education and other anti-poverty programmes.

The primary source of the IFF's income would be annual payments form donors which would be legally binding, subject to one or two high-level financing conditions. These could be, for example, not having prolonged arrears to the IMF or UN sanctions. The risk to the IFF is expected to be small, given that the IFF would have commitments to a large number of recipient countries, and across to individual countries would have limits.

The UK has committed to make the necessary long term contributions, but is attempting to achieve support from other donors. The idea is for donors to make legally binding commitments to paying into the IFF. These commitments would be made to the IFF at regular, for example, three yearly intervals.

Preliminary analysis indicates that the IFF bonds would secure the highest possibl ratings, reflecting the credit quality of donor commitments. The proposal is for disbursements by the IFF to build up over 5 years (eg until 2010) when they would peak at US $50 billion, until 2015, and then phase out over the subsequent 5 years. In total, if fully implemented, the IFF could provide over $500 billion in additional total aid, most of it before 2015. The proposed IFF would not securitise more than around 85% of the net present value of future income (that is, the Fund would “over collateralise”).

The IFF is an important initiative in that it recognises the need to increase aid significantly and suggests a concrete mechanism for doing so, temporarily. The problem is that over a long period, it would imply bringing aid spending forward and not an overall increase in aid, (which could be funded by SDRs or other means) which would be clearly superior.

From a developing country point of view, the key issue is whether it is more desirable to have far more aid now and far less (or possibly zero) aid in the future. If it is assumed that aid will have very high returns, and will help catalize significant growth and poverty reduction, increased levels of domestic savings and long term private flows, this is a clearly attractive strategy. However if growth does not become sustainable, and poverty is not significantly reduced and domestic savings do not grow, the future decline of aid could become very problematic. Naturally, if it becomes possible in the future to increase aid, then this problem would not arise. However, there would be no certainty that this would be the case.

Besides possible reservations on whether the financial engineering involved implies the most efficient manner of leveraging public resources, an important concern expressed by other G7 countries is whether countries can effectively absorb a doubling of aid flows, especially if this is temporary.

IV – Conclusions and policy suggestions

The review of recent trends in private capital flows and recent changes in the international financial system is not particularly encouraging.

As regards private flows, there has been an excessively sharp fall in the five years since the Asian crisis, especially in bank lending. There has been only limited action to encourage private flows, especially long-term ones, to developing countries, especially emerging ones. Below we outline some preliminary proposals that could encourage such flows. Whilst there has been an improvement in the structure of private flows, with a change from debt to FDI, the favourable impact should not be over-estimated, due to problems such as hedging of FDI for the domestic market and short-termism and reversibility of non-FDI flows.

As regards measures to improve the international financial and development architecture, progress has been insufficient and excessively slow; there have even been some reversals, although these have perhaps not been as major as seemed likely previously (eg. in terms of formally reducing access to IMF lending during capital account crises).

Recently, there has been valuable theoretical work on the need for counter-cyclical regulation, which could help curb boom-bust cycles in financial and banking markets. But there has been as yet little implementation and as a result little assessment of how effective such measures would be. It is a source of concern that the only major regulatory change being discussed internationally, a rather major modification of the Basle Capital Accord, whilst having some positive features could actually increase pro-cyclicality of bank lending and discourage excessively international bank lending to developing countries, especially those below investment grade (the majority).

As regards IMF lending to prevent capital account crises or manage them better, the CCL remains unused and could expire by the autumn of 2003. There seems to be some tightening of access to IMF lending in times of capital account crises and the possibility of some slowing down of granting such access.

From the point of view of the development architecture, the UK proposal suggests an ingenuous mechanism for front-loading aid in a very large amount – via the IFF and money raised on the bond market - is encouraging, because it recognises the urgent need for increasing aid, to levels suggested by the Zedillo Report; however the IFF is not yet agreed internationally and would be clearly inferior to a more permanent increase in aid.

The above synthesis of more recent developments, as well as a broader evaluation of progress on reform of the international financial architecture since the Asian crisis (see Griffith-Jones and Ocampo, 2003) seems to lead to the conclusion that the international financial system does not provide a particularly encouraging framework for countries to liberalise their capital account. Whilst many actions to limit risks of costly crises of such an opening have been taken, it is unlikely that they are sufficient; the potential rewards of significant and long-term flows – seem at present to have almost evaporated for large parts of the emerging economies, whilst falling also for low-income countries, as flows have shrunk.

We will finish with some suggestions on measures to encourage private flows in times of drought, which seem particularly relevant at the present time. Such measures could be reduced or reversed if private capital surged; indeed, in such a case, particularly recipient countries would need to discourage flows.

To the extent that the new trend towards a drought of capital flows to emerging markets is likely to last longer, the policy agenda needs to shift, both at the national and the international levels. The immediate problem is how to encourage sufficient private flows to developing countries. Here we will focus on measures to be taken internationally, and/or in source countries, though measures in developing countries are also important.

One of the novel problems that has arisen during and in the aftermath of recent crises is that *trade credit* has dried up. At present, government institutions such as export credit guarantee agencies (ECAs) and multilateral development banks limit their activities (providing guarantees and credits) to longer-term assets. An important policy question is whether they should extend their activities to cover also short-term assets. In fact, the Inter-American Development Bank is currently exploring the creation of a guarantee mechanism specifically tailored to encourage trade finance provided by commercial banks. Such guarantees might be particularly useful for a country like Brazil in 2002 that was experiencing difficulties in accessing short-term trade credit, but not in a full crisis. One could of course go one step further, and have an institution like an ECA or the IADB grant trade credit in special circumstances, e.g. if a guarantee program failed to restore an adequate level of trade credit. Such a program for either guarantees or the direct provision of trade credits could be temporary, and be phased out once full access to trade credit from commercial banks was restored.

In the case of *long-term trade credit*, ECAs already play a large, even if declining, role in guaranteeing credits. An important issue is the extent to which ECAs and development banks should be willing to be counter-cyclical in the guarantees they grant. If it is accepted that international financial markets tend to overestimate risk in difficult times and underestimate it in good times, there is a strong case for introducing an explicit counter-cyclical element into risk evaluations made by export credit agencies. In times when banks and other creditors lowered their exposure, export credit agencies would increase or at least maintain their levels of guarantees. When matters were seen to improve by the markets, so that banks increased their willingness to lend, then export credit agencies could decrease their exposure, for example by selling export credit guarantees in the secondary market. This would avoid a greater counter-cyclicality of guarantees resulting in an increased average level of guarantees.

To the extent that ECAs are increasingly using models to estimate risks (as is the case of the UK ECGD), it is important that these models "see through the cycle". Such models should utilize measures of risk that are less affected by short-term variations than market-sensitive measures of risk typically are.

One possible way to increase the effectiveness of MDB guarantees in inducing private flows would be to guarantee only those risks that the markets are not prepared to cover (e.g. possibly covering only country risk and not commercial risk). It would also be possible to cover only initial maturities, and then roll over the guarantee once these initial payments have been made. Other mechanisms include introducing guarantees in local currency instruments. Alternatively, in some cases private actors may be willing to lend for early maturities and institutions like the IADB or World Bank may need to guarantee later maturities or provide co-financing for later maturities. This is particularly appropriate for infrastructure investments, which have high initial sunk costs and very long gestation periods before the project becomes profitable (see Gurria and Volcker, 2001, Griffith-Jones, 1993). Because of this, infrastructure projects often need financing for periods of up to 25-30 years, while the private market normally will only provide loans with significantly shorter maturities.

One suggestion is therefore to have public sector institutions play a much more consciously anti-cyclical role than has been customary. Another suggestion is to urge a more pro-active role for *socially responsible investment* (SRI). Traditionally, SRI has tended to have a negative slant, focusing on restrictions on investing in undesirable activities, such as those that employ child labour, do not meet environmental or labour standards, or indulge “sins” like tobacco, alcohol and gambling. These restrictions can discourage investment in developing countries.[3]

A new definition of SRI should specify that one of its central aims would be a *positive one*, to support *long-term* private flows to developing countries that *help fund pro-poor growth.* This would over time help to improve labour standards, both because incomes and especially wages would grow faster and because SRI foreign investors by being present and engaged in developing countries could have a positive influence on wages.

A change in the concept of what amounts to SRI, both by institutional and retail investors (where SRI has an important and growing presence), from a negative “anti-bad things” to an emphasis on pro-poor growth in developing countries, could potentially have a positive impact on both the level and stability of private flows to developing countries. In particular, pension funds could potentially provide more stable flows as their liabilities are on average very long term. In the UK, legislation introduced in 1999 required that all pension funds set out in their annual report the way that social and environmental factors were taken into account in their investment decisions. This facilitates the ability of pension fund trustees and members to examine the practice of their fund, and lobby for change if they wish. The change in the UK regulation was soon replicated in a variety of other European countries. Also in the United States there are large institutions, both pension funds and religious foundations, that have a tradition of socially responsible investment, whose investments could be in part channelled to emerging markets.

An important challenge is therefore to influence SRI investors to expand their horizons and recognize their responsibility for helping to promote development. This need not imply an inferior long-run investment performance, for there is evidence that the return/risk ratio of a portfolio that has a part of its assets invested in developing country equities will be higher in the long term than if it invests purely in developed countries. (See for example, Armendariz, Griffith-Jones, Gottschalk and Kimmis, 2002.) The potential is large, given the rapidly growing scale of SRI assets. For example, in the UK, Sparkes (2002) reports that the scale of these funds has

[3] A recent example of this is when the large US pension fund, Calpers, introduced a number of restrictions on their investment (e.g. minimum labour standards). This led to the withdrawal of their investments from several major developing countries. I thank Shari Speigel for this point.

increased ten fold in ten years to stand at US $326 billion in 2001. An estimate of global SRI assets (Persaud 2003), calculated a total of US $2700 billion for 2001.

The introduction of measures to encourage – via guarantees via SRI, or through other mechanisms – higher and more sustainable flows to developing countries would significantly increase potential rewards of capital account liberalisation.