FACING VOLATILITY AND CONCENTRATION OF CAPITAL FLOWS

Stephany Griffith-Jones and Jose Antonio Ocampo [1]/

The recent phase of financial turmoil in emerging markets 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 the recognition that the potential benefits that globalisation potential offers is being seriously undermined by the high frequency of financial and currency crises. On the other hand, the expectation that rising private capital flows would substitute for decreasing official flows has not materialised. In particular, poor and small countries continue to have very restricted access to private capital markets.

The crisis set in motion positive responses: a special impetus to international efforts to strengthen standards of prudential regulation and supervision, as well as information; the drafting of codes and guidelines for macroeconomic management; a more preventive focus of IMF surveillance; the approval of new credit lines and the expansion of IMF resources; the recognition that financial liberalisation in the developing world generates risks and must thus be carefully sequenced; 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.

[1] / Papers prepared for the FONDAD Workshop held in The Hague, 26-27 June, 2000.

Nonetheless, emphasis has been placed almost exclusively on domestic reforms in the capital recipient economies. Though useful, this asymmetrical approach implies wrongly that recent financial crises were caused largely by problems in the recipient economies. Most of the literature on these crises has argued, on the contrary, that imperfections in international capital markets were also a major (if not the main) cause of these crises. Moreover, to a significant extent, some of the domestic policies in recipient economies that led to crises –financial and capital-account liberalisation and pro-cyclical spending policies in the face of booming capital flows—were determined by pressure of private capital markets and even that of international financial institutions (IFIs). Therefore, complementary significant reforms in the source countries and the approach of IFIs are required.

In some cases, responses during the recent crisis were insufficient or clearly inadequate: IMF conditionality was overextended; the issues associated with stable arrangements to guarantee the coherence of the macroeconomic policies of industrialised countries has not received sufficient scrutiny; the 1997 proposal to create an Asian Monetary Fund gave rise to strong unwarranted opposition that led to its rapid dismissal, though it was revived in 2000 in the form of a swap arrangement of major Asian countries; more generally, the role which regional institutions can play in an appropriate international financial arrangement has not been given adequate attention; and no significant steps were taken to ensure a fair representation of developing countries in the discussion on reform or in a revised international architecture.

Indeed, even though the G-22 and more recently the G-20 have been created, in which some (usually large) developing countries participate, they are many times only loosely related to the decision-making process. A major source of concern is that in the fora where important decisions on international reform are made (like the International Monetary and Financial Committee), there is a significant under-representation of developing countries. Moreover, a very important and valuable new forum –the Financial Stability Forum (FSF)– has no representation from developing countries (for a very good review of these issues, see *Culpeper, 2000*).

The fairly rapid though incomplete normalisation of capital markets gave way to a sense of complacency that slowed down the reform effort. Moreover, it could lead efforts in the wrong direction. One such step would be to give new impetus to discussions on capital account convertibility. Also, a negative road would be to follow recommendations (see, for example, *Meltzer et al., 2000*) to significantly scale down lending –and several important functions and facilities– by the IMF and the World Bank. These recommendations are based on the incorrect diagnosis that government failures (both in developing countries and in the actions of IFI's) and in particular moral hazard played the key role in explaining recent crises. On the contrary, as many analysts have stressed, recent crises have been caused to an important extent by imperfections in international capital markets, linked to problems such as herding. Furthermore, as indicated, private capital flows are still heavily concentrated and do not reach large parts and sectors of the developing world. Such recommendations are also based on the assumption that crises are intense but short, a fact that is contradicted by the fact that capital markets have not completely normalised more than three years after the onset of the Asian crisis.

This indicates that the reform effort in international finance should be broadened and deepened. In this regard, this paper argues that a relevant international financial reform must face the two major problems that private capital flows to developing countries have manifested: volatility and concentration. To face the first of these problems, mechanisms need to be created or strengthened at an international level to guarantee macroeconomic and financial stability, similar to those that exist at the national level strengthened. These would include: (1) mechanisms to guarantee the coherence of macroeconomic policies world-wide and, particularly, to guarantee that macroeconomic policies in industrialised countries internalise the externalities that they generate; (2) a world financial regulatory authority; (3) an international lender of last resort that provides adequate liquidity to manage large capital account shocks, as well as emergency financing to manage more traditional shocks; and (4) international arrangements to facilitate debt work-outs. To face the second issue, official development assistance (ODA) should meet internationally-agreed targets and development finance should be strengthened to fill market gaps in countries and sectors which cannot access private flows and to catalyse additional private flows where feasible. Actions in these two areas should be complemented by the increasing participation of developing countries in international financial institutions and decision making fora, and in the design of complementary regional and subregional mechanisms.

Though much of this agenda may be unrealistic in the short-term, it is important that work continues to be done on a blueprint for such a future international financial order, as this type of vision is a valuable guide to current debates and efforts. Such a blueprint clearly argues, if anything, for an increased role of IFIs and other official resources, and for strong international as well as regional and subregional institutional arrangements.

This paper concentrates on some aspects of this broader reform agenda. As a background, section I briefly summarises the problems that the current system faces. This serves as a background for analysis of the regulatory agenda, both in source (section II) and recipient countries (section III), on liquidity (section IV) and development finance (section V).

I. THE NATURE OF THE PROBLEMS THAT THE SYSTEM FACES

International capital flows to developing countries have exhibited four outstanding features in the 1990s. [2]/ 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 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. Although access to markets has tended to be restored faster than in the past, conditions of such access –spreads, maturities and special options to reduce the risks of investors— have

[2]/ For a full evaluation of trends, see UNCTAD (1999), Chapters III and V, and World Bank (1999).

deteriorated and significant instability in capital flows have been the rule since the eruption of the Asian crisis.

In contrast to the growth of private flows, official development finance and particularly its largest component, bilateral aid, has lagged behind. Indeed, bilateral aid has fallen in real terms and in 1998 it reached 0.24% of the GDP of industrialized countries, a significant fall with respect to the 0.33% of GDP reached in the early-1990s.[3]/ The reduction in bilateral aid has been strongest in the case of the largest industrialized countries. This trend has been partly offset, in terms of effective resource transfers, by the increasing share of grants in official development assistance. Also, contrary to private flows, official finance has been stable and some components of it –particularly balance of payments support but also multilateral development finance—has displayed an anti-cyclical behaviour.

<INCLUDE TABLE 1>

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 are particularly relevant to them.

<INCLUDE TABLE 2>

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 official 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. Both patterns are closely associated, as cyclical borrowing by a few large countries is the major determinant of the overall cyclical pattern. The latter feature has become even more marked in recent years. As a

[3]/ World Bank (2000), p. 58.

result of this, the share of IMF financing going to large borrowers has displayed a strong upward trend over the past two decades.[4]

Thus, although the volatility exhibited by private capital flows, the centre of recent debates, are certainly problematic, no less important problems are the marginalisation 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 both problems.

II. FINANCIAL CRISIS PREVENTION: REGULATION IN SOURCE COUNTRIES

The issues associated with financial crisis prevention have received extensive attention in recent discussions.[5] 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. The recent Financial Stability Forum Working Party Reports has stressed the crucial role of 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.

---

[4] Griffith-Jones and Ocampo (1999).

[5] See, among others, IMF (1998, 1999, 2000a, 2000b), Group of Seven (1998), UNCTAD (1998), Part One, Chapter IV, United Nations Task Force (1999), Miyazawa (1998), Rubin (1999), *Summers (2000),* Akyüz and Cornford (1999), Eatwell and Taylor (2000), Eichengreen (1999), Griffith-Jones (1998), Griffith-Jones and Ocampo (1999), Ocampo (2000a, 2000b), White (2000a, 2000b) and Wyploz (1999).

Though important progress has been made on defining these issues, far less progress has been made on implementation, particularly at the international level.

Nonetheless, some divergence of opinion remains. First, there is not yet total consensus on institutional arrangements for international regulation. It is clear in this regard that the BIS should continue to play a leading role, but this requires an expansion of developing-country membership in this organisation and, more broadly, in the definition of all sorts of international standards and codes of conduct. A crucial role will also be played by the Financial Stability Forum to coordinate regulation between countries and financial sectors but, as noted, this also requires that developing country should participate in its decision making process. Secondly, there are some 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. Thirdly, 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. Finally, there are disagreements on the best methodologies for regulation and in particular on how large a role should be given to market actors (e.g. rating agencies) themselves.

A. The welfare-enhancing effects of regulation

In spite of the limitations of international financial regulation a very clear case can be made that strengthening it will be welfare enhancing. This is particularly true, if –as we discuss below–, such regulation has explicit counter-cyclical elements, to compensate for inherent pro-cyclical behaviour by financial actors, that can also partly characterise traditional financial regulation.

Indeed, there is growing support for the view that welfare for both source and recipient countries can be increased by regulatory changes (through measures in source and/or recipient countries) that would reduce excessive lending and borrowing. It is noteworthy that Alan Greenspan proposed –for the case of interbank lending– that it could be appropriate for either borrowing countries or lending ones to impose reserve requirements to "deter aberrant borrowing: sovereigns could charge an explicit premium, or could impose reserve requirements, earning low or even zero interest rates, on interbank liabilities. Increasing the capital charge on lending banks, instead of on borrowing banks, might also be effective" (Greenspan 1998).

There is, indeed, growing recognition that it may often be desirable to regulate excessive surges of potentially reversible capital flows in recipient countries. An important part of the responsibility with discouraging such excessive reversible inflows –as well as managing them– lies with the recipient countries. However, the experience of the 1990s, with very large scale of international funds –compared to the small size of developing country markets– leads to the question whether measures to discourage excessive short-term flows by recipient countries are sufficient to deal with capital surges and the risk of their reversal.

Aizenman and Turnovsky (1999) have formalised such analysis, by developing a rigorous model that considers the impact via externalities of reserve requirements on international loans (both in lending and recipient countries) on the welfare of both categories of countries. In particular, they evaluate the macro-economic impact of reserve requirements in a second-best world, where there is moral hazard due to likely bail-outs on the lender's side and sovereign risk on the borrower's side; both generate large negative externalities on welfare. The general conclusion of their model is that the introduction of a reserve requirement in either the source or the recipient country reduces the risk of default and raises welfare in both countries.

B. Removing distortions and introducing anti-cyclical provisions in banking regulation

There is broad agreement that the 1988 Basle accord was a major step forward in the design of minimum common standards for banking regulation. Nonetheless, it has also generated some distortions and, particularly, has maintained incentives for bank lending to behave in a pro-cyclical fashion. It has been argued, first of all, that, due to significantly lower capital adequacy requirements for short-term lending than for long-term lending, it contributed to the build up of short-term bank lending and its reversal in East Asia and elsewhere,. The new proposal published in June 1999 attempts to address this distortion, by reducing somewhat (though perhaps not sufficiently) the differential between capital adequacy for short-term and other lending.

The new Basle recommendations, though including many positive elements (see, for example, *Cailloux and Griffith-Jones, 1999*), also have suggestions that were widely seen as problematic. These included increasing the role of rating agencies to determine country weightings for capital adequacy, which could aggravate the pro-cyclical nature of bank lending, thus encouraging larger surges and larger reversals –clearly an undesirable outcome. There is, indeed, significant evidence that rating agencies act in a pro cyclical fashion. Indeed, as pointed by various authors (see, for example, *Turner, 2000*; *Reisen, 1999*), rating agencies failed to downgrade the East Asian countries before the crisis but then worsened it because they brought down the ratings as the crisis unfolded. *Reisen and von Maltzan (1999)* find that sovereign ratings lag rather than lead the market.

The major problem with current regulatory practices, including the Basle accord is, however, that they do not serve to moderate pro-cyclical market behaviour (Ocampo, 2000a, 2000b). Indeed, current rules do not seem adequate to internalise the rising risks in which banks incur during booms. On the contrary, during crises, increased amounts of bad loans (which are usually not fully covered by provisions) will impact upon the lending bank's capital and can lead to a credit crunch if the bank is already facing a relatively low capital asset ratio, and –as is likely in a recession– is unable to raise new capital.

The answer thus may lie in the implementation of an explicit counter-cyclical mechanism which would, in boom periods, and in contrast to ratings, dampen excess bank lending. On the contrary, in periods of slowdown and of scarcity of finance, the new mechanism should not further accentuate the decline in lending but rather encourage it. Counter-cyclical elements can also be introduced in regulating other financial agents (see below for mutual funds).

There would be two linked objectives for introducing counter-cyclical elements in regulation. One would be to help smooth capital flows and the other would be to smooth the impact of volatile capital flows on the domestic financial system and therefore on the real economy. Introducing counter-cyclical elements into regulation would help build a link between the more microeconomic risks on which regulators have traditionally tended to focus on and the macroeconomic risks which are becoming increasingly important, both nationally and internationally. Counter-cyclical elements in regulation related to bank lending could be applied, either internationally, nationally or at both levels.

Several mechanisms could be used to introduce a counter-cyclical element into regulation of bank lending. One mechanism would be to require a higher capital ratio in times of boom, and to allow banks to use the additional cushion provided by the higher capital ratio so they could sustain lending in times of recession at a lower capital asset ratio. Some practical difficulties may arise in implementing such a mechanism, of which the most serious one may be getting international agreement on a general formula for cyclically adjusted capital asset ratios.

A second mechanism for introducing counter-cyclical elements in bank lending regulation is to strengthen provisioning rules during booms, requiring, for example, banks to provision larger proportions of due loans or special provisions linked to the rapid increase in lending. Prudential supervision should certainly be strengthened for institutions experiencing a very rapid growth of lending. Also, generally precautionary provisioning could be encouraged or forced on intermediaries to cover normal cyclical risks (*Turner, 2000*). Any of these mechanisms would allow for provisions built up in good times to be used in bad times, without affecting reported capital. A problem that must be faced is the limited tax deductibility of precautionary provisioning. The large-scale application of this mechanism would thus require a change in tax laws, as indeed was done in the late eighties in the UK.

A third mechanism, relevant particularly for domestic bank lending, is for regulators to place caps on the value of assets (such as real estate or stocks and shares) to be acceptable as collateral, when the value of such assets has risen sharply in a boom and is at risk of declining sharply in a recession. Rules could be used such as averaging values for the last five years, or accepting only 50% of current prices in the peak of a boom. The latter mechanism seems to have the least problems of implementation (indeed, reportedly it is already applied in some jurisdictions, e.g. Hong Kong).

A fourth possible counter-cyclical mechanism would be to limit or discourage lending for property, construction and personal consumption, as these items tend to increase substantially – and often even be a major factor– in booms (*McKinnon and Pill, 1997).* A possible implementation problem would be that it may be difficult to verify final use of credit, and such measures could be partially evaded.

Furthermore, regulators should be flexible in the downturn, particularly to allow banks to easily use cushions (e.g. of capital or of provisioning) in times of recession; it may even be advisable, if a recession is very serious one, to allow ratios to fall below normally required levels, in the understanding that they will be rebuilt as soon as the economy starts recovering. A tension may arise here between the regulatory concerns about individual bank liquidity and solvency and the macro-economic externalities of their actions, particularly in recessions.

Several issues require further scrutiny. What are the best mechanisms through which counter-cyclical measures should be introduced (flexible capital adequacy ratios, higher provisioning against losses, more "realistic" pricing of collateral)? How best can the distinction between a temporary boom and a permanent increase in growth be made? After what period of "boom" should regulatory changes be introduced? How large should such changes be? Should such measures be introduced for both international and domestic lending, or preferably for one of them? The previous remarks provide only initial thoughts on these important issues.

C. <u>Filling gaps</u>

The broad welfare case for applying reserve requirements in both source and recipient countries can also be applied to institutional investors and in particular to mutual funds, which grew in relation to banks in the 1990s. This occurred both within the developed countries, and particularly within the US –where mutual funds receive more than 50% of total deposits in the financial system– and in capital flows from developed to developing countries (see *d'Arista and Griffith-Jones, 2000*). The narrowing of differences between banks and institutional investors, and the fact that securities markets and thus mutual funds also have access to the lender of last resort –nationally in the US but more importantly in our context also internationally, due to the frequent rescue packages put together by the IMF in recent serious currency crises—, suggests the importance of improving prudential standards for institutional investors such as mutual funds.

As regards portfolio flows to emerging markets, there is an important regulatory gap, as at present there is no regulatory framework internationally, for taking account of market or credit risks on flows originating in institutional investors, such as mutual funds (and more broadly for flows originating in non-bank institutions). This important regulatory gap needs to be filled, both to protect retail investors in developed countries and protect developing countries from the negative effects of excessively large and potentially reversible portfolio flows.

Institutional investors, like mutual funds, given the very liquid nature of their investments can play an important role in contributing to developing country currency crises (for recent evidence, see *Kaminsky, Schmukler and Lyons, 1999*). It seems important, therefore, to introduce some counter-cyclical regulation to discourage excessive surges of portfolio flows. This could perhaps best be achieved by a variable risk-weighted cash requirement for institutional investors. These cash requirements would be placed as interest-bearing deposits in commercial banks. Introducing a dynamic risk-weighted cash requirement for mutual funds (and perhaps other institutional investors) is in the mainstream of current regulatory thinking and would require that standards be provided by relevant regulatory authorities and/or agreed internationally. The guidelines for macro-economic risk, which would determine the cash requirement, would take into account vulnerability variables as defined by the IMF and BIS (for a more detailed discussion of this proposal, see *Griffith-Jones, 2000*).

The September 1998 Emerging Markets IOSCO Report (IOSCO, 1998) has in fact described in some detail and evaluated rather positively the above proposal. This report emphasised that "there appears to be scope – and an urgent need for further work. This is very likely to require a multilateral effort – i.e. by regulators from both source and recipient countries in collaboration with the industry".

As regards highly-leveraged institutions (HLIs), the corresponding FSF working group rightly focussed on two problems: systemic risk linked to high leverage and reduction of market and economic impact of collapse of unregulated HLIs. Particular emphasis was placed on their activities in small and medium sized open economies where the potential damage that can be caused by large and concentrated positions can seriously amplify market pressures.

The working group considered the possibility of introducing formal direct regulation of currently unregulated institutions. This would include a licensing system, minimum capital and liquidity standards, large exposure limits, minimum standards for risk management, and even an enforcement regime with fines for transgressions. Such regulation was seen to have several very desirable effects, such as regular oversight and the reduction in the likelihood of disruptive market events. However, due to what were seen as both philosophical and practical problems, the working group did not recommend applying a system of direct regulation to currently unregulated HLIs at this stage, though it did not reject the possibility of establishing such a regime in the future. It emphasised that the failure to carry through their recommended measures (*FSF, 2000a*) would prompt such reconsideration.

The philosophical objection relates to the fact that direct regulation would not be aimed at investor protection (as investors are sufficiently wealthy or sophisticated to do their own due diligence), but on the mitigation of systemic risk. However, it can be argued that mitigation of systemic risk is also an increasingly valid regulatory aim. There are also practical objections, including how to avoid leakage through offshore centres. However, current efforts to improve and complete regulation in off-shore centres should help overcome those problems (see *FSF, 2000b)*. Other practical technical issues are more valid, including the need to adapt capital adequacy and large exposure rules to the specific risk profile of HLIs. This should be done in ways that avoid the adverse effects that capital requirement could have on the efficiency and liquidity of markets in which HLIs are significant participants. This seems particularly important in a context when several large hedge funds have been wound down, which may diminish some of the negative impacts they had in recent crises, but could, according to some observers, deprive markets of countrarian actors, with some useful roles to play in financial markets.

The need to regulate directly HLIs may need to be re-visited, partly in relation to the implementation (or not) of other measures recommended by the Working Group and their perceived impact.

III. CAPITAL ACCOUNT AND PRUDENTIAL REGULATIONS IN RECIPIENT COUNTRIES

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 issues as to the national policies necessary to guarantee financial stability and the areas where national autonomy should be maintained. At least in the developing countries, national autonomy should be maintained 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.

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.[6]/ 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. Avoiding unsustainable expansion of spending and currency overvaluation, facilitated by extraordinary access to external financing or temporary export windfalls, play the crucial roles in this regard.

The regulation of capital inflows may be essential in open developing economies as a mechanism for monetary and domestic credit restraint and for avoiding 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 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. Regulations governing outflows may 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. They generate, nonetheless, credibility issues that should not be ignored by the authorities and they would be subject to considerable leakage if improvised during a crisis (see below). It is essential, of course, that any sort of capital account regulation be used as a complement and not a substitute for fundamental macroeconomic adjustment.

[6]/ The literature on national policies is extensive. See, among recent contributions, ECLAC (2000, ch. 8); World Bank (1998), Chapter 3; Ffrench-Davis (1999); Helleiner (1997); and *Ocampo (2000c).*

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 price-based signals. An interesting, simple price-based policy tool are 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. 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.[7]/ A basic advantage of this instrument is that it is targeted at capital inflows and is thus a preventive policy tool. It has also other specific advantages: it is a non-discriminatory price instrument [8]/ and affects both financial and non-financial agents, thus avoiding arbitration between domestic and external borrowing.

Any mechanism in place 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

[7]/ Agosin (1998), Agosin and Ffrench-Davis (1999), Le Fort and Lehman (2000), Ocampo and Tovar (1999), and Villar and Rincón (2000).
[8]/ Ocampo (2000a). Indeed, this instrument is similar to practices used by private agents, such as the sales fees imposed by mutual funds on investments held for a short period in order to discourage short-term holdings. See J. P.Morgan (1998), p. 23.

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 over borrowing during booms and thus target primarily capital inflows rather than outflows.

From the point of view of borrowing economies, there is growing agreement that greater weight needs to be given by domestic prudential regulation and supervision to the accumulation of short-term liabilities in foreign currencies, to risks associated with the rapid growth of credit and to currency mismatches of assets and liabilities. This implies that they must thus 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. 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) are strongly complementary to stricter prudential regulation and supervision.

Due to the important externalities which large non-financial firms can generate for the domestic financial sector, particularly in the context of exchange rate depreciation, the external liability exposure of these firms should also be subject to some regulation. Such exposure should be taken into account in risk evaluation, by requiring stricter rules on classification and provisioning standards for domestic lending to non-financial firms with high currency mismatches. Tax provisions (e.g., explicit taxation on external borrowing or exposure, or limits on the deductibility of exchange-rate losses) and rules that force non-financial firms to disclose information on their external liabilities may also be relevant complements to such prudential rules. It is unclear, however, whether a system based on such tax and prudential rules is a substitute for direct capital account regulations. A basic advantage of this alternative is that it would facilitate financial integration, but it would not tackle the direct source of the problem and would be more complex than a simple price-based instrument such as the Chilean-Colombian reserve requirement.

It should also be noted that, due to the strong link between financial and macroeconomic risks, prudential standards should probably be stricter in developing countries. This would be reflected, however, in higher spreads on domestic lending, generating strong incentives for non-financial firms to borrow directly abroad. This indicates that capital account regulations are complementary to stronger prudential regulation.

As the recent literature has emphasised and as recent experience of many developing countries indicates, 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 the appropriate instrument of a liability policy. Exchange rate flexibility may deter some short-term private flows and may thus partly operate as a "liability policy", but its effects are limited in this regard. Direct controls on inflows may also be an appropriate instrument to achieve a better private debt profile. A flat tax or reserve requirement on external borrowing 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. This effect has been subject to less controversy than the effect of such regulations on the magnitude of inflows.

The former analysis indicates that capital account regulations may be an essential instrument for crisis prevention and management in the face of strong volatility of capital flows and 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 <u>permanent</u> policy instrument. 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.[9]/ 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 conclusive evidence of an association between capital account liberalization and economic growth, and there are some indications that point in the opposite direction.[10]/ 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. Furthermore, 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?

IV. EMERGENCY AND COUNTERCYCLICAL FINANCING

The enhanced provision of emergency financing during crises is another pillar of the system to prevent and manage financial crises. Indeed, although the direct focus of emergency

---

[9]/ For a more extensive analysis of this subject, see United Nations Task Force (1999), UNCTAD (1998), Part One, Chapter IV, ECLAC (1998), Part III, Eichengreen (1999), Griffith-Jones (1998), Grilli and Milesi-Ferreti (1995), Krugman (1998a, 1998b), Ocampo (2000) and Rodrik (1998).
[10]/ See, in particular, Eatwell (1996), Rodrik (1998) and, for Latin America, Ocampo (1999).

financing is crisis management, it also has crisis prevention effects, as it plays an essential role in avoiding the destabilising expectations that are responsible for deepening and spreading of crises (contagion) and, ultimately, for systemic failures. This has been, in fact, the essential defence for the role that central banks play at the national levels as lenders of last resort. Current international arrangements are weaker in this regard. Indeed, the IMF provides “emergency financing” but certainly not liquidity, a fact that is reflected in the lack of automaticity in the availability of financing during crises.[11]/ Although the Fund has the capacity to create fiat money, through the issue of Special Drawing Rights (SDRs), it was used only in the past and in a very limited way.

It is important to emphasize that, in this regard, emergency financing is not a substitute but a complement to strong regulation and debt workout procedures. Regulatory changes help smooth capital flows to emerging markets. Together with private sector involvement in crisis resolution, through adequate debt workouts, they are essential to avoid moral hazard. However, the view that the appropriate way to combat such moral hazard is by scaling down the role of the IMF in providing financial packages during would make crises even more costly and/or lead to a sharp reduction in private flows to developing countries. Indeed, as discussed below, there may be a case in the current context of large and volatile private flows even for significantly larger emergency official emergency financing than currently exists. The great majority of recent reports support this view (Williamson, 2000), with the major exception of the Meltzer Report (although the minority view in Meltzer also strongly values the broad role of the IMF).

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

The main lessons from recent crises are, indeed, that: (1) as a preventive measure, wider use should be made of private contingency credit lines that are agreed during periods of adequate access to capital market, following the (partly successful) pioneering experiences of some "emerging" economies; (2) that large-scale funding may be required, though not all of it needs to be disbursed if support programs rapidly restore market confidence; (3) that funds should be made available before --rather than after-- international reserves reach critically low levels; and (4) that, due to strong contagion effects, contingency financing may be required even by countries that do not exhibit fundamental disequilibria. 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 and its redesign in September 2000.

The major controversies relate to inadequate funding, the design of some specific credit lines and the broadening scope of conditionality. With respect to the first issue, bilateral financing and contributions to the IMF will continue to be scarce during crises. This might reduce the stabilizing effects of rescue packages, 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 may be to allow additional issues of SDRs during episodes of world financial stress; these funds could be destroyed once financial conditions normalize.[12] This procedure would create an anti-cyclical element in world liquidity management and would give SDRs an enhanced role in world finance, a principle that developing countries have advocated in the past and should continue to endorse in the future. Second-best alternatives are to make a more active use of Central Bank swap arrangements under IMF or BIS leadership, and or to allow the IMF to raise the resources needed in the market.

It is useful to put the discussion on the second issue in the broader context of the functions that IMF facilities have to perform in today's world. In this regard, there are, first of all, the traditional needs of emergency financing to face balance of payments crises due to two sets of causes or a mixture of both: (a) inconsistent macro-economic policy, and (b) traditional external shocks, such as deterioration in the terms of trade, increased interest rates in developed countries, and/or a slow-down in developed countries' growth. The Stand-By Arrangement (SBA), the Extended Fund Facility (EFF) and the recently modified Compensatory Financing Facility (CFF) have for some time dealt with these traditional needs.

There are, secondly, the new needs, linked to "XXI century-style" currency and financial crises, which are mainly caused by the interaction of volatile capital flows and domestic financial fragilities, and which can spread via contagion amongst countries (including, as we have noted, those with fairly sound macro-economic fundamentals). The challenges here are both improved crisis prevention and better crisis management if these crises do occur. Recent crises have led to the creation of the Supplemental Reserve Facility (SRF) and the above mentioned Contingency Credit Line (CCL) While these facilities reflect the clear new need for significantly enhanced

[12]/ See United Nations Task Force (1999), Council on Foreign Relations (1999), Group of 24 (2000), Camdessus (2000).

public liquidity provision in a globalised world, where the risk of crises has significantly increased, they do not go as far as may be desirable and necessary in the provision of official liquidity financing.

There are, finally, the special needs to provide to low-income countries, to strengthen in a sustainable way their balance of payments position, whilst supporting growth and poverty reduction. In 1999, the traditional facility in this area, ESAF was transformed into the Poverty Reduction and Growth Facility (PRGF).

This broad menu is essential to respond to the call by the G-24 for the Bretton Woods institutions to "maintain a range of instruments to address the needs of their diverse membership". It should also be added that in the first two cases, but also possible in the third, IMF lending should be perceived as "a bridge to and from private sector lending" (*Summers, 2000*).

Some facilities seem to function fairly well, as regards the scale of financing they provide, and the circumstances under which they are used, though the nature and the scope of the conditionality should be narrower, as argued below. The facilities that function reasonably well to meet current needs include are the stand-by arrangement (SBA), which it is agreed will remain the Fund's main instrument, and the Extended Fund Facility (EFF), though some observers have challenged its value, in spite of its importance to developing countries because it allows longer periods of adjustment to balance of payments disequilibria of a structural character. The simplified CFF can also perform a useful function in helping primary-producing countries cope with exogenously determined terms of trade shocks. However, the CFF should be expanded to cover the full extent of export shortfalls, and its conditionality reduced, given the fact that the cause of the problem is international. The fairly recently created Supplemental Reserve Facility (SRF), designed to provide exceptional financing during crises, has also worked well, even though resource limitations make it fall short of what would be desirable in today's world.

The CCL was created as "a precautionary line of defence readily available against future balance of payments problems that might arise from international financial contagion" (*IMF, 1999*). The philosophy of the IMF moving more strongly into precautionary lending that would reduce the chances of countries being caught by contagion, and give leverage to the IMF to encourage countries to pursue policies that would make crises less likely, is clearly the right one. However, the fact that the CCL has not been used since its creation in April 1999 reflects design problems that were only partly corrected in the recent redesign of this facility. These include: (a) the limited scale of the facility; (b) the lack of automatic triggering in the original design, which was partially corrected by making "activation" a fairly automatic process, though still requiring a "post-activation" review that would result in a conditional adjustment program; (c) the "two-phase or double conditionality" that characterizes such design; and (d) the fear of countries that private lenders and investors might see the use of the CCL as "the ambulance outside the door", which could contribute rather than deter a speculative attack or withdrawal of flows.

An active monitoring of the experience with the CCL is thus necessary to improve this clearly innovative facility. As pointed out above, if these and other new facilities (the SRF, in particular) are to made more effective, they must be accompanied by better regulation, to avoid problems of excessive moral hazard. Debt standstills and orderly debt workouts would also help reduce the excessive cost borne by debtor countries in crises under present arrangements (for detailed discussions, see UNCTAD, 1998, and United Nations Task Force, 1999). However, care must be taken in designing such measures so they do not excessively discourage private flows to developing countries nor significantly increase their cost (*Soros, 2000*).

As regards Fund conditionality, it is now accepted that it should be streamlined, refocusing on IMF's central competencies (see IMF International Monetary and Financial Committee, 2000), thus reversing the trend towards increase in its areas and scope over the past two decades. Furthermore, while conditionality is clearly valuable when domestic policies are the source of macroeconomic diseliquibria that lead to balance of payments and financial difficulties, its relevance is unclear when difficulties are generated, due to external shocks such as contagion.

As *Rodrik (1999a)* clearly warned in relation to recent widening of conditionality, "An unappreciated irony is that conditionality on developing countries is being ratcheted up at precisely the moment when our comprehension of how the global economy works and what small countries need to do to prosper within it has been revealed to be strongly lacking (…) The reality is that our prescriptions often go considerably beyond what can be supported by careful theoretical reasoning or empirical demonstration". Conditionality should thus be carefully tailored to the specific circumstances of the particular balance of problem faced.

The Fund's core competence has traditionally been in macro-economic policy and has rightly been expanding into financial vulnerabilities, as their interactions with the macro-economy are strong. The new emphasis on growth and poverty reduction as a key aim for Fund programs and of countries' macroeconomic policies, especially in low-income countries, is clearly welcome, as is its greater collaboration with the World Bank on these issues. However, it should not lead the Fund into involvement in detailed poverty-related conditionality. Similarly, great care must be taken that in both middle-income and low-income countries, the large number of standards and codes of conduct, that have arisen after the Asian crisis, however useful they may be individually, do not collectively pose an excessive burden (via IMF conditionality) on countries' administration and policy-making. Indeed, it seems best if implementation of such standards remain voluntary. On the other hand, to ensure that Fund conditionality truly contributes to growth, automatic rules could be included in Fund agreements with countries to ease the restrictions of the adjustment programme, should evidence of overkill become clear.

Finally, but most importantly, the principle of ownership of policies should be respected, not just in rhetoric but in actual practice, and should cover all areas of policies, including short and long-term macroeconomic policies and poverty-reduction strategies. This can only be possible if policy alternatives suggested by the authorities are actually discussed, even if they contradict the traditional preferences of IMF and World Bank programs. Indeed, the principle of ownership can only be effectively pursued in the context of a broad policy discussion, in which these and many other institutions, including those in the developing world, that significantly overcomes the narrow range of alternatives that have been the focus of both macroeconomic and structural conditionality over the past two decades.

V. DEVELOPMENT FINANCE

Private capital flows can and should play not only an important, but hopefully a growing role in international development finance. However, there are clear and important market gaps in private lending and investing in developing countries, which can only be filled by official development assistance and multilateral lending, and there are also important circumstances where such aid and multilateral lending can help catalyse additional developmentally valuable private flows, which would otherwise not take place. It is noteworthy that many private bankers and institutional investors are aware of such limitations and welcome official flows both to fill market gaps and to help catalyse new private flows.

The unwillingness of private lenders and investors to provide long-term financing is particularly critical for low-income countries (see Table 2). This is also true of smaller economies (even middle-income ones), given that entering economies has high transaction costs. This is one factor, which would seem to explain why the share of multilateral to total external debt tends to be far higher in smaller than in larger countries. Also, private lenders and investors are less willing to channel resources to activities where the social returns may be higher than the private returns (such as education, health as sustainable development), especially in the short to medium-term, or that are riskier but developmentally essential (such as lending to the financial sector in times of crises).

Official financing is also provided on clearly advantageous terms and conditions as Table 3 indicates. Loans from both bilateral and multilateral sources have longer payback periods and lower interest rates than private credit. These characteristics are especially strong in new lending to the relatively less developed countries, but are equally valid for middle-income countries. Indeed, a very large proportion of bank lending to developing countries is very short-term –less than one year. According to BIS data, in mid-1999, the proportion of short-term lending to total bank lending for all developing countries was 49.6%, proportion that had been even higher in the previous years. As a result, any large shift from official to private sector borrowing would significantly decrease the average maturity of the debt of these countries, which would increase, in turn, the risk of volatility and reversibility of such flows.

<INCLUDE TABLE 3>

It should be added that these problems are even more acute in domestic financing. Even in certain developed economies (e.g. Greece or Portugal), but more so in middle-income countries and even more in low-income countries, domestic capital and financial markets are relatively under-developed, especially for long-term maturities, and country risk is seen as relatively higher than elsewhere, which means that only shorter maturities are available.

Not only is multilateral lending more long-term, it also tends to be counter-cyclical. During the debt crisis of the 1980s, World Bank lending increased significantly, thus helping to compensate the contractionary effects on the economy of the large falls in private lending. A similar pattern has been observed during the years of contraction in private flows to developing countries that was unleashed by the Asian crisis (see Griffith-Jones and Ocampo, 1999, Table 4).

As we will see below, the role that development banks play in this regard is complementary to that of the IMF.

Not only does multilateral lending step in to fill important market gaps; also, of clear importance, is its catalytic role in encouraging additional private flows, especially to countries (e.g. poorer and smaller countries) or sectors (e.g. infrastructure) with limited access to private finance. It can also play a useful role in supporting the renewal of capital flows after crises. The preferential relations of development banks to countries are seen as the crucial factor in reducing the risks to private lenders or investors. It should be emphasized that the financial corporations associated to development banks play an essential role in this regard. Private lenders and investors clearly appreciate and value this catalytic role.

For low-income countries, the major issue is the reversal of trends in ODA flows, particularly those originating in the largest industrialized economies. In this regard, ODA levels should meet the target of 0.7% of industrialized countries' GDP agreed upon in the framework of the United Nations. It is important that efforts to accelerate the Highly-Indebted Poor Countries (HIPC) Initiative should not crowd out new ODA financing in the budgetary processes of the industrialized countries. Official Development Assistance should also provide additional resources to support the provision of global public goods, or those with strong international externalities, including peace process, the global sustainable development agenda (climate change and conservation of biodiversity) and the fight agains the worldwide drugs problem. Recipient countries should obviously improve the efficiency and transparency with which resources are used.

Equally important, however, is the acceleration of the growth of multilateral lending. Multilateral lending should continue to play an essential role in at least four areas: (1) to channel funds to low-income countries; (2) to provide long-term financing to middle-income countries that 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 play a catalytic role for attracting additional private flows. To these we should add the traditional "value added" of multilateral financing: lending-associated technical assistance [13]/. Given the fact that old functions are still relevant and new ones (such as counter-cyclical lending) have been added, there is a case for additional resources and lending. Recent trends – whereby for example net IDA lending declined sharply – are a source of major concern.

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 with respect to low income countries, as a complement to ODA flows. It has received widespread support in recent debates. The second and third functions emphasize the role that multilateral development financing will continue to play even for middle-income countries [14]/.

The central role that multilateral banks play in the provision of counter-cyclical financing should be seen as a complement to balance-of-payments financing provided by the International

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

Monetary Fund. Indeed, financing from multilateral banks constitutes for many countries the only long-term financing that is available during crises. This type of funding is essential to smooth out necessary fiscal adjustments, averting the need to cut critical social programs and making it possible to introduce social safety nets (see below). No less important, the support provided by multilateral banks has acted, together with IMF financing, as a major catalysts in shoring up or regaining confidence in countries at times of crises and hence in helping to restore private flows. In this regard, there have been some pioneering operations aimed at guaranteeing service on public debt in bond issues made at times of great uncertainty in capital markets.

[14]/ Some authors reject, nonetheless, the validity of these arguments. The strongest argument in this regard is that of Meltzer et al. (2000) but a weaker version can be found in Gilbert, Powell and Vines (1999), who nonetheless argue that the World Bank should be allowed to lend to middle-income countries to improve its portfolio.

Table 3
DEVELOPING COUNTRIES: AVERAGE TERMS OF NEW COMMITMENTS

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Average maturity *(years)*									
Official									
All developing countries	**22.2**	**20.9**	**21.1**	**21.4**	**22.1**	**19.2**	**21.2**	**20.1**	**18.5**
Income groups									
Low income	27.0	25.9	26.8	25.4	26.2	24.4	26.8	26.2	26.6
Middle income	18.8	17.8	17.0	18.1	18.4	15.8	17.2	17.2	14.2
Private									
All developing countries	**13.9**	**10.2**	**10.0**	**9.4**	**8.9**	**7.4**	**8.3**	**10.0**	**8.8**
Income groups									
Low income	13.7	11.5	12.3	11.3	11.2	8.0	7.5	7.0	7.0
Middle income	13.9	9.9	9.0	8.4	8.1	7.2	8.6	10.8	9.0
Average interest (%)									
Official									
All developing countries	**5.5**	**5.5**	**5.3**	**4.8**	**4.9**	**5.8**	**4.8**	**5.4**	**5.2**
Income groups									
Low income	4.0	4.5	3.8	3.8	3.9	4.5	3.9	4.2	3.7
Middle income	6.6	6.1	6.4	5.6	5.8	6.7	5.6	6.0	6.0
Private									
All developing countries	**8.5**	**7.8**	**6.8**	**6.3**	**6.3**	**6.4**	**7.3**	**7.3**	**7.9**
Income groups									
Low income	7.9	7.5	6.7	6.0	5.7	6.4	6.6	6.4	6.9
Middle income	8.8	7.8	6.9	6.4	6.5	6.4	7.5	7.5	8.0

Source: World Bank (2000).

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 [15]/. Thus, if multilateral development financing is not significantly expanded, its role as a counter-cyclical device will necessarily be very limited, and it would certainly be of secondary importance relative to its first two roles, particularly the provision of long-term development financing to poor countries. This is underscored by the data from Table 2, which indicate that multilateral financing in 1992-1998 represented only 15% of that provided by the private sector, excluding FDI, and only 8% in the case of middle-income countries. Thus, a useful counter-cyclical function would certainly require a significant increase in resources available to multilateral development banks or a more active use of cofinancing and credit guarantees by these institutions.

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

Multilateral banks have been involved in the former for a long time and have also accumulated some experience with the latter. However, the preferred mechanism since the late 1980s has been social emergency funds (later transformed in many countries into more stable social investment funds). Although they have introduced some innovations in social policy (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 [16]/. 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

---

[15]/ Wolfensohn (1998).
[16]/ See, in particular, Cornia (1999).

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 [17]/. Secondly, given the heterogeneity of labour markets in developing countries, a combination of several programmes, with different target groups, is necessary [18]/. 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.

Development banks and their associated financial corporations should also act as catalysts for private resources, through three different mechanisms: guaranteeing timely payment of public debt, or the timely discharge of liabilities (in the form of guarantees or subsidies) assumed by the State in support of private projects; the direct financing or cofinancing of

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

innovative private projects, provided by the banking system directly or by the related financial corporation; and risk capital provided by the financial corporation to innovative firms [19]/. These mechanisms have been developed in a variety of ways by the banks and their corporations, and have served particularly to boost private-sector investments in infrastructure. One new mechanism could be to underwrite bond issues by countries that have not previously used this financing modality.

In all these cases, as well as in the guarantees offered on public-sector bond issues at times of crisis, private investors value not only the solidity of multilateral institutions, but also their privileged relationships with governments, which gives added value to their support, beyond the funds they provide. Guarantee mechanisms need to be carefully designed, so that they only cover those risks which the markets themselves are unwilling on their own to cover, this will lead to additionally of flows. Both multilateral lending and guarantees should only be given when projects have been carefully evaluated, and they are economically viable. Naturally the modalities used by the multilaterals to help catalyze private flows need to be reviewed and evaluated carefully, so that relevant modifications improvements and updating can be introduced to maximize their development impact and minimize any problematic effects, not least those they could have on the rating of multilateral banks.

The preferential relationship with developing countries as well as risk dispersion have resulted in multilateral development banks obtaining better risk-ratings than the countries or the regions they belong to, even when such institutions are entirely owned by developing countries

---

[18]/ Márquez (1999).

(such as the Andean Development Bank –*Corporación Andina de Fomento*). This enable them to gain access to external funds at lower cost than the countries can individually, thus performing useful intermediation activities. The overestimation of risk typical of private capital markets is another source of profitable intermediation by such institutions.

[19]/ To this we should add new mechanisms such as extending preferred creditors transations (see Standard and Poor, *Credit Week*, June 1999.

References

Agosin, Manuel (1998), "Capital inflow and investment performance: Chile in the 1990s", *Capital Inflows and Investment Performance: Lessons from Latin America*, Ricardo Ffrench-Davis and Helmut Reisen (eds.), Paris, OECD Development Centre/Economic Commission for Latin America and the Caribbean (ECLAC).

Agosin, Manuel and Ricardo Ffrench-Davis (1999), "Managing capital inflows in Chile", *Short-Term Capital Flows and Economic Crises*, Stephany Griffith-Jones, Manuel F. Montes and Anwar Nasution (eds.), New York, Oxford University Press and United Nations University (UNU)/World Institute for Development Economics Research (WIDER), forthcoming.

Aizenman, Joshue and Turnovsky, Stephen J. (1999) "Reserve Requirements on Sovereign Debt In the Presence of Moral Hazards - on Debtors or Creditors?" NBER Working Paper, No. 7004.

Akyüz, Yilmaz and Andrew Cornford (1999), "Capital Flows to Developing Countries and the Reform of the International Financial System", *UNCTAD Discussion Paper*, No. 143, November.

Cailloux, Jacques and Griffith-Jones, Stephany (1999), "Global capital flows to East Asia, Surges and reversals", paper presented at the IDS workshop on Global Capital Flows, Institute of Development Studies, Brighton, 13-14 September.

Camdessus, Michel (2000), "An Agenda for the IMF at the Start of the 21st Century", *Remarks at the Council on Foreign Relations,* New York, February.

Cornia, Giovanni Andrea (1999), "Social Funds in Stabilization and Adjustment Programmes", *Research for Action*, Nº 48, Helsinki, United Nations University (UNU)/World Institute for Development Economics Research (WIDER), April.

Council on Foreign Relations, Task Force Report (1999), *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture*, Carla A. Hills and Peter G. Peterson (chairs), Morris Goldstein (Project Director), Washington, D. C., Institute for International Economics.

Culpeper, Roy (2000), Global Financial Reform: How? Why? When? Ottawa: North-South Institute

D'Arista, Jane and Griffith-Jones, Stephany (2000), The Boom of Portfolio Flows to Emerging Markets and its Regulatory Implications in S. Griffith-Jones, M. Montes and A. Nasution (eds). opcit

Eatwell, John (1996), *International Financial Liberalization: The Impact on World Development*, UNDP-Office of Development Studies Discussion Paper, Nº 12, New York, United Nations Development Programme (UNDP), September.

Eatwell, John and Lance Taylor (2000), *Global Finance at Risk: The Case for International Regulation*, forthcoming.

ECLAC (Economic Commission for Latin America and the Caribbean) (2000), *Equity, Development and Citizenship* (LC/G.2071(SES.28/3), Santiago, Chile, March.

_____ (1998), *The Fiscal Covenant: Strengths, Weaknesses, Challenges*, (LC/G.1997/Rev.1), Santiago, April.

Eichengreen, Barry (1999), *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*, Washington, D. C., Institute for International Economics (IIE).

Ffrench-Davis, Ricardo (1999), *Reforming the Reforms in Latin America: Macroeconomics, Trade, Finance*, London, Macmillan, forthcoming.

FSF (2000a), Working Group Report on Highly Leveraged Institutions.

(2000b), Working Group Report on Offshore Centers.,

Greenspan, Alan (1998), Remarks before the 34th Annual Conference of the Federal Reserve Bank of Chicago, May 7th.

Griffith-Jones, Stephany (2000), *"An International Financial Architecture for Crises Prevention", Financial Crises in 'Successful' Emerging Economies, Ricardo Ffrench-Davis (ed.), ECLAC/Ford Foundation Project, forthcoming.*

______(1998), *Global Capital Flows, Should They Be Regulated?*, London, Macmillan.

______(1993), *Loan Guarantees for Large Infrastructure Projects Commission of the European Communities.*

Griffith-Jones, Stephany, José Antonio Ocampo with Jacques Cailloux (1999), *The Poorest Countries and the Emerging International Financial Architecture*, Expert Group on Development Issues (EGDI), Stockholm.

Grilli, Vittorio and Gian Maria Milesi-Ferretti (1995), "Economic Effects and Structural Determinants of Capital Controls", *IMF Staff Papers*, vol. 42, n.3, September.

Group of 7 (1998), *Declaration of G-7 Finance Ministers and Central Bank Governors*, 30 October.

Group of 24 (2000), *Communiqué*, 23 September.

Helleiner, Gerry (1999), “Financial markets, crises and contagion: issues for smaller countries in the FTAA and Post-Lomé IV negotiations”, paper prepared for the Caribbean Regional Negotiating Machinery, Kingston, Jamaica, January.

_____ (1997), “Capital account regimes and the developing countries”, *International Monetary and Financial Issues for the 1990s*, vol. 8, New York, United Nations Conference on Trade and Development (UNCTAD).

IMF (2000a), *Report of the Acting Managing Director to the International Monetary and Financial Committee on Progress in Reforming the IMF and Strengthening the Architecture of the International Financial System*, Washington, D. C., April.

_____ (2000b), *Report of the Acting Managing Director to the International Monetary and Financial Committee on Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF*, Washington, D. C., September.

_____ (1999), *Report of the Acting Managing Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System*, Washington, D. C., September.

_____ (1998), *Toward a Framework for Financial Stability*, Washington, D. C.

IMF International Monetary and Financial Committee (2000), *Communiqué*, 24 September.

IOSCO (1998), *Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets*, September.

J. P. Morgan (1998), *World Financial Markets*, New York, 7 October.

Kaminsky, G Schmukler, and Lyon, R (1999), Managers, Investors and Crises: Mutual Fund Strategies in Emerging Markets, Mimeo. World Bank. Washington DC.

Krugman, Paul (1998), “The Eternal Triangle”, Cambridge, Massachusetts, Massachusetts Institute of Technology (MIT), unpublished.

_____ (1998), “Curfews on Capital Flight: What are the Options?”, Cambridge, Massachusetts, Massachusetts Institute of Technology (MIT), unpublished.

Le Fort, Guillermo and Sergio Lehmann (2000), "El encaje, los flujos de capitales y el gasto: una evaluación empírica", *Documento de Trabajo* Nº 64, Central Bank of Chile, February.

Márquez, Gustavo (1999), “Labor Markets and Income Support: What Did We Learn from the Crises?”, Washington, D.C., Inter-American Development Bank (IDB), unpublished.

Meltzer, Allan H. (chair) (2000), Report to the US Congress of the International Financial Advisory Commission, March.

Miyazawa, Kiichi (1998), "Towards a New International Financial Architecture", *Speech at the Foreign Correspondents Club of Japan*, 15 December.

Mohammed, Aziz Ali (1999), "Adequacy of liquidity in the current international financial environment", *Studies on International Monetary and Financial Issues for the Group of Twenty-Four,* Intergovernmental Group of Twenty-Four on International Monetary Affairs, April.

Ocampo, José Antonio (2000), "Developing Countries' Anti-Cyclical Policies in a Globalized World", *Temas de Coyuntura Series*, N° 13, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), October.

Ocampo, José Antonio (2000), "Reforming the International Financial Architecture: Consensus and Divergence", in Deepak Nayyar (ed.), *New Roles and Functions of the UN and the Bretton Woods Institutions,* forthcoming.

______(1999), *La reforma de un sistema financiero internacional: un debate en marcha,* Fondo de Cultura Económica/Economic Commission for Latin America and the Caribbean (ECLAC).

Ocampo, José Antonio and Camilo Tovar (1999), *Price-Based Capital Account Regulations: The Colombian Experience*, Financiamiento del desarrollo series, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), forthcoming.

Reisen, Helmut (1999), "After the Great Asian Slump: Towards a Coherent Approach to Global Capital Flows", OECD Development Centre, Paris, OECD Policy Brief No.16.

Reisen, Helmut and von Maltzan, Julia (1999), "Boom and Bust and Sovereign Ratings", International Finance v.2, n.2 (July): (273-93)

______(1999), "Governing the Global Economy: Does One Architectural Style Fit All?", paper prepared for the Brookings Institution Trade Policy Forum Conference on Governing in a Global Economy, 15-16 April.

Rodrik, Dani (1999), "The New Global Economy and Developing Countries: Making Openness Work", *Policy Essay*, N° 24, Washington, D. C., Overseas Development Council.

______(1998), "Who needs capital account convertibility?", *Essays in International Finance*, Nº 207, Princeton, Department of Economics, Princeton University.

Rubin, Robert E. (1999), "Remarks of the Treasury Secretary on Reform of the International Financial Architecture to the School of Advance International Studies", *Treasury News*, Office of Public Affairs, 21 April.

Soros, George (2000), Open Society: Reforming Global Capitalism. New York: Public Affairs, First Ed.

Summers, Larry (2000), "International Financial Crises: Causes, Prevention, and Cures", American Economic Review, v90, n.2 (May), 1 - 16

Turner, Philip (2000), "Procyclicality of regulatory ratios?", in John Eatwell and Lance Taylor (eds.), Oxford University Press, New York, forthcoming.

UNCTAD (United Nations Conference on Trade and Development) (1999), *Trade and Development Report*, *1999* (UNCTAD/TDR/1999), Geneva.

_____ (1998), *Trade and Development Report, 1998* (UNCTAD/TDR/1998), Geneva. United Nations publication, Sales Nº E.98.II.D.6.

United Nations Task Force of the Executive Committee of Economic and Social Affairs (1999), *Towards a New International Financial Architecture, Report of the Task Force of the United Nations Executive Committee of Economic and Social Affairs* (LC/G.2054), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), March.

Villar, Leonardo and Hernán Rincón (2000), "The Colombian Economy in the Nineties: Capital Flows and Foreign Exchange Regimes", paper prepared for the conference "Critical Issues in Financial Reform: Latin American, Caribbean and Canadian Perspectives", organized by The Munk Centre for International Studies Programme on Latin America and the Caribbean, Toronto, University of Toronto, June.

White, William R. (2000a), "New Strategies for Dealing with the Instability of Financial Markets", *The Management of Global Financial Markets*, Jan Joost Teunissen (ed.), The Hague, FONDAD.

_____ (2000b), "Recent Initiatives to Improve the Regulation and Supervision of Private Capital Flows", paper prepared for FONDAD's Conference on Crisis Prevention and Response: Where Do We Stand with the Debate on Reform of the International Financial Architecture?, The Hague, Ministry of Foreign Affairs, June.

Williamson, John (2000), "Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option", *Policy Analyses in International Economics* 60, Institute for International Economics, Washington, D.C., September.

World Bank (2000), *Global Development Finance, 2000*, Washington, D. C., April.

_____ (1999), *Global Development Finance*, *1999*, Washington, D.C., March.

_____ (1998), *Global Economic Prospects and the Developing Countries, 1998-99*, Washington, D. C., December.

Wyplosz, Charles (1999), “International Financial Instability”, *In Global Public Goods: International Cooperation in the 21st Century*, Inge Kaul, Isabelle Grunberg and Marc A. Stern (eds.), New York, United Nations Development Programme (UNDP), Oxford University Press.