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The Poorest Countries and the Emerging International Financial Architecture

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List of acronyms

BIS	Bank for International Settlements
CAF	Andean Development Bank
CCL	Credit contingency line
ECLAC	Economic Commission for the Latin American and the Caribbean
ESAF	Enhanced Structural Adjustment Facility
FDI	Foreign Direct Investments
FSF	Financial Stability Forum
GDDS	General Data Dissemination System
GDP	Gross domestic product
HIPC	Heavily indebted poor countries
HLI	Highly leveraged institution
IAIS	International Association of Insurance Supervisors
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IIF	Institute of International Finance
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
LICs	Lower income countries
ODA	Official Development Assistance
OED	Operations Evaluation Department, World Bank
PINs	Public Information Notices
SDDS	Special Data Dissemination Standard
SDR	Special drawing rights (of the IMF)
UN	The United Nations
WB	The World Bank
WFP	World Food Programme
WTO	World Trade Organisation

Executive summary

Private capital flows have tended to concentrate in middle-income countries, with the share of private flows to low-income countries being clearly lower than the low-income countries' share of all developing countries' GDP. This is problematic in many respects. However, it has implied that the low-income countries have suffered less directly from issues of capital flow volatility and contagion in recent crises.

As regards public flows, low-income countries are – naturally – the major recipients of official development assistance (ODA), particularly grants, which are given mainly bilaterally. Of World Bank and IDA lending, a fairly high proportion has also gone to low-income countries. However, the declining level of World Bank lending in the 1990s (and especially in the 1995–97 period) has implied declines in loans to low-income countries.

IMF lending shows a striking pattern in that it has been very anti-cyclical (in relation to private flows) and has increasingly concentrated on a few large borrowers: the countries suffering major currency crises. Large IMF lending substitutes for private financing when it collapses or reverses. This has implied a concentration of official liquidity financing in middle-income countries. The very elastic supply of official liquidity to a few large, mainly middle- and high-income countries due to their needs in times of crises, raises serious worries as to the global rationality with which global capital flows, including official ones, are allocated. If a new financial architecture is implemented, and if it is effective in reducing or significantly moderating currency crises, then this somewhat perverse pattern of flows can be reversed, and more attention devoted to the needs of low-income countries.

There are two important transmission channels in the wave of the contagion that affected low-income countries in 1997 and 1998. Firstly, through volumes and prices of international trade in commodities. Secondly, through international capital flows. The low-income countries have mostly been less affected by the Asian crisis when compared to middle-income countries, particularly due to the lack of integration with international capital markets. However, a complete assessment of the impact of the crisis on Africa is still premature. Further adverse effects on the terms of trade of some countries are expected throughout 1999 with a possible recovery only in 2000. In addition, there are diminished prospects of a return to the same increasing levels of foreign financial flows to the region as before the crisis.

In the short-term, there is an urgent need to reverse declines of ODA to low-income countries, to accelerate again multilateral lending to them, facilitate their access to the more stable forms of private flows (especially foreign direct investments, FDI), as well as significantly reduce heavily indebted poor countries' (HIPC) debt. More broadly, there is a clear gap in current discussions of a new financial architecture in that these – and other – crucial issues of development finance, of particular significance to low-income countries,

have not been included. Other issues include improving the access by low-income countries to private finance, via mechanisms such as guarantees.

These issues must be directly integrated into the current discussion of a new financial architecture. This implies that separate, but linked, studies, task forces etc. are organised (with large participation from the low-income countries, but also from Bretton Woods institutions, donor governments and the UN) on the major issues of development finance. The result of these studies and task forces would then be integrated into a broader international financial architecture, which would facilitate appropriate flows (both in terms of scale and stability), to both middle- and low-income countries. A positive feature is that a fairly significant proportion of the proposals on the table by spring 1998, have either been seriously studied or actually began to be implemented. This is particularly true for those proposals that do not require significant institutional innovation.

Amongst the most positive steps is the creation of the Financial Stability Forum (FSF), the creation of new facilities of the IMF (including most recently and significantly the Credit Contingency Line, the CCL), as well as improvements in information, particularly on developing countries. However, the ways in which each of these has been implemented have serious limitations. Furthermore, in the area of internationally sanctioned standstill arrangements and the required amendment of bond clauses, little actual action has taken place, though the discussion has become increasingly more specific and certain consensus seems to be broadly emerging.

The rapid initiation of the FSF is an important step forward in the global regulation of private flows. However, the current lack of participation of developing countries in the decision-making FSF is a serious limitation, even though these countries do participate in the Working Groups, where important work is beginning. Participation of developing countries, including low-income ones, in the FSF is urgent, as they are the main victims of the volatility that the FSF is attempting to stem. Secondly, the FSF may need to be strengthened in its decision-making power, as its purely co-ordinating and consensus-seeking role may not be sufficiently strong in the future.

Thirdly, it is unfortunate that certain regulatory changes have taken so long to be made. An example it the modification on capital adequacy rules to reduce regulatory incentives for short-term bank lending to developing countries, on which very broad consensus has been reached. Fourthly, the initial priority areas of work (highly leveraged institutions, offshore centres and curbing volatility of short-term flows) are extremely important; however, other areas – such as evaluating prudential regulation of other institutional investors, for example, mutual funds, could be usefully added.

The creation of the CCL is also potentially an important step forward to limit contagion, by encouraging countries to adopt policies that will discourage crises and by signalling to the markets that this facility is available. Both may help to avoid crises. However, there are several concerns regarding the

way the CCL is being structured. Firstly, would the scale be sufficient to stem a crisis? Would low-income countries also receive CCL support if they were hit by a contagion-caused crisis? Secondly, why is disbursement – in the stage of crisis threat – not automatic, for countries that have pre-qualified? Thirdly, why is the CCL not open to countries with current or expected regular IMF financing? Fourthly, will conditions be too restrictive, and thus make countries unwilling to negotiate CCL? Careful monitoring of evolution of the CCL and its use is required, as well as continuous analysis on the complex issue of how official liquidity best can be used in emergency financing.

Much useful progress has also been made on improving information on developing countries, which hopefully will help markets and policy-makers take better decisions. However, the possibilities and benefits of improved information have very important limits, both due to asymmetries of information and because of the significance of how information is processed. Furthermore, more limited progress has till now been made on the equally important issue of improving information on international financial markets. The latter is extremely important, and further initiatives need to be taken by the Bank for International Settlements (BIS) and the FSF. Low-income countries should have easy access to this new information on international capital markets. Much emphasis has also been placed on the development of numerous standards, and their implementation by developing countries. A source of concern is that developing countries – especially low-income ones – do not on the whole participate much in the definition of those standards, though they are being asked to implement them. Both meeting standards and enhancing information puts an important burden on developing countries, especially low-income ones. As a consequence, technical assistance in this field, especially to the poorer countries, is a priority.

On the issue of emergency measures involving the private sector during crises, some limited progress has been made, especially as regards broadening the power of IMF lending into arrears and the arrangement of concerted rollover of credit for Brazil and Korea. However, the larger issues have not yet been tackled, both because of their complexity and because of different interests and perspectives involved. Concrete progress needs to be made on orderly debt work-outs, including particularly changes in bond covenants; interestingly UK-issued bonds already have more flexible clauses, and these do not as yet carry higher spreads; this provides a very important precedent for modifying clauses in US and German bonds. It is important that changes in these clauses are introduced both by developed and developing country borrowers, to avoid stigmatising and marginalising developing country borrowers. In particular, modifying bond contracts should not be imposed by IMF conditionality on developing country debtors, as has been suggested. Developing countries need to have the freedom to decide whether they want to modify them, assessing carefully costs and benefits of such a measure. The costs include possible reduction in access to bond markets and possible in-

creases in spreads, whereas the benefits include greater flexibility and better burden-sharing in times of crises. As regards internationally sanctioned standstills, even less progress has been made, though a number of interesting proposal have emerged on mechanisms, modalities and institutional arrangements.

There is still much to do on financial architecture. This is particularly so because recent crises have had an unacceptably high cost in terms of interrupting and – sometimes – reversing growth and development, increasing poverty, and discouraging future private investment, both by national and foreign investors. These currency crises also distract the international official community from the crucial task of increasing and improving official flows to low-income countries, which need to play a continued role in helping their growth and in supporting poverty alleviation in them.

Though our report focuses more on issues of international measures to prevent and better manage crises, clearly these need to be complemented by national measures, both in the prudential and capital account regulatory areas and in macro-economic policy. These measures include prudent regulation of domestic financial systems. Moreover, adequate regulation and control of capital flows are also ingredients. These measures are important for low-income countries, even though they do not receive very large private flows. Indeed, even relatively small private volatile flows could destabilise small, low-income countries (with disastrous effects on poverty). Learning to manage sharp financial cycles with adequate policies is a slow process that needs accumulation of experience since the early stages of development, to avoid costly mistakes later on. Prudence in the liberalisation of certain categories of capital flows (the more volatile ones) to avoid excessive surges of such flows may be an important area, where low-income countries may benefit from being late-comers to the game. This should help minimise low-income countries' vulnerability to currency crises, which would be particularly costly for them as so many of their people are so close to their poverty line.

More generally, the traditional emphasis on crisis management needs to be changed to the management of booms, since it is in the periods of euphoria from capital inflows and terms of trade improvement that crises are incubated. This implies introducing stronger counter-cyclical elements in the following areas:

(1) Macro-economic policy, by fiscal targeting of the sustainability of public sector debt ratios throughout the cycle. This will imply fiscal tightening in the upswing and some loosening in the downswing. Anti-cyclical fiscal devises can include fiscal stabilisation funds based on temporary public sector revenues, to be saved during booms and well-designed social safety nets that would be particularly valuable in times of crises. This would reduce spending during the boom and increase it during crises.
(2) Strengthening as well as increasing counter-cyclical elements of financial regulation and supervision, to prevent excessive risk taking. Indeed, pru-

dential regulation must take into account not only the micro- but also the macro-economic risks typical for developing countries in an increasingly globalised and volatile world. Firm as well as total debt exposures need to be carefully monitored, as well as their profiles, to prevent vulnerability to crises.

(3) If excessive short-term, potentially reversible, capital flows enter the economy, measures – such as Chilean style or Colombian style reserve requirements – clearly need to be taken. Furthermore, a permanent system of reasonable capital account regulations, which is strengthened or loosened throughout the cycle, is preferable to free capital movements during booms and quantitative controls during crises. This is especially so, since the latter may be ineffective or counter productive, and will lack adequate institutional backing.

There is one area of macro-economic policy, both in developing countries in general and for low-income countries, where further research is urgently required. This is the area of the appropriate exchange rate policy for small, increasingly open economies in a world of large global capital flows. These flows provide new sources of volatility to developing countries, and may further magnify the traditional source of volatility, i.e. terms of trade shocks.

1. Introduction

The current functioning of the international financial system is clearly unsatisfactory. It leads to recurrent financial crises, which have very high development and social costs. It concentrates private flows in a few emerging countries and it may thus further marginalise the poorest countries in the context of the current "aid fatigue". Through both channels, it risks undermining the still moderate achievements associated to the restructuring of development strategies.

An important distinction has arisen in the ongoing debate between foreign direct investment and other long-term capital flows, and excessive short-term, easily reversible capital flows. The former are widely seen as having net positive development effects, while the latter can cause or contribute to developmentally costly currency crises (Griffith-Jones *et. al.*, 1998). A new financial architecture must contribute to encourage the former, whilst curbing the negative effects of the latter. It must also encourage increasing long-term flows towards the poorest countries.

As a result of the Asian crisis – which spread to other emerging markets – a broad consensus has emerged on the need and the urgency for reforming the international financial system. Though quite important progress has been made, there is however lack of agreement and precision in proposals on the exact nature of the changes required. Furthermore, in the discussion of the new financial architecture, there is hardly any emphasis on meeting the needs of the poorest countries (the so-called HIPCs, i.e. the heavily indebted poor countries, as well as the other poor countries). Indeed, it is important to recognise that the discussion on the new financial architecture has not focussed on all aspects of the international financial system, which are of central concern to developing countries, especially low-income ones (Ahluwalia, 1999). Thus, issues such as the high burden of debt for many low-income countries, declining levels of aid, stagnation of official flows and the limited access that many developing countries (particularly the poorer and smaller ones) have to private capital flows, have not been the focus of the new architecture discussions. This paper aims to contribute to the discussion, both by making more precise and comprehensive proposals and by taking account of the needs of the poorest countries. We will also suggest further studies and action relating specifically to the needs of the low-income countries.

Section 2 defines the context by outlining the links between the poorer countries and the international financial system. It examines the broad picture of capital flows to poorer countries, and also the indirect impact of currency crises in middle-income countries on private flows and terms of trade of poorer countries. It also raises some of the key policy issues for low-income countries. Section 3 looks at improved transparency and information on developing countries, as one way to prevent currency crises; however, the limits of this approach are also analysed, and the need for improved transpar-

ency on international financial markets. Section 4 deals with the other mechanism to prevent crises – better regulation nationally as well as internationally. At the domestic level, it analyses the need for counter-cyclical elements both in domestic regulatory and macro-economic policy. At the international level, it examines the need to fill global regulatory gaps, as well as discussing the recently created Financial Stability Forum (FSF). Section 5 deals with the provision of official liquidity in times of crises. The discussion includes an analysis of the recently created Contingency Credit Line (CCL). Section 6 brings forth some points concerning conditionality in the process of providing international liquidity. Section 7 deals with involving the private sector, both in crisis prevention, for example, via private contingency credit, as well as in crisis management, for example, via amendment of bond clauses or via standstill arrangements. Section 8 concludes briefly.

2. International capital flows and low-income countries

2.1 General trends

International capital flows to developing countries have exhibited four outstanding features in the 1990s. First of all, foreign direct investment (FDI) and all types of private financial capital flows have experienced an extraordinary growth. Secondly, these flows have exhibited a striking difference in terms of stability: whereas FDI have been more resilient in the face of crises, other private financial flows have experienced strong "volatility" and "contagion" effects and in fact have sparked off several currency and domestic financial crises. Thirdly, the instability of private financial flows has required the design of major emergency financial packages, of unprecedented size, which have been funded by both the International Monetary Fund (IMF) and bilateral sources; multilateral development banks have also contributed to emergency packages, but on a relatively smaller scale. Fourthly, official development finance has lagged behind, particularly bilateral aid. Indeed, bilateral aid has fallen in real terms throughout the decade, and in 1998 it is estimated to have reached 0.22 percent of the gross domestic product (GDP) of industrialised countries, a significant fall with respect to the 0.35 percent of GDP reached in the mid-1980s. The reduction in bilateral aid has been stronger in the case of the largest industrialised countries and has been only partly compensated by the increasing share of grants in official development assistance. Table 1 shows some of these major trends in international capital flows in the 1990s.[1]

Table 1. Net long-term resource flows to developing countries, 1990–1998 (billion USD)

	1990	1991	1992	1993	1994	1995	1996	1997	1998a/
Net long-term resource flows	**100.8**	**123.1**	**1 52.3**	**220.2**	**223.6**	**254.9**	**308.1**	**338.1**	**275.0**
Official flows	56.9	62.6	54.0	53.3	45.5	53.4	32.2	39.1	47.9
Private flows	43.9	60.5	98.3	167.0	178.1	201.5	275.9	299.0	227.1
From international capital markets	19.4	26.2	52.2	100.0	89.6	96.1	149.5	135.5	72.1
Private debt flows	15.7	18.6	38.1	49.0	54.4	60.0	100.3	105.3	58.0
Commercial banks	3.2	4.8	16.3	3.3	13.9	32.4	43.7	60.1	25.1
Bonds	1.2	10.8	11.1	37.0	36.7	26.6	53.5	42.6	30.2
Others	11.4	3.0	10.7	8.6	3.7	1.0	3.0	2.6	2.7
Portfolio equity flows	3.7	7.6	14.1	51.0	35.2	36.1	49.2	30.2	14.1
Foreign direct invest	24.5	34.4	46.1	67.0	88.5	105.4	126.4	163.4	155.0

Note: Net long-term resource flows are defined as net liability transactions of original maturity greater than one year. Although the Republic of Korea is a high-income country, it is included in the developing country aggregate since it is a borrower from the World Bank.
a/ Preliminary.
Source: World Bank, 1999.

[1] For a full evaluation of recent trends, see World Bank (1999).

Table 2. Net flow of resources, 1992–1997 (Annual averages, billion USD and percentages)

	Direct foreign investment		Portofolio equilty flows		Grants		Bilateral financing		Multilateral financing (excluding IMF)	
	Amount	Per-centage	Amount	Per-centage	Amount	Per-centage	Amount	Per-centage	Amount	Per-centage
Developing countries	**99.0**	**100.0**	**35.7**	**100.0**	**29.7**	**100.0**	**2.9**	**100.0**	**13.7**	**100.0**
Excluding China	66.8	67.5	31.7	88.9	29.4	99.0	0.5	19.0	11.6	84.5
Low income countries	**6.7**	**6.8**	**3.4**	**9.5**	**15.8**	**53.2**	**0.8**	**27.1**	**5.9**	**43.4**
India	1.6	1.6	2.5	6.9	0.6	1.9	–0.3	–11.3	1.0	7.4
Other countries	5.1	5.2	0.9	2.6	15.2	51.3	1.1	38.4	4.9	36.0
China a/	**32.1**	**32.5**	**3.9**	**11.1**	**0.3**	**1.0**	**2.3**	**81.0**	**2.1**	**15.5**
Middle income countries	**60.1**	**60.8**	**28.3**	**79.4**	**13.7**	**46.1**	**–0.2**	**–8.1**	**5.6**	**41.1**
Argentina	4.4	4.5	1.7	4.9	0.0	0.1	–0.1	–3.2	0.9	6.6
Brazil	7.7	7.7	4.1	11.5	0.1	0.2	–1.3	–43.4	–0.1	–0.6
Russian Federation	1.9	1.9	1.1	3.1	1.1	3.7	0.6	21.4	0.9	6.2
Indonesia	3.5	3.6	2.4	6.8	0.2	0.8	1.2	41.7	0.1	0.9
Korea Republic b/	1.5	1.5	3.1	8.8	0.0	0.0	–0.2	–5.4	0.6	4.1
Mexico	8.1	8.2	5.1	14.3	0.0	0.1	–0.6	–21.4	0.3	2.2
Other countries	33.0	33.3	10.7	30.1	12.2	41.2	0.1	2.2	3.0	21.7

Table 2. *(continued)*

	Bonds		Commercial bank loans		Other loans		Total		Memo: GDP	Memo: Population
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	Percentage	Percentage
Developing countries	**34.6**	**100.0**	**28.3**	**100.0**	**4.9**	**100.0**	**248.7**	**100.0**	**100.0**	**100.0**
Excluding China	32.9	95.2	26.6	94.0	1.1	21.4	200.7	80.7	89.2	74.8
Low income countries	**0.5**	**1.5**	**0.9**	**3.3**	**0.4**	**7.2**	**34.5**	**13.9**	**11.4**	**41.0**
India	0.4	1.1	0.8	2.8	0.4	8.9	6.9	2.8	5.6	19.3
Other countries	0.2	0.4	0.2	0.6	–0.1	–1.7	27.6	11.1	5.8	21.7
China a/	**1.7**	**4.8**	**1.7**	**6.0**	**3.9**	**78.6**	**48.0**	**19.3**	**10.8**	**25.2**
Middle income countries	**32.4**	**93.7**	**25.7**	**90.7**	**0.7**	**14.2**	**166.3**	**66.9**	**77.8**	**33.9**
Argentina	5.5	15.9	0.8	2.9	0.0	–0.9	13.3	5.3	5.0	0.7
Brazil	3.1	9.0	8.2	29.0	–0.6	–11.3	21.2	8.5	10.5	3.3
Russian Federation	0.8	2.2	0.3	1.1	1.4	28.7	8.1	3.2	7.3	3.1
Indonesia	1.6	4.7	0.9	3.2	0.2	3.7	10.2	4.1	3.4	4.0
Korea Republic b/	4.5	12.9	4.1	14.5	–0.2	–4.8	13.4	5.4	7.3	0.9
Mexico	5.2	15.2	0.3	1.1	–0.3	–6.9	18.2	7.3	6.7	1.9
Other countries	11.7	33.8	11.0	38.9	0.3	5.6	81.9	32.9	37.6	19.8

a/ The World Bank considered China as a low income country until 1998. Since 1999 it is included as a middle income Country. In this Table it is considered as a different category.

b/ The World Bank considers it as a high income country, but it is included as a middle income country in the Global Development Finance 1999.

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

Different capital flows have had strikingly different destinations, as Table 2 indicates. Private capital flows have concentrated in middle-income countries. The share of low-income countries in private financing has been lower than their share in the total population of developing countries, a fact that may be expected, but also lower than their share in developing countries' total GDP. This fact is particularly striking in bond financing, commercial banking flows and portfolio flows, if India is excluded in the latter case. In all of these cases, private financing to poor countries is minimal (3 percent of financing received by developing countries as a whole). The share of low-income countries in FDI is also smaller than their contribution to developing countries' GDP. Indeed, 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 more volatile flows in middle-income countries, excluding China, has implied, in turn, that issues of financial volatility and contagion have been more relevant to them, with poorer countries being mainly affected by the effects of financial crises on trade, including commodity prices.

2.2 Official flows to poorer countries

Low-income countries are, naturally, the major recipients of official development assistance, particularly grants, mostly in the form of bilateral aid. If we again exclude India, grants are 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). Bilateral financing, which is a relatively small source of financing, is highly concentrated in China.

A more detailed analysis of World Bank and IMF financing (including the International Development Association, IDA, and the Enhanced Structural Adjustment Facility, ESAF, respectively) is presented in Tables 3 and 4.[2] The weight of a few large borrowers is important. Seven major borrowing countries, which are the largest borrowers of the IMF and the World Bank (China, India, Indonesia, Russia, Argentina, Brazil and Mexico) are thus singled out for this analysis.[3]

World Bank financing grew rapidly till the late 1980s but has tended to slow down in the 1990s. It has experienced a rapid growth during the recent

[2] The original data refers to the stock of disbursed debt, net of amortisation. The manufacturing export unit value of industrialised countries has been used to convert the series into 1995 dollars. What we term net real flows thus refer to variations in real stocks. Aside from new disbursements and amortisation, they thus capture the effect of world inflation on real stocks.
[3] It must be pointed out that the relative importance of these countries varies considerably in the case of World Bank vs. IMF financing. Thus, for example, China is an important net borrower from the World Bank but not from the IMF.

Table 3. Net real flows, IMF-ESAF a/ (million USD, 1995)

	1970–74	1975–79	1980–84	1985–89	1990–94	1995–97
Low income	**847.0**	**348.2**	**3144.4**	**–1965.2**	**853.3**	**–1114.0**
India	407.7	–326.2	1515.0	–1137.2	573.5	–1333.6
East Asia Pacific	13.4	22.9	–0.6	–10.4	56.8	87.1
Europe & Central Asia	0.0	0.0	0.0	0.0	70.8	216.5
Latin America & Caribbean	14.7	10.4	58.5	–70.1	24.7	–27.7
Middle East & North Africa	7.2	10.8	0.1	–16.4	–0.2	94.8
South Asia exc. India	261.7	65.2	346.0	–241.0	92.1	–200.4
Sub-Saharan Africa	142.3	565.1	1225.5	–490.0	35.6	49.3
Low middle income	**2.0**	**1089.4**	**1910.3**	**–1310.9**	**984.6**	**6423.7**
China	0.0	0.0	103.0	116.0	–219.0	0.0
Indonesia	–121.9	0.0	140.4	6.3	–146.7	1126.4
Russian Federation	0.0	0.0	0.0	0.0	926.1	3474.3
East Asia Pacific exc. China, Indonesia	–5.9	352.5	232.2	–277.1	–113.0	866.6
Europe & Central Asia exc. Russian Federation	149.9	133.9	726.7	–815.0	611.0	887.2
Latin America & Caribbean	–25.0	327.2	527.4	–327.5	–71.6	–144.5
Middle East & North Africa	–8.1	209.3	165.9	42.8	–52.2	277.0
South Asia	12.9	64.9	7.1	–49.4	47.8	–62.6
Sub-Saharan Africa	0.0	1.6	7.6	–7.0	2.2	–0.5
Upper middle income	**149.1**	**154.1**	**3567.6**	**–530.5**	**155.3**	**1109.2**
Argentina	51.3	–41.0	373.3	374.5	181.1	677.2
Brasil	0.0	0.0	1422.9	–838.3	–543.5	–56.6
Mexico	0.0	44.2	758.2	425.7	–376.6	2027.4
East Asia Pacific	0.0	0.0	87.7	–87.7	0.0	0.0
Europe & Central Asia	–64.9	205.7	603.1	–687.3	684.9	–855.0
Latin America & Caribbean exc Argentina, Brasil, Mexico	162.7	–82.1	294.9	289.5	39.3	–527.9
Middle East & North Africa	0.0	0.0	0.0	0.0	0.0	0.0
South Asia	0.0	0.0	0.0	0.0	0.0	0.0
Sub-Saharan Africa	0.0	27.3	27.4	–7.0	170.0	–155.8
High income (Korea, Slovenia)	**88.6**	**–26.2**	**488.6**	**–533.3**	**0.0**	**4195.9**
Total	**1086.7**	**1565.5**	**9110.8**	**–4339.9**	**1993.2**	**10614.8**

a/ Data was converted into 1995 US dollars using the index of industrial countries.
Source: World Bank, 1999.

Table 4. Net real flows, IBRD-IDA a/ (million USD 1995) b/

	1970–74	1975–79	1980–84	1985–89	1990–94	1995–97
Low income	**1033.5**	**965.1**	**4228.0**	**3910.6**	**5077.6**	**1811.7**
India	456.8	239.7	1778.5	1136.9	1734.2	–704.4
East Asia Pacific	–7.2	35.9	106.3	47.1	101.7	220.3
Europe & Central Asia	0.0	0.0	0.0	0.0	51.0	290.9
Latin America & Caribbean	13.2	47.4	126.8	47.8	35.0	81.6
Middle East & North Africa	2.6	33.3	64.5	31.8	40.4	67.4
South Asia exc. India	157.0	85.5	557.9	596.1	937.5	524.0
Sub-Saharan Africa	411.1	523.4	1594.0	2051.0	2178.0	1331.8
Low middle income	**529.1**	**1383.5**	**3611.2**	**3451.9**	**2623.9**	**3210.6**
China	0.0	0.0	86.4	1029.3	1538.1	1671.0
Indonesia	134.4	299.8	669.0	1186.8	553.5	–640.1
Russian Federation	0.0	0.0	0.0	0.0	150.9	1664.8
East Asia Pacific exc. China, Indonesia	64.9	230.4	844.6	210.5	104.4	–193.2
Europe & Central Asia exc. Russian Federation	65.6	339.6	509.5	–494.9	69.7	1057.2
Latin America & Caribbean	132.1	103.1	684.0	746.1	–335.0	–164.9
Middle East & North Africa	119.7	402.0	721.5	691.5	418.1	–265.8
South Asia	15.1	5.0	88.0	67.2	123.1	76.4
Sub-Saharan Africa	–2.6	3.6	8.2	15.4	1.1	5.1
Upper middle income	**633.1**	**248.6**	**1908.7**	**3210.0**	**1606.1**	**–1303.7**
Argentina	64.9	–59.6	51.7	379.2	356.2	572.8
Brasil	359.3	149.8	767.7	655.5	–612.7	–142.4
Mexico	129.6	50.7	407.1	917.0	989.5	–487.0
East Asia Pacific	25.0	26.7	70.3	21.2	9.5	–123.6
Europe & Central Asia	100.2	147.7	569.7	841.5	462.8	–575.4
Latin America & Caribbean exc Argentina, Brasil, Mexico	–50.4	–102.1	3.9	362.1	413.3	–524.6
Middle East & North Africa	–10.3	2.5	10.3	1.2	–0.6	26.5
South Asia	0.0	0.0	0.0	0.0	0.0	0.0
Sub-Saharan Africa	14.7	5.9	27.8	32.2	–11.8	–50.2
High income (Korea, Slovenia)	**165.5**	**377.7**	**530.3**	**–218.8**	**–303.2**	**830.3**
Total	**2361.2**	**2975.0**	**10278.1**	**10353.8**	**9004.5**	**4548.9**

a/ Net flows of outstanding debt
b/ Data was converted into 1995 US dollars using the index of industrial countries manufactured exports (IMF index).
Source: World Bank, 1999.

crisis, a fact that is not totally captured in the data, which covers up to 1997. In the first half of the 1990s, as a whole, the rising share of low-income countries, excluding India, in net real IBRD-IDA financing is a noticeable feature. In particular, Sub-Saharan Africa considerably increased its share. However, due to the loss of dynamism of World Bank financing, after increasing rapidly till the late 1980s, net real flows to Sub-Saharan Africa stagnated in the first half of the decade and then declined significantly in 1995–97 (Table 4). China, Russia and Argentina explain the dynamism of financing to large borrowers in the 1990s. Among middle-income countries, the rapidly rising share and level of loans to Russia and other transition economies in Europe and Asia is marked in the second half of the 1990s. On the contrary, World Bank financing to Latin America and the Caribbean as a whole, as well as that to East Asia and the Pacific, which was quite dynamic in the 1980s, has lost importance in the 1990s; net real flows actually turned negative in many cases. It must be pointed out, however, that the Inter-American Development Bank has been a more important source of financing in the 1990s than it was in the previous decade, and exceeds now the World Bank in net financing to the Latin American and Caribbean region. In the case of East Asia and the Pacific, the recent crisis has given rise to new financing, which is not totally captured in the data up to 1997. Overall, therefore, IBRD-IDA Bank financing has thus been significantly less dynamic in the 1990s than in the previous decade and very moderately more progressive in its destination.

IMF-ESAF financing has shown a strikingly different pattern. Its most important features is the strong anti-cyclical behaviour (in relation to private flows), and the rising share of a few large borrowers. Both patterns are closely associated, as cyclical borrowing by a few countries is the major determinant of the overall cyclical pattern. The latter feature has actually become even more marked during the recent years. India and the three largest Latin American borrowers received 45 percent of the net flows from the IMF in the first half of the 1980s. In 1995–97, net real flows to only four large borrowers, Indonesia, Russia, Mexico and Korea, have in fact exceeded by a small margin total net real flows from the Fund (Table 3). Indeed, IMF-ESAF financing underestimates in recent years the magnitude of the concentration of emergency lending in a few large countries, as the counterpart bilateral financing to the rescue packages of six nations (the four just mentioned for the 1990s, plus Brazil and Thailand) is not included in the data.[4] As a result of this feature, IMF-ESAF financing to large borrowers has experienced a strong upward trend throughout the 1980s and 1990s. On the contrary, financing from this source to low-income countries has been small or even negative after its peak in 1980–84 (in the second half of the 1980s it was negative in

[4] It must be emphasised, however, that pledged bilateral financing tends to be disbursed in smaller proportions than the IMF and IBRD shares in the rescue packages. See World Bank (1999), Ch. 5.

the case of real stocks). IMF net real flows to low-income Sub-Saharan Africa were also negative in the second half of the 1980s, and small but positive in the 1990s.

Broadly speaking, however, "crowding out" by the largest borrowers does not seem to have taken place. IMF lending to low-income countries seems to evolve more responding to Balance of Payments needs of those economies. However, it is possible that the great deal of attention given by IMF staff to the large borrowers may distract efforts from low-income and even smaller middle-income countries. In particular, in moments when the IMF faces some liquidity constraints due to its very large lending to big borrowers, there may be less willingness to lend to low-income countries. This issue may require further research. What emerges clearly from our empirical analysis is that overall IMF-ESAF financing has responded with some elasticity to the growing needs of the few large borrowers, with financing to other poorer or middle-income countries remaining stagnant or increasing marginally if they also required additional liquidity financing. This was particularly the case in the 1980s, but has also been true in recent years for some low middle-income countries (i.e. in the East Asia and Pacific region). In any case, IMF-ESAF and counterpart bilateral liquidity financing have complemented private financing through the business cycle – they have tended to provide funds when private financing collapses or reverses. Given the high concentration of private financing in middle-income countries, this has led to a similar pattern of concentration in the case of official liquidity financing. In an era of significant scarcity of official financing of different types for low-income countries, and a relative marginalization of them from private financing, the very elastic supply of official funds to a few large, mainly middle- and high-income countries at times of crises raises significant concerns as to the global rationality with which global capital flows, and even official flows, are distributed. Indeed the emerging pattern in official flows implies that the poorest countries have even less access to global capital flows, contributing to their further marginalization.

From the point of view of low-income countries, the major issues raised by this analysis are, thus, the need to reverse trends in ODA, to accelerate the growth of multilateral lending, and to generate mechanisms that would allow their full integration into private capital markets. A necessary complement is, obviously, the need to provide a definite solution to the outstanding debt overhang of low-income countries, through the enhancement of the highly indebted poor countries (the HIPCs) or a bolder debt relief initiative, which we discuss below. All these issues have received insufficient or no attention in the discussions on a new international financial architecture, which deal mainly with the issues of preventing and better managing currency crises, that have occurred basically, in middle-income countries. It therefore seems important to more explicitly integrate the financing needs of the low-income countries in the discussion of a new financial architecture. In addition and possibly

more appropriately, it is vital to generate separate studies, commissions, and task forces on the issues of development finance for low-income countries and how those should be integrated into a new financial architecture (in the Bretton Woods institutions, the United Nations, UN, by groups of countries etc.). However, it should be stressed that the issues currently being discussed under the new financial architecture are also of relevance to low-income countries. Both because capital account led crises may increasingly affect them directly as they become more integrated into international capital markets, and because currency crises in middle-income developing countries (and their effects on the world economy) may have important negative indirect effects on low-income countries. Furthermore, if currency crises of the kind that occurred in East Asia occurred in low-income countries, the negative welfare effects would be even larger, as so many people in low-income countries are so close to the poverty line, and levels of absolute and relative poverty could increase quite dramatically.

2.3 The HIPC initiative

The current HIPC initiative has been slow in its operation due to three major problems. Firstly, there is the complexity of the process required for eligibility, which is based on the implementation of two successful ESAF programs, a fact that requires a minimum of six years to complete it. Secondly, there is the inappropriate definition of debt sustainability levels, which are based on dual (fiscal and balance of payments) criteria, with relatively high threshold levels, particularly for the ratio of debt service to fiscal revenues (25 percent). And thirdly, there is a lack of adequate funds to finance it (United Nations Task Force, 1999b). These problems are interrelated, as the lack of adequate funding had led to the adoption of more stringent access requirements. Indeed, the fairly general recognition that the Initiative is facing major problems has led in the first months of 1999 to several proposals to expand it, and to the approval, by the G-7, of the Cologne debt initiative, which provides "faster, deeper and broader debt relief".[5]

The first of the aforementioned problems relates to the issue of conditionality in international official lending. The second refers to the problems faced by inadequate debt workouts that lead to repeated renegotiations of debt. It indicates the need to be more aggressive in this area to avoid the effects of debt overhangs on investment and growth for protracted periods.

In an environment of scarcity of Official Development Assistance (ODA) funds, financing for the HIPC Initiative has tended to crowd out new ODA flows in the budget allocation process of industrialized nations. This is regrettable, as new financing is a necessary complement to debt relief, and the

[5] G-7 includes Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

latter is unlikely, by itself, to accelerate economic growth in highly indebted poor countries. Moreover, the lack of adequate funding has generated an additional demand on the net income (profits) of the development banks, which has led some of them, including the World Bank, to increase spreads and thus lending rates. This implies, paradoxically, that other debtor countries will pay part of the debt relief of the poorer nations. Financing problems are particularly acute in the case of regional and sub-regional development banks with a large share of HIPCs, leading some of them to cut on programs, particularly those with a high grant element.

A more ambitious, adequately financed HIPC Initiative must thus be a priority of the international agenda in the immediate future. According to recent recommendations from a special United Nations Task Force on the subject, the revised initiative must include the full cancellation of ODA debts of all HIPCs, debt reductions of at least 80 percent on other bilateral official debts, a shorter time span to become eligible (one ESAF program), less restrictive thresholds of debt-to-exports and debt service to exports ratios, and a lower ceiling for the share of fiscal revenues allocated to external debt service.[6] Funding must include a partial sale of IMF gold, a fresh allocation of special drawing rights (SDRs) for this purpose, and additional financing (i.e. additional to traditional allocation of ODA) from industrialised countries to the HIPC Trust Funds. The resources from these Funds should, in turn, finance primarily the costs of the Initiative for regional and sub-regional development banks. The Cologne Debt Initiative made significant advances in this direction.

2.4 *Poorer countries' terms of trade and availability of private finance in crises times*

In this section, we assess the importance of two transmission channels in the wave of contagion that affected low-income countries during 1997 and 1998. The first channel of transmission is through volumes and prices of international trade in commodities. A second channel is through international capital flows. Although the levels of private capital flows to the low-income countries are relatively small compared to middle-income countries, they had been increasing throughout the 1990s, partly following greater access to financial markets (Bhinda *et. al.*, 1999). In this context, financial contagion to poorer countries could well take the form of disruptive reversals due to lack of confidence.

Firstly, we study the impact of the Asian crisis on commodity prices and the subsequent effect on the terms of trade of low-income countries. Secondly, we analyse the extent to which the international finance channel played an important role as shock transmitter.

[6] World Bank (1999), Ch. 5.

The importance of Asia in low-income countries' exports

During the 1990s, the Asia-5[7] represented a growing share of low-income countries' exports (especially in primary commodities). This was particularly true for commodities such as food, agricultural raw materials, minerals and metals. Export led strategies with high import contents were also largely responsible for the trade deficit widening of the Asian countries.

South and East Asia (including China) represented, before the crisis, about 20 percent of Africa's exports of agricultural products, and ores and metals, while it amounted to about 14 percent of agricultural products, and 12 percent of ores and metals in Latin America's total exports. Furthermore, Africa as well as Latin America experienced export growth rates to Asia four to five times higher than to other regions of the world. African exports of agricultural products, and of ores and metals respectively, grew at an annual average growth rate of 13.8 and 16 percent over the period 1980–94 (UNCTAD, 1998).

The impact of the crisis on international commodity prices and terms of trade of low-income countries

The unfolding of the East Asian crisis during 1997 led to a strong reduction in production of the most affected economies and thus in imports of intermediate goods. The crisis also negatively impacted upon domestic consumption (due to falls in income), lowering the demand for imported final goods.

The sharp decline in international commodity prices (in dollar terms) appears clearly in Table 5 and Figure 1. Table 5 summarises price changes for products of main interest to developing countries. Very sharp falls in prices were experienced between June 1997 and April 1998, and have thus lowered revenues of some low-income exporters. For example, copper felt by over 30 percent, and crude oil by 25 percent.

It is worth underlining that the second half of 1998 also saw very steep falls in prices, although fewer commodities were affected (23 percent in nickel, 26 percent in crude oil and 12.5 percent in sugar). Wheat and wool experienced much smaller decreases while the price of wood went up. These signs of recovery should strengthen during 1999 as Asian countries start recovering and sustained growth is achieved in a broader group of industrial economies. Nevertheless, overall weak prices are still expected. Indeed, it would be wrong to attribute the recent price changes only to the Asian crisis, especially during the second half of 1998. Other forces with a longer lasting effect, such as advances in technology, surges in global commodity supplies and "forced" exports due to debt service pressures, may well have contributed to a structural decline in commodity prices.

[7] Malaysia, Indonesia, Thailand, South Korea and the Philippines.

Table 5. Changes in prices of a selection of products (percentage change)

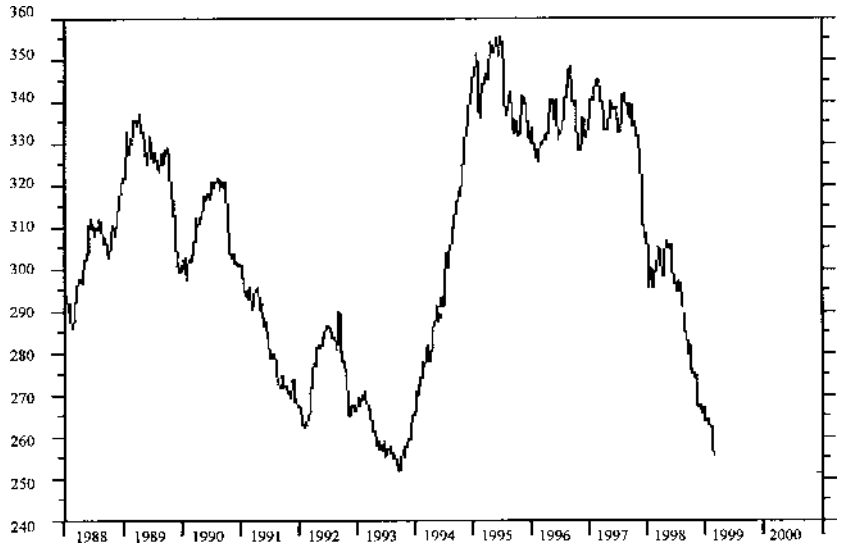
Products	June 97–Apr. 98	May 98–Dec. 98	Products	June 97–Apr. 98	May 98–Dec 98
Tropical Beverages	–19.3	–11.6	Cotton	–14.6	–2.7
Sugar	–17.7	–12.5	Copper	–31.1	–15.0
Wheat	–10.1	–1.5	Nickel	–23.6	–22.7
Maize	–9.3	–7.1	Zinc	–19.0	–9.6
Rubber	–32.9	–16.1	Lead	–7.0	–7.8
Tropical sawnwood	–32.7	+3.2	Aluminium	–9.5	–8.5
Wool	–14.6	–2.7	Crude oil	–24.6	–25.9

Sources: UNCTAD, 1998 and United Nations, 1999

Sub-Saharan Africa has certainly been the region of the world worst hit by the fall in commodity prices as commodities constitute three-fourth of its exports revenues, excluding South Africa[8] (CMDC, 1998). As a result, its 1998 per capita income felt for the first time in three years.

Declines in commodity prices do not necessarily translate into a deterioration of the terms of trade as it depends on the structure of international trade, and on the price of imports. As can be seen from Table 6, the terms of trade deteriorated by 9.1 percent for Sub-Saharan Africa in 1998 (the largest fall in

Figure 1. Raw industrials spot price index (1967 = 100)



Note: Includes copper scrap, lead scrap, steel scrap, tin, zinc, burlap, cotton, print cloth, wool tops, hides, rosin, rubber, tallow.
Source: Deutsche Bank Research, 1999

[8] For an account of the impact of the Asian crisis on South Africa, see Harris (1999) and Crefsa (1997).

Table 6. Terms of Trade in Africa and Latin America (percentage change)

	1990–94[1]	1995–97[1]	1996	1997	1998	1999[2]	2000[2]
Sub-Saharan Africa	–1.3	1.9	5.0	–0.6	–9.1	–2.5	3.6
Oil exporters	-2.6	7.7	22.6	1.9	–28.8	–10.4	16.5
Nonfuel exporters	–0.4	0.1	–1.1	–0.3	–1.3	–0.1	–0.5
Latin America and Carribbean	na	na	–0.9	3.8	–4.1*	na	na

(1) Average (2) Estimate
* estimate; na = not available
Source : IMF, 1999c and ECLAC, 1998c

the 1990s). The terms of trade deterioration has been particularly bad for oil exporting Sub-Saharan Africa (–28.8 percent in 1998) as the price of oil has been decreasing more than most other commodity prices. The fall in oil prices in 1998 reduced quite significantly real income of the five major oil producers in Sub-Saharan Africa (Nigeria, Gabon, The Republic of Congo, Angola and Cameroon) by an estimated 13 percent and worsened fiscal balances by 6 percent of GDP on average (IMF, 1999c).

Non oil exporters in Sub-Saharan Africa (including South Africa) experienced a much smaller fall in their terms of trade (–1.3 percent). This is mainly due to the fact that price declines in imported oil almost compensated for lower export earnings. Furthermore, volumes of exports growth have been lower in response to increased competition from Asia and to lower global demand for commodities.

The relative weight of international finance versus the trade channel

The scale of the impact through international finance varies from country to country and depends largely on the structure of external financing, the access to international capital markets, the level of international reserves, and the policy response to the fall in the terms of trade. In the case of low-income countries, it could be expected that they were not very affected through this channel by the Asian crisis, due to their relatively limited integration into international capital markets, even though their access had increased slightly throughout the 1990s. Low-income countries received, during the 1990s, only 10 percent of total portfolio investment and bank loans to developing countries (Bhinda *et. al*, 1999).

The availability and reliability of data on private financial flows to developing countries is in general poor, especially for low-income countries. Table 7 attempts to synthesise information from different sources on global flows, bearing in mind problems of comparisons between databases and the absence of readily available data for 1998.

FDI represented the bulk of private flows to low-income countries (about two thirds), increasing steadily over the period from 1.1 billion USD in 1990

Table 7. Financial flows to low-income countries (billion USD)

	1995	1996	1997	1998
Net private capital flows				
Low inc countries[1]	**11.3**	**14.6**	**17.0**	**15.2**
Africa	**6.8**	**7.6**	**16.3**	**na**
Sub-Saharan Africa[2]	**9.7**	**4.4**	**8.1**	**na**
South Africa[3]	**8.3**	**5.9**	**13.3**	**9.9**
India[4]	**5.1**	**16.8**	**15.1**	**6.6**
Pakistan	**2.6**	**3.7**	**1.3**	**na**
Net direct investment				
Low inc countries[1]	7.3	9.3	10.6	10.6
Africa	4.2	5.5	7.6	6.8
South Africa[3]	1.0	0.8	1.7	0.5
India[4]	2.1	2.4	3.3	1.6
Pakistan	0.7	0.9	0.7	na
Net portfolio investment				
Low inc countries[1]	3.0	5.9	4.7	0
Of which Bonds	0.3	0.2	2.3	–0.4
Equities	2.7	5.7	2.4	0.4
Africa	1.5	–0.2	2.9	3.5
South Africa[3]	3.1	3.0	12.8	10.7
India[4]	1.6	4.0	2.5	–0.3
Pakistan	na	0.3	0.4	na
Other net investment[5]				
Low inc countries[1]	1.0	-0.6	1.7	4.7
Africa	1.2	2.3	5.8	na
South Africa[3]	4.2	2.1	-1.2	–1.3
India[4]	1.4	10.4	9.3	5.3
Pakistan	1.9	2.5	1.2	na

1 : Global Development Finance, 1999
2 : These data come from CMDC and are not necessarily comparable.
3 : First three quarters of 1998
4 : First two quarters of 1998
5 : Mainly loans
Sources : IMF, 1999c; CMDC, 1998; World Bank, 1999; International Financial Statistics, 1999.

to 10.6 billion USD in 1997 and 1998. Since the fall in inflows in 1998 of about 1.8 billion USD is mainly due to a sharp fall in net portfolio investment (due to a reversal in bonds and a sharp decrease in equities) it is interesting that total loans increased significantly in 1998 (Table 7).

As can be seen from Table 7, aggregate annual private capital flows to Africa (including South Africa) averaged about 10 billion USD annually from 1995 to 1997. However, South Africa was the major recipient of those flows. It was affected by the Asian crisis with a reversal in bank loans of about 3.3 billion USD between 1996 and 1997. Other countries apparently remained

largely unaffected mainly due to the very low levels of inward foreign investments.

The structure of external financing of most African countries seems to have largely contributed to their isolation from external financial shocks (with the exception of South Africa). Indeed, external finance in Sub-Saharan Africa takes mainly the form of international aid and trade credit. Nonetheless, since the mid-1990s, private capital flows have gained more importance relatively to official aid and might thus lead, in the future, to further vulnerability to external shocks.

South Asia has not been affected very much by the crisis in terms of growth. On the contrary, it actually constituted the most rapidly growing region in the world in 1998 with a rate of growth of 5.2 percent (World Bank, 1999). Nevertheless, differences remain among countries: India did not suffer much from contagion thanks to its deep domestic financial market and to the restrictions imposed on foreign investments. Sri Lanka and Bangladesh do not seem to have been affected either because of sustained export levels. On the other hand, Pakistan suffered a loss in revenues due to the fall in the price of cotton. It was forced to devalue its currency and have a moratorium on its public debt in May 1998 following a loss of confidence by international investors.

As a conclusion, low-income countries have been affected somewhat less by the Asian crisis when compared to middle-income countries, particularly due to the lack of integration to international capital markets. However, low-income countries like Nigeria, Zambia and Pakistan have been quite severely affected.

The East Asian crisis versus the debt crisis of the 1980s

The debt crisis of the 1980s clearly affected Africa to a far greater extent than has the East Asian crisis, as the debt crisis spread to large parts of Sub-Saharan Africa. This can be explained by a much more adverse domestic and international environment in the late 1970s and early 1980s, than in 1997 to 1998. Indeed, African countries suffered heavily from the huge increase in real interest rates in industrialised countries and from the second oil shock, none of which have been experienced during those recent years. Moreover, declining terms of trade of most products exported by Sub-Saharan Africa together with depressed demand for primary products from industrial countries further accentuated the debt crisis. Incidentally, some countries were badly hit by both crises. Nigeria, as an oil exporting country, was not affected by the deterioration in terms of trade at the end of the 1970s but seriously suffered from debt servicing problems. In 1997 to 1998, it was hit again following the sharp decline in oil prices.

Nevertheless, it should be reminded that a complete assessment of the impact of the recent crisis on Africa is still very premature, notably because

further adverse effects on the terms of trade are expected throughout 1999 with a possible recovery only in 2000. The recent increase in the oil price might play a significant role in this deterioration especially in the case of non oil exporting countries. Finally, even if their limited access to international finance, the capital controls, and the long term structure of external financing shielded low-income countries against external shocks and major reversals, there are now diminished prospects of a return to the same increasing levels of foreign financial flows to the region as before the crisis.

3. Improved transparency and information

The following sections contributes to the discussion of a new international financial architecture, which has resulted from the vast development costs of currency crises in East Asia and elsewhere. We present measures for both prevention and better management of these crises. We consider crisis prevention as more effective and less costly than better crisis management. However, better crises management is also important as crises – even if less frequently and deep – are likely to continue occurring.

3.1 Actions taken

All developing countries

One of the areas defined initially by the G-7 countries and the IMF as central for future crisis avoidance was enhancing transparency and disclosure of timely and reliable information, basically on developing countries, so as to make it available to market actors. The assumption was that insufficient information had contributed significantly to the Asian crisis (for a critique of this assumption see below).

A flurry of activity in improving information followed, as reflected in the fact that the first of the three working groups of the G-22 (which included G-7 countries and a range of emerging economies) was devoted to Enhancing Transparency and Disclosure of Information. Amongst some of the key significant data gaps and deficiencies identified were: i) information on foreign exchange reserves, including undisclosed forward positions, and any other claims against them; ii) maturity and currency exposures of the public and private sectors, and iii) the health of the financial system, including information on non-performing loans.

A number of steps have already been taken, of which the main ones are Public Information Notices (PINs) by countries, and strengthening by the IMF of the Special Data Dissemination Standard (SDDS)[9]. The PINs are prepared yearly by all countries after their Article IV consultation with the IMF, and countries are encouraged to release them speedily. The IMF has also started a pilot programme for voluntary release of Article IV staff reports. Of particular importance has been the strengthening, in the areas of international reserves and external debt, of the SDDS, the information standard that the IMF had already established in 1996, after the Mexican peso crisis. Particularly significant is that these will incorporate full details on reserves, and any claims against them (for all countries), from April 1999.

Besides information standards, a number of other standards are being de-

[9] For details of these and some of the other main measures of progress on transparency and standards, see IMF website: http://dsbb.imf.org

fined (by the IMF and the Bank for International Settlements, BIS, in collaboration with institutions like the World Bank and the Organisation for Economic Co-operation and Development, OECD). These are meant to provide codes of good practice for economic, financial and business activities. The IMF will help in the dissemination of these standards and the monitoring of their implementation, among which is to possibly have them as conditions for IMF lending. The standards will include creating Codes of Good Practices on Fiscal Transparency, monetary and financial policies, and improving the quality of banking supervision. In addition, it will include developing standards relevant for the functioning of financial systems, for example, standards on accounting and auditing, bankruptcy, corporate governance, insurance regulations, payment and settlement systems, and securities market regulations.

Though many of these standards and their implementation may have very positive effects, for example, those on strengthening the financial systems, three rather serious concerns need to be raised and addressed. Firstly, is the definition of "desirable standards" sufficiently participatory? That is, do developing countries, which will be asked to implement these standards in their own economies, have enough participation in the definition of these standards? Should developing countries just be encouraged to adopt these standards, rather than them being part of IMF conditionality? These concerns could be summarised in the phrase "No standardisation without participation".[10] Secondly, will implementing these standards be really effective in improving the resilience of developing countries for avoiding crises, and making them less acute if they do happen? Thirdly, will implementing these standards not impose excessive administrative and other burdens on developing country governments, especially the poorer ones, which have more limited resources and expertise? To help deal with the third problem, appropriate technical assistance, particularly for the poorer countries, is essential.

Poorer countries

As regards poorer countries, an important distinction made has been between a) the somewhat less stringent first tier General Data Dissemination System (GDDS), and b) the above mentioned SDDS. The focus of the GDDS is on improvement in data quality applicable to all IMF members. It is therefore relevant to many poorer countries, which do not yet have access to the international capital markets. The SDDS focuses on dissemination in countries that generally already meet high data quality standards, and which have or are seeking access to international capital markets. This applies to some of the poorer countries.

The IMF hopes that the GDDS will be useful by providing a basis for bilateral and multilateral technical assistance, and the GDDS can also pro-

[10] We thank Gerry Helleiner for this point.

vide the basis for enhanced co-operation with other providers of technical assistance.

It is noteworthy that the GDDS shares the same basic framework as the SDDS, which includes four dimensions dealing with dissemination of economic and financial data: data (coverage, periodicity and timeliness), quality, access, and integrity. However, the GDDS differs from the SDDS in that: a) it is less prescriptive in relation to periodicity and timeliness of data dissemination b) it recognises that improvements may be achieved only in the long run and c) it is broader, as it includes also a range of socio-demographic indicators.[11]

To summarise, major efforts have been taken – particularly by the IMF and the developing countries – to improve information. The requirement of improvement of information is far more demanding for developing countries (including low-income ones) which have or are seeking access to international capital markets. It is important that, particularly for low-income countries, sufficient and appropriate technical assistance is provided in a co-ordinated manner by the IMF and by others, to improve provision of information by those countries.

3.2 Limits of this approach, due to inherent problems of asymmetries of information

Clearly, improved information, along the lines of the changes described above, will be welcome and very valuable, and will contribute to a better market performance. However, improved information on developing countries will probably not by itself avert crises. First, information available to financial markets will never be perfect and information asymmetries will always exist. Secondly it is not clear that better information will be sufficient on its own for financial markets to function well, as the key issue is how available information is processed by market actors and acted upon by them. Phenomena such as euphoria and herding (see, for example, Griffith-Jones, 1998a) imply that "bad news" are ignored in periods of "boom" and magnified in periods of "bust", with the reverse being true for "good news". Thirdly, better information on developing countries has to be complemented by equally important improved information on international financial markets.

As regards the first point, there is both clear theoretical analysis and practical experience which shows that information will always be imperfect, and that this may cause or contribute to financial crises. A clear forerunner of much of the imperfect information literature was Keynes, who in Chapter 12 of the *General Theory* stressed "the extreme precariousness of the basis of knowledge on which our estimates of prospective yields have to be made".[12]

[11] For more details on the GDDS, see IMF website: http://dsbb.imf.org

[12] Keynes (1936), p. 165.

The seminal contributions in modern analysis of asymmetries of information and their particular significance for financial markets, have come from Stiglitz.[13] Most recently, Eichengreen has rather strongly summarised the limits of improved information for crises prevention: Relying excessively on improved transparency "underestimates the extent to which information asymmetries are intrinsic to financial markets…. It is unavoidable that borrowers should know more than lenders about how they plan to use borrowed funds. This reality is a key reason why banks exist in market economies…. Bank fragility is inevitable. The advocates of information-related initiatives mislead when they assume the problem away."[14]

Indeed, sophisticated and increasingly informed financial markets have continued to be extremely (and even increasingly) volatile. This has occurred even in some of the most developed economies in the world, where serious problems and even crises have occurred in their banking systems, even though they had the highest ratings on transparency, as illustrated by the banking crises in Scandinavian countries. It should, however, be pointed out that banking crises in Scandinavia had a far less negative effect on those countries' economies than in the East Asian countries (Bhattacharya and Miller, 1999; Stiglitz and Bhattacharya, 1999).

One very important reason for imperfect information is the fact that much of the relevant information to which the market reacts comes only with a lag. In addition, it depends on macro-economic conditions not entirely known in advance (although the changes in macro-economic conditions may be partly – or largely – determined by the aggregate effects of the behaviour of financial agents). For example, some of the lending or investment decisions made in East Asia before the 1997 crisis may have been unsound. However, the magnitude of the losses associated to them were even more determined by the major and largely unpredicted macro-economic shocks that these regions experienced. Increasing information may thus be relevant to improve micro-economic market efficiency, but may do little to reduce macro-economic volatility (Ocampo, 1999). Particularly, as regards macro-economic information, markets are necessarily imperfect when time is involved, as the information necessary to correct such "market imperfections" will never be fully available.

Secondly, there are problems as regards the processing of information. As pointed out above, increasingly investors (and lenders) are not concerned with what an investment is really worth to a person who buys it for keeps, but with what the market will value it at in a few hours or days. The concept behind this was perhaps best captured by Keynes' "beauty contest", in which each actor tries to interpret what the average opinion in the market is. To the extent that this is true, available information on developing countries will be

[13] See, i.e., the classic paper by Stiglitz and Weiss (1981).
[14] Eichengreen (1999), p. 17.

less important than how the average of the market is likely to perceive it. The interrelation of the "information" that financial actors manage at any particular time – or rather, of the opinions and expectations that are formed from such information – is central to the rich contemporary literature on self-fulfilling booms and busts.

Micro-economic factors, on how financial firms and banks operate, reinforce such problems. This may be related both to costs and to firm organisation. A board of a financial institution deciding to invest or lend to a particular country may not be able (or willing) to take account of the rich information available in the research departments of that institution.[15] Smaller banks, with small research departments, tend to rely even less on their internal expertise, and follow even more decisions of other banks. As a result, changes in the opinions of those investors that are considered to be "informed" may lead to overreactions by non-informed ones, who rely on the formers' lead to make their decisions (Calvo, 1998).

A key problem is that changes in opinion can occur without any significant change of underlying fundamentals; this occurs basically because the same information about a country may be interpreted totally differently at different times, due to factors such as the "mood of the markets", events in other economies, etc. A good metaphor may be that a glass may be deemed either half empty or half full, depending mainly on the mood of the viewer and not so much on how clean and transparent the glass is (the cleaner glass represents better information). Also, "small news" that do not alter fundamentals, may affect market perceptions dramatically. The importance of "small news" and its potential impact on changes in market perceptions is magnified in a world of dramatically improved communications and 24-hour trading.

Some concern has even been expressed that, in some cases, information disclosure could lead to more, and not less, variability in the price of an asset (Stiglitz and Bhattacharya, 1999). Lack of information may serve to "average" good and bad news; as a consequence, it could even be the case that improved capabilities of processing and transmitting certain information could increase volatility. However, empirical evidence on this is inconclusive, and further research is required.

A related issue is that of rating agencies. Given the important weight that subjective factors have played in rating agencies' risk analysis, and the significant volatility that has characterized such subjective opinions in the past, there have been suggestions that these agencies could be regulated and their risk evaluations could be improved. Moreover, it has also been suggested that the role of these institutions in sovereign ratings could be eliminated, substituting it by ratings made by the supervisory agencies of the countries where

[15] A recent survey of banks by the BIS showed that most of them took decisions without taking much notice of information available in research and other departments even within their own bank.

capital flows originate, according to parameters that are internationally agreed upon. This would imply that rating agencies' activities would concentrate in the evaluation of private risks (Economic Commission for the Latin American and the Caribbean, ECLAC, 1998b). Such suggestions deserve careful study, as there is evidence that evaluations of emerging markets have not helped avoid crises, and may have contributed to accentuate them when they occurred.

Overall, we can conclude that, though on the whole very helpful and important, improved information on developing countries will by itself be necessary but clearly not sufficient to prevent future crises, and that far stronger actions are required. This is increasingly – though slowly – being recognised by the international community.

3.3 Providing additional information on markets to developing countries

As pointed out above, better information to markets on developing countries has to be complemented by better information on international financial markets available to developing countries. Particularly during the crisis that started in Asia, emerging country policy-makers (and specifically emerging country Central Banks) have found important limitations in the essential information available on the functioning of international capital and banking markets. The type of information required is both on more long-term structural changes in these markets, but particularly on almost day to day changes in the functioning of markets – and their key actors – globally and regionally. Such needs are especially large for low-income countries, which – due to their more limited and briefer integration with international capital markets – tend to have even less detailed information on international financial markets.

The IMF has led the way in improving information – and its dissemination – on emerging market economies, which is of particular use to markets. A parallel symmetric effort needs to be done to gather and provide timely information on market evolution to emerging markets' policy-makers. This task should perhaps be led by the BIS, and co-ordinated by the newly created Financial Stability Forum (FSF). Inputs from other institutions would be very valuable, for example, the IMF and the private sector (for example, the Institute of International Finance, IIF). Although possibly not giving it sufficient emphasis, suggestions in the October 1998 G-22 Report of the Working Group on Transparency and Accountability did provide important elements for this task. These suggestions relate not just to better statistics on international banks' exposures, but also on "compiling data on international exposures of investment banks, hedge funds and other institutional investors"; the latter would include presumably pension funds and mutual funds. Furthermore, the growth of financial innovations, such as over-the-counter derivatives, while designed

to facilitate the transfer of market risk and therefore enhance financial stability, have also made financial markets more complex and opaque. This has created difficulties in monitoring patterns of activity in these markets and the distribution of risks in the global financial system for market participants, regulators, central banks, and other authorities, including particularly those in developing countries.

In response to this situation, the Euro-Currency Committee at the BIS has drawn up a framework for the regular collection of statistics on over-the-counter derivatives markets on the basis of reporting by leading market participants. Such efforts to improve transparency, particularly in relation to derivatives, and on highly leveraged institutions (such as hedge funds), are widely welcomed. However, this sector is constantly evolving and there is a concern that regulatory reporting will never be able to keep pace with these complex and dynamic markets. Difficulties are made greater by the fact that there are already many gaps in reporting derivatives and activities of institutions like hedge funds; it would seem appropriate for major Central Banks and the BIS to attempt to improve registration of derivatives and institutions like hedge funds, by making it obligatory. It seems essential that developing countries – including representatives from the poorer countries – should participate in the relevant Working Groups where information needs are discussed and decided, so that their information needs on markets are also fully considered.

Given the speed with which markets move, it seems particularly important that the frequency with which relevant data is produced is very high (and possibly higher in times of market turbulence, when it becomes particularly crucial), and that dissemination is instant to all countries' Central Banks. Indeed, a special additional service could be provided by the BIS, in which it would play the role of clearing house of information. For this purpose, it could draw not just on information it can gather directly from markets, but by collecting and centralising information on their markets that individual Central Banks have, and where the aggregate picture is not easily available to any individual Central Bank. This could possibly include both quantitative and qualitative information. Via the internet, the BIS could standardise the information requirements, collect the information, aggregate it, and disseminate it rapidly to all central banks, as well as to other relevant institutions. Such a service would be of the greatest usefulness to developing country policy-makers, especially immediately before and during crises; however, it would naturally also be very valuable to developed country policy-makers and international institutions (including the BIS itself) in handling crisis prevention and management.

A set of meetings, including representatives from developing countries with BIS staff or the appropriate BIS Committees, seems appropriate for effective implementation of this proposal. Representatives of developing countries' Central Banks – including those of low-income countries – could, for exam-

ple, appropriately present initial ideas on desirable additional information, especially from a developing country perspective, that the BIS (or more broadly the FSF) could provide. The feasibility and value of such additional information could then be explored.

4. Better regulations, nationally and internationally

4.1 National regulations[16]

The experience of developing countries at different levels of development indicate that the management of capital account volatility requires: a) consistent and flexible macroeconomic management; b) strong prudential regulation and supervision of domestic financial systems; and c) equally strong "liability policies", aimed at inducing good debt profiles, public and private, domestic and external. Moreover, despite the traditional emphasis on crisis management, the focus of authorities should rather be the management of booms, since it is in the periods of euphoria from capital inflows and trade expansion, and terms of trade improvement that crises are incubated. Crisis prevention is thus, essentially, an issue of adequate management of boom periods.

The nature of policies will certainly vary according to structural peculiarities of different economies, as well as macroeconomic traditions and levels of development. The fact that private capital flows tend to concentrate in middle-income countries should not be taken, however, as an indication that the management of financial volatility is peculiar to them (Helleiner, 1999). Even relatively small financial flows can destabilise small, low-income countries. Learning to manage sharp financial cycles with adequate prudential and capital account regulations is a slow, time-consuming process that requires experience that must be accumulated since the early stages of development. Indeed, the lack of adequate learning is the reason behind the deep financial and currency crises experienced by many "emerging" economies when faced with surges of capital in recent decades.

Macroeconomic policies

In the macroeconomic area, the two major objectives should be to avoid the accumulation of high levels of indebtedness by either public or private agents, and to avoid also disequilibria in major prices, particularly exchange rate and domestic asset prices. In the fiscal area, the objective should not be to run balanced budgets (or low deficits) in every period, as simplistic orthodox analysis recommends. Indeed, such fiscal targeting is strictly pro-cyclical, as public sector revenues naturally have a pro-cyclical pattern. This is particularly so in raw material exporting countries, where fiscal revenues are bound to depend directly on the terms of trade and the value of imports, which tend

[16] The literature on national regulations is extensive. See in particular, among recent contributions: *World Bank* (1998a), Ch. 3, ECLAC (1998a). An earlier English language version appeared in CEPAL (1995). ECLAC (1998b), Ffrench-Davis (1999), Helleiner (1997a) and Ocampo (1999).

to vary significantly through the business (export) cycle. Under these conditions, increasing revenues during the boom have a strong temporary component, which, if spent, would lead to expenditure levels that are unsustainable during the ensuing downswing. Reducing public sector spending during the downswing tends, in turn, to enhance the crises, a fact that has been subject to strong criticisms during the recent Asian crises and has led the IMF itself to allow Asian countries to run larger budget deficits (Fischer, 1998). Moreover, the recent emphasis on the need to strengthen social safety needs to protect vulnerable groups during crisis can only be consistent with anti-cyclical expenditure patterns, to allow for additional social spending during the crisis. Thus, the focus of fiscal targeting should be the sustainability of public sector debt ratios throughout the cycle, through a fiscal strengthening during the upswing, which allow the authorities to generate enough degrees of freedom to permit some fiscal loosening during the downswing. The two major anti-cyclical devices should be: a) fiscal stabilisation funds that force temporary public sector revenues, from either raw material export or more generally tax revenues, to be saved during the booms; and b) on the expenditure side, well-designed social safety nets, which would reduce spending during the boom and increase it during the crises.

A second major area of macroeconomic management is monetary and domestic credit restraint during boom years. Sterilised foreign exchange reserve accumulation is a first alternative, but experience indicates that it may be self-defeating in the absence of adequate restraint on capital inflows, as domestic interest rates are kept high, inducing additional capital flows. A second possibility is increased reserve or liquidity requirements for the domestic financial system's liabilities. A third alternative is direct control of the growth of credit from domestic financial intermediaries, but this alternative may again be relatively ineffective in the absence of adequate control on external borrowing by domestic residents. It also tends to protect inefficient intermediaries.

Regulation of capital inflows and capital account liberalization

Regulation of capital inflows may also be essential to avoid unsustainable exchange rate appreciation during booms, particularly in the face of improved terms of trade in commodity-exporting countries. Some appreciation may be inevitable and even an efficient way to absorb the increased supply of foreign exchange, but an excessive revaluation may also generate irreversible "Dutch disease" effects. Regulations of capital inflows thus play an essential role in open developing economies as a mechanism to allow monetary and domestic credit restraint, as well as to avoid unsustainable exchange rate appreciation during booms. The macroeconomic role of regulation of inflows has, unfortunately, received much less attention in discussions than the issue of regulation on outflows during crises; they are, however, more important, as they are

associated to the essential issue of crisis prevention.[17] The nature of such regulations is considered below. Regulations on outflows may obviously play a useful role during crises, as a way to avoid overshooting interest or exchange rates, which may generate adverse macroeconomic dynamics, including a deterioration of the liability position of borrowers in domestic or foreign currencies, respectively. It is essential, however, that they be used as a complement and not a substitute for fundamental macroeconomic adjustment.

In the case of low-income countries, many of which still have relatively closed capital accounts, the key issue is how to liberalise the capital account in ways that minimise exposure to volatility.[18] As we will discuss below, such opening of the capital account needs to be done gradually and – above all – selectively. Countries whose capital account is still closed have some advantage of being "latecomers" to capital account liberalisation, as they may benefit from the lessons of capital account liberalisation in other countries.

The recent experiences in East Asia have shown how complex the liberalisation of the capital account can be, especially in the context of surges and reversals of capital flows. There is now extensive evidence that a mismanaged capital account liberalisation can prove very costly, especially if it is done in the absence of a well defined regulatory framework at the domestic and at the international level of the financial system. Amongst the most affected countries in Asia, Indonesia and South Korea liberalised their capital account in a rather different way than what conventional wisdom would prescribe. The former liberalised its capital account first (well before the trade account) and its financial sector last. Korea, on the other hand, lifted barriers to short term flows while preventing FDI. Although quite successful for a period of time, both liberalisation processes seemed to have greatly increased the fragility of these economies.

These recent experiences, along with a number of past experiences (for example, those of the Southern Cone in the late 1970s or of Mexico in the early 1990s) reinforce the need for orderly capital account liberalisation. Liberalisation should proceed in ways that make its benefits outweigh potential costs, or at least in ways that minimise the probability of crises to happen. This is particularly relevant for poorer countries, many of which have not yet embarked into a full process of financial liberalisation domestically and internationally.

First, priority should be given to the liberalisation of flows which do not exhibit short term fluctuations and contribute most evidently to growth.[19] In reality, and for the policy maker, this is not an easy task, as flows that enter a

[17] This has been an important emphasis of the work of ECLAC on crisis prevention. See ECLAC, 1998a and 1998b. For a similar emphasis, see Helleiner (1999) and Helleiner (1997a).
[18] We are particularly grateful to Benno Ndulu for suggesting this point.
[19] Trade credit should also be encouraged as it is crucial for trade and thus growth promoting.

country with a long term "label" might well be highly reversible. Nevertheless, there is an overwhelming consensus that FDI (especially greenfield investments) are by far the most beneficial flows.[20] They not only provide long term financial resources but they also contribute to transfers of technology and know-how. However, FDI flows tend to be highly concentrated in a small number of countries. Indeed, FDI are attracted by two broad factors: the policy framework of recipient economies in terms of barriers to entry and of incentives, and the economic characteristics of the host country (UNCTAD, 1999). Although it is difficult for low-income countries, special effort should be given to attract them and receive support via guarantee mechanisms and international institutions.

As far as the other flows are concerned, the hierarchy of volatility is less clear. But there is also broad consensus that long-term loans and long-term bonds are preferable as long as they have no put options. Indeed, long-term bonds issued with put options allow for bond holders to pull out in times of high uncertainty and reduced liquidity in the secondary market. In this particular case, a loss of confidence can lead to large redemptions from investors, which might itself directly aggravate the issuers' financial conditions. The initial long term financial flow then turns out to be highly reversible.

As far as portfolio equity investments are concerned, although they are generally considered as a long-term form of investment, they can also be highly reversible. The size of the reversal largely depends on the depth of the local secondary market. In low-income countries, where secondary markets are typically small, capital outflows will lead to a sharp fall in stock prices, that would reduce the amount of capital outflows. However, these falls in prices would themselves have negative effects both on the wealth of investors and on the ability of firms to access capital markets.

Large fluctuations of capital flows, in the absence of a well-developed financial institutional framework, are bound to be transmitted to the real economy in a magnified way. Given the potential reversibility of financial flows described above, it seems thus important, as a pre-condition to further capital account liberalisation, to have a sound financial system. This includes both a sound banking system and a deep capital market (see below).

The issue of capital account liberalisation is thus of prime importance for economies that engage or will engage in greater openness and integration in global capital markets. As underlined above, although it is quite difficult to attract foreign direct investment to low-income countries and to differentiate between stable and non stable flows, these tasks are important and high

[20] It is worth underlining that the recent increase in the role of institutional investors as key players in cross border investments has made the distinction between portfolio investment and FDI in secondary markets less clear. Indeed, investors sometimes own more than the 10 percent threshold of assets but do not exercise any direct control over the management as the high share of ownership only reflects a higher weighting in the portfolio.

priority should be given to them. Domestic measures together with international measures outlined below should, to a great extent, reduce the negative impact of volatility, while allowing for greater access to long-term international finance.

Furthermore, to increase the chance of a successful capital account liberalisation, it seems crucial that the autonomy of the country in this respect should be preserved. Considerations on the autonomy of low-income countries to manage the capital account should, therefore, be incorporated into the current discussions to broaden the mandate of the IMF to include the convertibility of the capital account. Low-income countries should retain the right to impose controls on capital inflows, particularly in times of capital surges, and on outflows, during severe crises. More broadly they should be allowed to determine their own pace of capital account liberalisation.

Regulation and supervision of domestic financial systems

The experience of many countries indicates that strong domestic prudential regulation and supervision are essential to avoid costly financial crises. The experience of both developing and industrialised countries indicates that financial crises are, indeed, very costly, both fiscally and in terms of economic activity, particularly if they are mixed with currency crises (the so-called "twin" crises).[21] Given the role of the domestic financial system in the intermediation of external lending, prudential regulation and supervision also play an essential role in managing the risks associated to capital account booms.

The essential role of domestic financial regulation and supervision is to guarantee the solvency of domestic financial intermediaries, by guaranteeing capital requirements adequate to the risks that financial intermediaries face, avoiding excessive risk taking, including an excessive concentration of risks, and requiring that loan losses are adequately accounted for. However, it has become increasingly clear that in the face of financial volatility, domestic financial regulation and supervision should also guarantee an adequate liquidity of financial intermediaries, as the link between liquidity and solvency problems are stronger than traditionally perceived. Thus, avoiding significant mismatches between the term structure of assets and liabilities, and establishing higher reserve or liquidity requirements for the short-term liabilities of the domestic financial system also play an essential role in domestic financial management.

Prudential regulation and supervision must take into account not only the micro- but also the macro-economic risks typical of developing countries. In particular, due account should be taken of the links between domestic financial risk and changes in key macroeconomic policy instruments, notably exchange and interest rates. The risks associated to the rapid growth of domes-

[21] See in particular, IMF (1998), Ch. IV.

tic credit, to currency mismatches between assets and liabilities, to the accumulation of short-term liabilities in foreign currencies by financial intermediaries, and to the valuation of fixed assets used as collateral during episodes of asset inflation, must be adequately taken into account. Depending on the characteristics of the financial operation, higher capital adequacy requirements, matching liquidity requirements or caps on valuation of assets should be established. Moreover, given these macroeconomic links, prudential regulations should be stricter in developing countries, and should be strengthened during years of financial euphoria or terms of trade improvements to take into account the increasing risks in which financial intermediaries are incurring. Such criteria are not only important for middle-income, but also for low-income countries. These links also imply that contractionary monetary or credit policies during booms, particularly higher reserve or liquidity requirements and ceilings on the growth of domestic credit, may be strongly complementary to stricter prudential regulation and supervision. These counter-cyclical elements in both monetary and regulatory policies are particularly necessary in small economies subject to large trade or capital account shocks. Due to the important externalities which large non-financial firms could generate on the domestic financial sector, particularly in the context of exchange rate depreciation, the external liability exposures of these firms should also be subject to some regulation. Tax incentives (for example, limits on the deductibility of exchange rate losses) and rules that force non-financial firms to disclose information on their external liabilities may thus be relevant complements to appropriate prudential regulation and supervision of financial intermediaries.

Liability policies

The experience of many developing countries indicates that crises are associated not only to high debt ratios but also to inadequate debt profiles. The basic reason for that is that, under uncertainty, financial markets respond to gross, not only to net financing requirements, or what is equivalent, that 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 complementarity between a good external and internal debt profile. Thus, excessive domestic short-term borrowing may force a government trying to rollover the debt during a crisis to raise interest rates to avoid capital flight by investors in government bonds. Also, excessively high private short-term liabilities increases 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 adequate instrument of a liability policy. More indirect tools are nec-

essary to induce a better private debt profile. Again, direct exchange controls may be the appropriate instrument. An interesting alternative is reserve requirements on capital inflows, such as those used by Chile and Colombia in the early 1990s (Box 1), which are a type of (national) Tobin taxes. Indeed, in both countries reserve requirements can be substituted for a payment to central banks of the opportunity cost of the said requirement, which makes them in effect a tax on inflows. The equivalent tax level (3 percent in the case of Chile and 10 percent or more in Colombia during the boom) is much higher than that proposed for an international Tobin tax. A flat tax has a positive effect on the debt profile, as it induces longer-term borrowing, for which the tax can be spread over a longer time frame, and it is easier to administer. This has been generally recognized in recent controversies. The effects of this system on the magnitude of flows have been subject to a more heated controversy. In any case, to the extent that evasion is costly and that short- and long-term borrowing are not perfect substitutes, the magnitude of flows is also affected.[22] If this is the case, the system operates both as a "liability" and a macroeconomic policy tool. A basic advantage of this instrument is also that it is targeted at capital inflows, and it is thus a preventive policy tool.

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

To conclude, better – and probably more counter-cyclical – prudential regulation of the financial sector are important for crises avoidance, both for middle-income and low-income countries. Significance by both categories of countries needs to be attached to an appropriate term structure of external debt. As regards the capital account, countries that have already fully liberalised it may need to use market-based measures, such as those applied in Chile or Colombia, to discourage excessive surges of short-term capital. Those countries – mainly low-income ones – that still have fairly closed capital accounts need to liberalise gradually, at the appropriate time and in ways that mini-

[22] Agosin (1998), Ffrench-Davis (1999), Ocampo (1999), Ocampo and Tovar (1998).

Box 1. Restrictions to capital inflows in Colombia and Chile

Chile adopted in 1991 a system of price-based capital account regulations, based on one year non-remunerated reserve requirement (or forced deposits) on capital inflows. The corresponding dollar-denominated deposits must be kept in the central bank. Alternatively, they can be substituted by a payment to the bank equivalent to the estimated opportunity cost of the deposit, a fact that makes them equivalent to a (national) Tobin tax. The original requirement was set at 20 percent but was rapidly increased to 30 percent as a response to continuing capital surges. In the wave of contagion following the Asian crisis, the reserve requirement was lowered first to 10 percent and then to a zero rate (but it has not been eliminated).

A similar, but more complex system was established in Colombia in 1993. It required a dollar-denominated deposit for loans of less than certain maturity. The original "minimum maturity" was 18 months, but it was rapidly raised to three years, and then fluctuated between three and five years. The reserve requirement was lower the longer the maturity of the loan. In May 1997 the system was replaced by a simpler scheme, more similar to that of Chile, based on a 30 percent flat reserve requirement for all loans. Two major differences with respect to the Chilean system were the originally longer holding period for the requirement (18 months) and the fact that it is peso-denominated. As in Chile, the requirement was lowered during the Asian crisis, and it is currently 10 percent and must be held during 6 months.

Requirements are much higher than the rates that have been suggested for an international Tobin tax, particularly in Colombia. In Chile, the tax equivalent of the reserve requirement for a loan with a one year maturity was 3 percent prior to the Asian crisis. In Colombia it reached an average of 13.6 percent in 1994-1998 and as much as 6.4 percent for a loan with a maturity of three years. In both countries, requirements have been managed in a counter-cyclical fashion, but much more frequently in Colombia.

It must be emphasised that in both countries this reserve requirement coexists with additional capital account regulations. Particularly, in Chile portfolio inflows must be held in the country for at least a year, and in Colombia they must be approved directly by the Superintendency of Securities. In both countries, many other foreign exchange controls remain in place.

Sources: Agosin and Ffrench-Davis, 1999; Ocampo and Tovar, 1998 and 1999.

mise exposure to volatility from foreign capital flows. Also, prudence needs to be exercised about capital account liberalisation, so that it does not open channels for capital flight.

4.2 International measures

Clearly an important part of the responsibility with discouraging excessive reversible inflows – as well as managing them – lies with the recipient coun-

tries. However, the large scale of international funds – compared to the small size of developing country markets – leads us to question whether measures to discourage excessive short-term capital inflows by recipient countries are enough to deal with capital surges and the risk of their reversal. Three strong reasons make complementary action by source countries and internationally necessary. Firstly, not all major recipient countries will be willing to discourage short-term capital inflows, and some may even encourage them. Secondly, even those recipient countries which have deployed a battery of measures to discourage short-term capital inflows have on occasions found these measures insufficient to stem very massive inflows. Thirdly, if major emerging countries experience attacks on their currencies, which also result in difficulties to service their debt, they will be forced to seek large official funding. As a consequence, there is a clear need for international and/or source country regulation that will discourage excessive reversible capital inflows. If this is not developed, international private investors and creditors might continue to assume excessive risks, in the expectation that they will be bailed out if the situation becomes critical. This is the classical moral hazard problem.

The Asian crisis – and its repercussions worldwide – clearly demonstrated that it is necessary to strengthen source country regulations, coordinate them globally and fill important regulatory gaps.

The crisis also provoked a serious debate on how supervision and regulation of the international financial system could be strengthened in order to help prevent economic crises of this sort happening again in the future. The debate has partly focused on whether existing arrangements should be extended and improved, or whether there is now a need for new institutions to cope with the increasingly globalised financial system, to achieve the necessary improvement of international financial regulation and supervision.

At the more institutionally radical end of the scale, there have been proposals for the creation of a new international body such as a World Financial Authority (Eatwell and Taylor, 1999) or a Board of Overseers of Major International Institutions and Markets (Kaufman, 1992). Such a body would have wide-ranging powers for the oversight of regulation and supervision globally.

The other approach has been to develop and build on existing institutional arrangements. The virtues of this approach were the greater ease, both technically and especially politically, to move forward on this. Indeed, the Financial Stability Forum (FSF), which is described below, has been created and has started to operate, with impressive speed; this seems one of the most positive steps towards a new international financial architecture.

Both the Canadian and the British government put forward proposals based on this approach in 1998. In the autumn of 1998, Chancellor Gordon Brown and Secretary of State Clare Short proposed a standing committee for global financial regulation to co-ordinate the multilateral surveillance of national financial systems, international capital flows and global systemic risk. It was proposed that the committee would bring together the World Bank, the IMF,

the Basle Committee of the BIS and other regulatory bodies on a monthly basis to develop and implement ways to ensure that international standards for financial regulation and supervision were put in place and properly co-ordinated.

The Financial Stability Forum

In October 1998, the G-7 finance ministers and central bank governors approved this idea in principle. They asked Hans Tietmeyer, then president of the Bundesbank, to develop the UK proposal and more generally consider the co-operation and co-ordination between the various international regulatory and supervisory bodies and to make recommendations for any new arrangements. Tietmeyer's report, released in February 1999, outlined areas where improvements to current arrangements were necessary, but stated that 'Sweeping institutional changes are not needed to realise these improvements' (Tietmeyer, 1999). Instead it was proposed that a Financial Stability Forum (FSF), which would meet regularly to discuss issues affecting the global financial system and to identify actions needed to enhance stability, be convened. The FSF was formally endorsed by finance ministers and central bank governors from the G-7 at their February meeting in Bonn, and met already for the first time in the spring of 1999.

The Tietmeyer report had correctly outlined three main areas for improvement to current arrangements, which have been highlighted by recent events in international financial markets: i) the identification of vulnerabilities in national and international financial systems and sources of systemic risk, and the identification of effective policies to mitigate them; ii) to ensure that international rules and standards of best practice are developed and implemented, and that gaps in standards are identified and filled; and iii) improved arrangements to ensure consistent international rules and arrangements across all types of financial institutions.

The FSF will be limited in size to 35 members, in order to allow for an effective exchange of views and decision making. Each G-7 country will have three representatives on the FSF, from the finance ministry, central bank and supervisory authority. The G-7 stated that while the FSF initially be limited to G-7 countries, it is envisaged that other national authorities, including from emerging market countries, will join the process at some stage. The IMF and the World Bank will have two representatives each, as will the Basle Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). The BIS, the OECD, and the two BIS Committees will all have one representative on the FSF.

For the first three years the FSF will be chaired by Andrew Crockett, who is the general manager of the BIS. It will have a very small secretariat in Basle. The FSF will initially meet twice a year, beginning in the spring of 1999. One

of the key aims of the FSF will be to better co-ordinate the responsibilities of the main national and international authorities and supervisory bodies, and to pool the information held by these various bodies, in order to improve the functioning of markets and reduce systemic risk. Subsequent to its meeting in Washington on 14th of April, the FSF has defined three *ad hoc* working groups, to tackle recommendations on three defined key subjects.

i) To recommend actions to reduce the destabilising potential of institutions employing a high degree of leverage (highly leveraged institutions, HLIs) in the financial markets of developed and developing economies; this group will be chaired by Mr Howard Davies, Chairman of the UK Financial Services.
ii) To evaluate measures in borrower and creditor countries that could reduce the volatility of capital flows and the risks to financial systems of excessive short-term external indebtedness; this group will be chaired by Mr Mario Draghi. Amongst developing countries, Chile and Malaysia will participate.
iii) To evaluate the impact on global financial stability of the uses made by market participants of financial offshore centres, and the progress made by such centres in enforcing international prudential standards and in complying with cross-border information exchange agreements. As regards offshore centres, reportedly an assessment will be made of the additional efforts required to avoid under-regulation or inappropriate disclosure in offshore centres contributing to global financial instability; this group will be chaired by Mr John Palmer, Superintendent of Financial Institutions.

It is important to stress that the working groups comprise officials of developed and developing market economies, international financial institutions and supervisory groupings, and will draw on work completed or under way in various public and private sector forums. It is interesting that senior officials from developing countries have been included, where their expertise is seen as particularly relevant. For example, the group that will work on measures to study volatility of capital flows includes senior representatives from Chile and Malaysia, two countries that have implemented measures to curb inflows and outflows (Malaysia for both, and Chile for inflows). However, it is a source of concern that no low-income countries are represented in the working groups and that the overall participation of developing countries in this process is clearly insufficient.

The setting up of the FSF is clearly a necessary and valuable first step towards improving the co-ordination and co-operation of the various bodies, which work towards improving markets in order to improve global stability. The question lies, however, in whether the FSF, as it has been proposed, will be a representative enough and strong enough body to address all these complex issues.

First, the omission of any developing country authorities in the initial years of the FSF itself appears to be an important drawback. It has been increasingly accepted that international finance is more and more globalised, that developing countries are important actors in this globalised financial system, and that currency crises in developing countries pose both systemic threats to the international financial system and threats to their development prospects. The experiences of developing countries – including low-income ones – will not be directly represented at the FSF itself. Representation of developing countries on the FSF would be desirable for both legitimacy reasons, and because it would provide the body with a wider range of expertise and perspectives. However, the representation of developing countries in the *ad hoc* Working Groups is clearly a positive development.

Ways could easily be found to include developing countries in the FSF without making it too large. If three developing countries representatives were included, the membership of the FSF would rise from 35 to 38, that is by less than 10 percent. Developing country representatives, from countries with large levels of private capital inflows or with major financial centres could, for example, be chosen on a regional basis; there could be one Asian, one Latin American, and one African. This would ensure that the interests of poorer countries would also be represented. These representatives could be appointed for a fairly short period (for example, two years) and then rotated. This type of representation by developing countries has been working rather well in other contexts, for example, in the Boards of the Bretton Woods institutions. It has also been suggested that not all G-7 countries would need to be included if it was felt that size needed limiting. For example, all G-7 countries with large financial centres could be included as permanent members; other G-7 countries could be rotated.

The FSF is a very important initiative. It will hopefully reduce vulnerabilities in the international financial system, by promoting co-ordination and co-operation among G-7 regulators, central bankers and international financial institutions. Adding a small representation from developing countries to the FSF would increase those countries' commitment to its aims, as well as add valuable insights to its decision-making process. It would seem to be beneficial to all involved.

Second, doubts have been voiced over the institutional strength of the new FSF. With a very small secretariat in Basle (currently it has only three staff members), meeting only twice yearly, and no power of enforcement, will the FSF have the sufficient institutional muscle to deal with the tasks that have been identified? Can its response be speedy and agile enough to a rapidly changing international private system? The setting up of the FSF represents a significant enhancement of the system of global regulation by agreement and peer pressure that has been shown to work reasonably well in the context of the Basle Committees of the BIS (Griffith-Jones, 1999). International co-operation at the BIS has always been based on home country control, where

sovereignty remains at the level of the nation-state, and agreements are reached through negotiation and then implemented, where necessary, through national legislation or regulation. Countries that are not represented at the Basle Committee have also adopted some of their directives (most notably, the capital adequacy standards). However, in the medium term, in a world of open financial markets, an international body whose Board meets regularly and has the power to make and enforce policy may well be needed (Eatwell, 1999). This would point towards a body more akin to some kind of World Financial Authority, which would be endowed with executive powers along the lines of a WTO for finance.

In the meantime, however, the FSF is a very important step in the right direction. Time will tell whether this body is sufficient to promote international financial stability, and to fill the important gaps in financial regulation which undermine such stability.

Filling regulatory gaps

There are three categories of flows and institutions where additional international and/or source country regulation and supervision may be particularly necessary. These categories seem insufficiently regulated and their surges, as well as outflows, have played a particularly prominent role in sparking off recent currency crisis. The latter would seem to occur particularly because they are reversible. One kind is short-term bank loans (particularly important in the Asian crisis). The second is easily reversible portfolio flows, made by institutional investors, such as mutual funds (especially important in the Mexican peso crisis but also important in East Asia). The third category is the activities by hedge funds and more generally highly leveraged institutions, relating in particular to different types of derivatives.

As discussed above, the FSF for Financial Stability (FSF) will examine in its Working Groups issues relating to short-term bank loans and to highly leveraged institutions. However, it would also be desirable for the FSF to examine issues relating to easily reversible portfolio flows made by institutional investors such as hedge funds.

i) Short-term bank loans

International bank loans (including short-term ones) are already regulated by industrial countries' Central Banks; these national regulations are co-ordinated by the Basle Committee. However, existing regulations were not enough to discourage excessive short-term bank lending to several of the East Asian countries, whose reversal played a major role in triggering off crises in those countries. A key reason for such high short-term bank lending to East Asia was that until just before the crisis most of these East Asian countries (and particularly countries like South Korea) were considered creditworthy by everybody, including regulators. Another, important reason has been current

regulatory practice, which has a bias in favour of short-term lending. For example, for non-OECD countries, loans of residual maturity of up to one year have a weighting of only 20 percent for capital adequacy purposes, whilst loans over one year have a weighting of 100 percent for capital adequacy purposes. This was done to reflect the fact that is easier for individual banks to pull out from renewing short-term loans. However, as a result of this rule, short-term lending is significantly more profitable for international banks. Therefore, to banks' economic preference for lending short-term, especially in situations of perceived increased risk, is added a perverse regulatory bias that also encourages short-term lending. The initial intention was to protect banks, and their liquidity, by encouraging more short-term lending. An overall increase in short-term loans, however, makes countries more vulnerable to currency crises and therefore, paradoxically, banks more vulnerable to risk of non-payment of short-term loans.

It is interesting that soon after the Asian crisis (around April 1998), clear proposals emerged (Greenspan, 1998, see also Griffith-Jones with Kimmis, 1998) to increase the capital charge through the assignment of a higher risk weight to short-term interbank credits than the 20 percent assigned under the Basle Capital Accord. The objective was to reduce the excessive incentive towards such short-term loans. However, even though this change seemed to have very broad support, it made no progress as a stand-alone proposal for a whole year (IMF, 1999). Instead, a review on this issue was placed within the context of a comprehensive reassessment of the Basle treatment of credit risk, for which a special task force was created. Unfortunately, a totally separate issue (linked to the capital adequacy required for mortgages lent by German banks) delayed overall agreement for at least a year, on the revision of capital adequacy rules (*Financial Times*, May 14, 1999). A consultative document has been issued and action will not be taken before March 2000. Questions need to be raised, therefore, not just on appropriate technical measures to build a new international financial architecture, but on mechanisms for speeding up the process through which decisions – especially those on which there is agreement – can be quickly taken. This should be particularly so for the case where clear institutional mechanisms already are in place (in this case the Basle Committee of Bank Supervisors) that should allow rapid decision-making.

ii) Portfolio flows

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

The East Asian crisis confirms what was particularly visible in the Mexican peso crisis (Griffith-Jones, 1998a). Institutional investors, given the very liquid nature of their investments, can play an important role in contributing to developing country currency crises. It seems important, therefore, to introduce some regulation to discourage excessive surges of portfolio flows. This could perhaps best be achieved by a variable risk-weighted cash requirement for institutional investors, such as mutual funds. These cash requirements would be placed as interest-bearing deposits in commercial banks. Introducing a dynamic risk-weighted cash requirement for mutual funds (and possibly other institutional investors) is in the mainstream of current regulatory thinking and would require that standards be provided by relevant regulatory authorities or agreed internationally. The guidelines for macro-economic risk that would determine the cash requirement, would take into account such vulnerability variables as the ratio of a country's current account deficit (or surplus) to GDP, the level of its short-term external liabilities to foreign exchange reserves, and the fragility of the banking system, as well as other relevant country risk factors. It is important that quite sophisticated analysis is used, to avoid simplistic criteria stigmatising countries unnecessarily. The views of the national Central Bank and the Treasury in the source countries and of the IMF and the BIS should be helpful in this respect. The securities regulators in source countries would be the most appropriate institutions to implement such regulations, which could be co-ordinated internationally by IOSCO, probably best in the context of the FSF.

The fact that the level of required cash reserves would vary with the level of countries' perceived "macro-economic risk" would make it relatively more profitable to invest more in countries with good fundamentals. If these fundamentals in a country would deteriorate, investment would decline gradually, which hopefully would force an *early correction* of policy, and, a resumption of flows. Although the requirement for cash reserves on mutual funds' assets, invested in emerging markets, could increase the cost of raising foreign capital to some extent, this would be compensated by the benefit of a more stable supply of funds to these countries, at a more stable cost. Furthermore, this counter-cyclical smoothing of flows would hopefully discourage the massive and sudden reversal of flows that sparked off both the Mexican and the Asian crises, making such developmentally costly crises less likely.

Given the dominant role and rapid growth of institutional investors in countries such as the US, the UK and France, the proposal for a risk-weighted cash requirement on mutual funds, could possibly be adopted first in those countries, without creating significant competitive disadvantages. However, an alternative route would be for such measures to be studied and implemented internationally, initially within IOSCO and/or in the broader context of the FSF. International co-ordination of such a measure would prevent investments by mutual funds being channelled through different countries, and

especially off-shore centres, that did not impose these cash requirements (the latter point draws on communication with the Federal Reserve Board).

IOSCO international guidelines would be formulated through international consultations similar to those employed by the Basle Committee in developing the "Core Principles for Effective Banking Supervision". The guidelines could be developed in the context of IOSCO by a working group, consisting of representatives of the national securities' regulatory authorities in source countries, together with some representation from developing countries. Due account should be taken of relevant existing regulations, such as the European Commission's Capital Adequacy Directive.

Finally, it is important to stress that additional regulation of mutual funds should be consistent with regulation of other institutions (for example, banks) and other potentially volatile flows.

iii) Highly leveraged institutions

Further urgent study is required to detect and cover any other existing monitoring and/or regulatory gaps, for example, as relates to instruments such as derivatives and institutions such as hedge funds. Careful analysis is required, both technical and institutional, on how hedge funds and other highly leveraged institutions (HLIs) can best be regulated to reduce their impact on magnifying volatility of capital flows, exchange rates and stock markets in developing countries. Moreover, analysis of the negative effect that this volatility has on development and on poverty is also required. It is encouraging that there is a growing consensus that HLIs can pose important risks both to direct creditors and, under certain market conditions, to the financial system as a whole. This is reflected, for example, in the January 1999 Report by the Basle Committee on "Banking Supervision, on Banks' Interactions with Highly Leveraged Institutions (HLIs)".

An additional crucial concern of the impact of HLIs on magnifying volatility in developing countries, has not yet been sufficiently studied and accepted, nor have measures designed to deal specifically with this issue been proposed internationally. However, policy responses to address risks posed by HLIs to creditors and the financial system as a whole will also help reduce negative impact on developing countries.

It is important to stress that the problem does not just relate to hedge funds, but to other highly leveraged activities or institutions, such as proprietary desks of investment banks. HLIs can be defined as having three characteristics: they are subject to little or no regulatory oversight, as a significant proportion operates through offshore centres; they are subject to limited disclosure requirements, and often their operations are very opaque; in addition they take on significant leverage.

There are three sets of responses that can be used to address risks posed by the HLIs. Often, they are presented as alternatives. However, it would seem better to consider them as complementary.

The first response is indirect, through the major counter-parties of HLIs (mainly banks and securities houses). This can be done by promoting sounder practices in the way banks and securities houses assess risks when they deal with hedge funds and other HLIs. However, further actions by supervisory authorities also seem desirable. In particular it seems desirable for supervisors to impose higher capital requirements on lending or other exposures of banks to HLIs, to reflect the higher risks involved in such exposures, due to HLIs opaqueness, high leverage and the fact that they are not regulated. It may also be desirable for supervisors to, either formally or informally, prohibit banks from lending to a particular class of risky counter-parties. Such measures may not only protect banks, but could also possibly stimulate HLIs to manage risks in a more responsible way.

A second avenue, which is clearly complementary with the first, is to increase transparency on total exposures to HLIs by all financial institutions. One possibility would be an extension of the concept of a credit register for bank loans (along the model of the French *central des risques*, which provides banks access to the aggregate amount of bank lending to each company). Such a register would collect, in a centralised place, total exposures (both on and off balance-sheet positions) of different financial intermediaries to single counter-parties, such as major hedge funds. Counter-parties, supervisors and central banks (both of developed and developing countries) could then get information about total indebtedness of such institutions, which would help them assess risks involved far more precisely. For this purpose, the information would have to be both timely and meaningful (especially to take account of rapid shifts in HLIs positions). It would seem best if such a register would be based at the BIS itself or at the Basle Committee on the Global Financial System (formerly the Euro-Currency Standing Committee) which already has experience in similar information gathering.

A third avenue is to directly regulate hedge funds and other highly leveraged institutions. Such direct regulation could take a number of forms, including licensing requirements, minimum capital standards and minimum standards for risk management and control. In its recent report, the Basle Committee on Banking Regulation has argued that such a regulatory regime should focus on the potential of HLI activities to generate systemic risk, due to their excessive size and risk-taking, which could endanger financial stability. However, if as seems probable, HLIs also have additional negative effects on increasing volatility of exchange rates in developing countries, this concern should also be addressed in their regulation.

There is at present more support for the first two forms of dealing with HLIs and relatively less support for their direct regulation, even though the latter would deal with the problem in a more direct and straightforward manner.

The opposition to such direct regulation is based on practical grounds. For example, it is argued that HLIs could restructure themselves so they escape any regulatory definition that may exist. However, this problem can be over-

come by an appropriate system of monitoring and policing; its costs would surely outweigh the benefits of alleviating large potential systemic risks, as well as risks of currency instability in developing countries. Introducing such systems may be particularly difficult for developing countries.

The most frequent argument against direct regulation of hedge funds is that they would be able to circumvent such regulations, because these institutions either are or could move easily offshore. This problem can either be tackled by accepting the absurd status quo (and incurring continued high costs of risk of major instability) or raising the issue of extending that and other regulation to offshore centres. Indeed, if global supervision and regulation is genuinely accepted as essential in today's world of globalised financial markets, there can be no justification for "no-go" areas, where such regulations could be evaded or undermined. Both as regards provision of information, and as regards global regulation of institutions such as hedge funds, it is essential that off-shore centres comply with international standards. If the G-7 countries in particular backed this clearly, and if developing countries supported it, a political initiative in this respect should be both effective and useful.

More generally, further work is required to gain a better understanding of recent changes in global credit and capital markets. Specifically, it is vital to understand the criteria used by different categories of market actors, including banks, mutual funds, hedge funds and others, to go in and out of countries. Moreover, there is need to clarify the incentives that encourage market actors' behaviour that contribute to speculative pressures on individual countries and to contagion to other countries. A better understanding of behavioural patterns and of trends in outflows could help design measures to discourage market imperfections, like disaster myopia and herding, that contribute to currency crises. These measures could be taken by individual firms, by parts of the financial industry (via self-regulation), by regulators, and/or by governments (for example, via tax measures),

It can be concluded that a package of measures need to be taken to make currency crises in emerging markets far less likely, and therefore ensure the efficient operation of the market economy in emerging markets. The objective of crises avoidance seems to require some discouragement and/or regulation of excessive and potentially unsustainable short-term inflows. Such measures would be most effective if they are applied both by source and recipient countries (though the main responsibility lies with recipient countries). Moreover, these measures should avoid discouraging more long-term flows, which on the contrary need to be encouraged, particularly long-term flows to low-income countries. In addition, the rules designed need to be simple and clearly targeted at unsustainable flows. Finally and especially, the rules should be complemented by good policies in the emerging economies. In the case of low-income countries that still have closed capital accounts, prudent and well-timed liberalisation that minimises exposure to quickly reversible short-term flows is important.

5. Provision of official liquidity in times of crises

5.1 The role of IMF and other institutions in official liquidity provision

The need for liquidity provision in times of crises is a well-accepted principle. It may be called the principle of the "emergency financier", to differentiate it from the role that a central bank plays at the national level as a "lender of last resort". This is a role that is not exactly matched by the IMF, since the Fund provides exceptional lending but certainly not unconditional liquidity.[23] This is reflected in the lack of automaticity in the availability of financing during crises. Such emergency financing role has led, as we saw in Section 2, to the provision of anti-cyclical lending by the IMF, matched in some major "rescue packages" by bilateral financing from major countries, in addition to their contribution to IMF's agreements to borrow. A major advance during the recent international financial crises was the significant increase in IMF resources through: a) a new quota increase and the New Arrangements to Borrow, finally effective in 1998; b) the launching of the new window in December 1997, to finance exceptional borrowing requirements during crises; and c) the creation of the Contingency Credit Line (CCL) in April 1999, to provide financing to countries facing contagion. The CCL is analysed in more details in the following section.

5.2 Timing of provision of official liquidity, the new contingency credit lines

The CCL has responded to the strong demand for the IMF to leave aside the principles of "fundamental disequilibrium" of the balance of payments, on which it was built, to finance countries in difficulties before and not after international reserves are depleted. This is an essential requirement in the era of rapid capital outflows that can destabilise economies in a matter of days, a lesson that the international community learnt during the Mexican, Asian and post-Asian shocks. It is also a response to the request for new credit lines to finance countries facing contagion. Although this problem is certainly not new, it has reached unprecedented levels in the current decade, which led finally to a strong request for support to countries facing contagion.

The CCL has been widely perceived as a significant move from the IMF in the area of crisis prevention for countries victim of contagion. The facility was implemented by the IMF in April 1999 as part of its ongoing work on strengthening the architecture of the international financial system and as a response to the increased need for liquidity provision for crisis prevention. The facility is a "precautionary line of defence readily available against future

[23] This important distinction is made by Helleiner (1999).

balance of payments problems that might arise from international financial contagion" (IMF, 1999a). To qualify, the increased pressure on the recipient country's capital account and international reserves must thus result from a sudden loss of confidence amongst investors triggered by external factors.

Early provision of liquidity should help reducing external constraints on domestic monetary policy, increasing the level of reserves available for currency defence, and relaxing the constraints on interest rates. It is thus a very important and positive step further as it should, in principle, reduce the chances of entering into a crisis.

The CCL differs from the Supplementary Reserve Facility (SRF) mainly because of the timing of disbursement.[24] Indeed, the SRF is designed for countries already facing a financial crisis whereas the CCL is triggered early on, in a precautionary manner, for countries not facing a crisis at the time of commitment but rather fearing to be affected by contagion. The cost of the credit line, 300 basis points above the rate of charge on regular IMF drawings with a penalty of 50 basis points every six months, has been set up to reduce moral hazard on the debtor side and is the same as for the SRF. It should prevent countries from drawing on the line in "good" times.

The CCL's crucial aim is thus to reduce the chances of countries to be caught by contagion. Its way of functioning, to give leverage of conditionality to the IMF early on, is such that, ideally, countries should not suffer from contagion and thus need not draw on the line. The facility works as a two stage process, very much like an option that is bought in "normal times". Its cost is the country's compliance with four sets of criteria:

i) Adoption of strong policies: Member countries should have implemented a combination of policies that provide a stable economic environment such that in the absence of contagion, no IMF financing should be required. Economic stability together with financial sustainability should be evident. Special attention is paid to an economic and financial programme to be implemented within the period of examination.
ii) Macro-economic performance: The article IV consultation is used as a benchmark for economic performance. An ongoing assessment of the country is also carried out once the consultation is over. This monitoring is used to assess the countries' willingness to adopt – and effectiveness in adopting – policy suggestions.
iii) Advances in adhering to internationally accepted standards: This is an area which is still evolving as some standards have not been finalised yet (notably the codes of transparency in monetary and financial policy).

[24] The SRF was implemented at the end of 1997 as a response to the Asian financial crisis. It provides financial assistance for exceptional balance of payments difficulties due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence. Up until now, SRF loans have been made to Korea (December 1997) 12.5 billion USD; Russia (July 1998) 5.2 billion USD, and Brazil (December 1998) 12.7 billion USD.

Other standards include the subscription to SDDS, the Basle Core principles for bank supervision, the code of transparency of fiscal policy (see above). Countries need not necessarily meet all the standards but should prove some progress in adhering to them.

iv) Relation with the private sector: The IMF stresses the importance of "constructive" relations with private creditors. These relations encompass management of external debt (limiting external vulnerability) and a number of arrangements with private creditors. Examples of arrangements given by the Fund include private sector CCL, call options in debt instruments (allowing debtors to extend maturities), a modification of bond covenants (see section on involving the private sector below), and domestic bankruptcy laws.

The monitoring of external vulnerability through indicators of sustainability such as the level of international reserves, the ratio of short term external debt in relation to reserves, and the exchange rate regime, is also required.

Once the above criteria are met and the CCL agreed, the country can exercise the option at any time but with one further restriction. An "expeditious" consultation is carried out by the Board to verify if the country is still eligible, before funds are disbursed.

However, the new credit line raises a number of issues, in at least four areas:

Firstly, there is the question of the scale of liquidity provision. Formally, the size of the CCL is unlimited. This is imperative as very large amounts of liquidity might be required in times of a major loss of confidence. The rationale of this argument is based on Bagehot's rules, namely that, to perform well in a crisis, a Lender of Last Resort should lend quickly, freely and readily. However, in practice, because of financial constraints, the Fund has disclosed a range of disbursement from 300 to 500 percent of member nation's IMF quota.[25] This limitation is problematic, as in a crisis it is the unlimited nature of contingency financing that is crucial. A limited facility could, in certain circumstances, accelerate outflows; as creditors "rush for the door" for fear it may close, if revenues run out.

Estimates from April 1999, based on the upper ceiling of 500 percent of quota, evaluate the CCL to be of an order of 20 billion USD for Brazil, 11 billion USD for Korea, and 7.4 billion USD for Thailand. Non affected countries like Argentina would receive up to 14 billion USD, Chile 5.8 billion USD, Mexico 17 billion USD, Hungary 7 billion USD, and 12 billion USD in the case of South Africa (Davitte, 1999 and Chote, 1999). These amounts appear quite low and could turn out to be insufficient to fully absorb external shocks. Brazil, for example, which accessed a financial package in some

[25] In April 1999, the Fund had 76 billion USD in uncommitted resources plus 46 billion USD available under pre-arranged credit lines.

ways similar to the CCL but before its formal implementation, received more than twice the amount it is eligible for at present.

At the time of writing, no country had officially declared applying to the scheme although some policy makers had expressed their opinions on it. Mexican officials, for example, fear not to be eligible due to their current involvement with the IMF through a stand-by loan facility. Others have underlined the paradoxical situation that "good" countries are not willing to be labelled with the CCL, while countries in potential difficulty are finding it very hard to comply with too stringent conditions.

Second, the special "activation" review by the IMF Board – as the CCL is today structured – does not seem necessary. Indeed, the eligibility conditions have been designed so that the CCL is drawn as rarely as possible. As a matter of fact, the implementation of strong macro policies, and the adherence to international standards, and the building up of sound relationships with private creditors should, by themselves, protect countries from financial crisis triggered by the deterioration of domestic factors. If a given country complies with these criteria, then the only possible reason why it could face a financial crisis is because of external pressure.

Furthermore, the automatic triggering is critical to the good functioning of the CCL as it would give instantaneous access to new liquidity. Indeed, in the context of integrated world financial markets, a loss of confidence can have major impacts in a very short period of time. A few hours might then have a determinant impact on the outcome of the crisis. The approval required by the Board, even if it were expeditious, could still create further uncertainty, and thus an acceleration of outflows.

The automatic disbursement, if implemented, could be associated with a shorter repayment period, possibly six months. Countries that experienced liquidity crisis in the past usually required fairly large amounts of liquidity, extremely rapidly but for a brief period.

Third, it is still not very clear what will be the potential signalling effect on private investors of countries applying for the CCL but failing to meet the criteria, or of countries loosing their access to it. A certain degree of confidentiality could possibly dampen this effect. For example, information could only be disclosed on countries that have been accepted but not on those applying for it.

Fourth, as already mentioned, the facility is not open to countries with current or expected regular IMF financing. It could thus eliminate access to this type of financing to countries which are in a strong process of recovery from a past crisis but still have pending IMF credits.

So, despite significant advance, in practice the approved credit lines will continue to lack the full stabilising effects that are expected from IMF interventions during crisis. The negotiation process will continue to be cumbersome and funds may not be available to all countries that require them at the appropriate time and in adequate quantities. Equally important, funds avail-

able to the IMF for exceptional financing will continue to be short of the amounts required, as the experience of the 1990s indicates. This is obviously a crucial issue. Stabilising effects will continue to be absent if the market judges that the intervening authorities are unable or unwilling to supply funds in the quantities required to stabilise speculative pressures. Moreover, under these conditions, national authorities may be forced to overreact, adopting a pro-cyclical stance, in an effort to generate confidence in private markets. For the world economy as a whole, this would be reflected in enhanced deflationary biases.

Well-funded IMF contingency financing is obviously the *sine qua non* of any reform effort. As bilateral financing and contributions to the IMF will continue to be scarce, the best solution could be to allow additional issues of SDRs under critical financial conditions, to create the additional liquidity required (United Nations Task Force, 1999a). These funds could be destroyed once financial conditions normalise. This procedure would also create an anti-cyclical element in world liquidity management, and would give SDRs an increasing role in world finance. Developing countries advocated this principle in the past and should continue to do so. However, this proposal may face significant opposition, particularly as several of the major countries have been opposed to any issues of SDRs at all, which has implied that no issues have taken place for a very long time. A second best alternative would be to allow the IMF to raise the resources needed in the market, to adequately fund contingency financing or to rely on Central Bank swap arrangements, arranged either by the IMF or the BIS.

5.3 *The central role of development financing, especially for low-income countries*

Adequate financing from the IMF is certainly important to low-income countries. However, as the discussion in Section 2 indicated, the major issues for them are associated to the need to guarantee adequate development finance, through ODA and multilateral lending, and to generate mechanisms that would allow them to participate more actively in private capital markets. Given the relative magnitude of financing to low-income countries (Table 2), the reversal of ODA flows is certainly a very important issue, but so is the rate of growth of multilateral lending which, at least in the case of IBRD-IDA, has experienced a significant slowdown in the 1990s. Moreover, due to the high concentration of private flows in a few "emerging" economies, multilateral lending will continue to play an essential role even with respect to middle-income nations. More broadly, multilateral lending should continue to play a central role in at least four areas: a) to channel funds to low-income countries; b) to provide long-term financing to middle-income and small countries who, due to lack of adequate credit rating or to the fixed costs involved (for example, in bond financing) do not have adequate access to private funds;

c) to act as a counter-cyclical offset to fluctuations in private capital market financing; and d) to facilitate the transitions to new forms of private financing. The latter is also of particular interest to low-income countries. To these we should add the traditional "value added" of multilateral financing: lending-associated technical assistance.

The first of these functions underscores the central role that financing from IBRD-IDA and the regional and subregional development banks will continue to play in the immediate future. The second and third functions emphasize the role that official development financing will continue to play even for middle-income countries. It must be emphasized, however, that the anti-cyclical provision of funds should not be confused with the role of providing emergency financing, which is essentially a task of the IMF. In any case, the large requirements of counter-cyclical financing from development banks to middle-income countries may crowd out financing to poor countries, a point which has been made by the President of the World Bank (Wolfensohn, 1998). Thus, to the extent that multilateral development financing is not significantly expanded, its role as a counter-cyclical device will be necessarily very limited, and should certainly be of secondary importance to its first two roles, particularly to the provision of long-term development financing to poor countries. Drawing on the data from Table 2, multilateral financing in 1992–97 represented only 13 percent of that provided by the private sector, excluding FDI, and only 6 percent in the case of middle-income countries. So, a useful counter-cyclical function would certainly require a significant increase in resources. Playing such a role would also require anti-cyclical planning of multilateral banks' lending activities, which has not been the rule in the past.

The fourth role is of fairly recent origin, but has experienced rapid growth in the 1990s. These mechanisms are of particular interest to low-income countries. It has been associated, in particular, to direct financing (by the banks or the associated financial corporations) or to the design of guarantee schemes to support private infrastructure projects in developing countries. It could also be used to support the developing countries' return to markets during crises and, more importantly, to support the initial bond issues by developing (particularly poor) countries seeking to position themselves in private capital markets. Co-financing or guarantee schemes could be used for those purposes. It must be emphasized, however, that the full development of these schemes would require a radical change in the management of guarantees by development banks, as they are accounted for in current practices as equivalent to lending, a fact which severely restricts their usefulness. Such expansion of the role of development banks in guaranteeing private financing has been criticised on the grounds that it could involve excessive risk-taking by these institutions. Nonetheless, in a world that will continue to be dominated by private financing, it may be absolutely essential to avoid low-income countries from being left aside from major developments in capital markets. It should thus receive priority attention in current discussions.

Sub-regional development banks can also play a significant role as a mechanism to "pool" the risks of groups of developing countries, thus allowing them a more aggressive use of opportunities provided by private capital markets. In Latin America, an interesting experience in this regard is that of the Andean Development Bank (C*orporación Andina de Fomento*, CAF), an institution entirely owned by developing countries whose risk evaluations have exceeded even those of Colombia, the only Andean country that in the 1990s has had an "investment grade".

As it was pointed out above, the discussion of a new financial architecture – valuable though it has been – has not included a discussion of these crucial issues of development finance, that are especially relevant for low-income countries. It is therefore urgent to integrate these issues into the current discussion on a new architecture. As a complement and/or as an alternative, it is important to organize separate studies, task forces, etc. (in the Bretton Woods institutions, by low-income countries, by donor governments and the UN). These should focus on the major issues of development finance for low-income countries and how these should ultimately be integrated into a more broadly defined new international financial architecture.

6. Conditionality

The most controversial issue behind international liquidity or development financing is conditionality. In the case of the IMF, this issue has for long been a central area of contention. However, in recent years – and even decades – the issue has become increasingly troublesome for three different reasons. First, the scope of conditionality has been gradually expanded. Not only does it include the realms of other international organisations – for example, quite often, that of the World Trade Organization and development banks. It also includes domestic economic and social development strategies and institutions which, as the United Nations Task Force has indicated "by their very nature, should be decided by legitimate national authorities, based on broad social consensus".[26] Indeed, although not referred explicitly to IMF conditionality, this point has been recently made in strong terms by the President of the World Bank: "We must never stop reminding ourselves that it is up to the government and its people to decide what their priorities should be. We must never stop reminding ourselves that we cannot and should not impose development by fiat from above – or from abroad." (Wolfensohn, 1998).

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

Finally, many observers have criticised overkill in some IMF programmes. As it was pointed out above, due to this fact, the IMF itself has agreed to facilitate counter-cyclical fiscal management in the depressed Asian economies.

Even if the legitimacy of the principle of conditionality is accepted – or, as it is sometimes alternatively stated, "support in exchange for reforms" – these are reasons that should lead to a revision of the characteristics of such conditionality. Indeed, the perception that conditionality has gone too far in practice may contribute to undermine its legitimacy. Thus, a strong argument can be made that the way to restore full confidence in the principle of conditionality is by reaching a renewed international agreement on how it should be used.

Several principles can be advanced in this regard:

i) IMF conditionality should mainly be restricted to the macroeconomic policies that were its purview in the past. It should be used when expansionary policies are clearly associated with the generation of macroeconomic

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

imbalances, or when a country needs to draw Fund resources beyond some automatic low-conditionality facilities if the source of the imbalance is an international shock. Reforms of domestic prudential regulation and supervision may also be required, but parallel agreements could be made with the corresponding international authorities.

ii) Low-conditionality facilities should be available in adequate quantities when the source of the imbalance is an international shock. Important steps in this direction have been taken with the introduction of the CCL, but as discussed above further steps are required.

iii) More stringent credit conditions should not be used as a complement to conditionality. It could be argued that they should be a substitute (i.e., a characteristic of some low-conditionality funds), but this is also controversial, as it undermines the "credit union" character of the IMF without really approaching "market conditions" that, under such circumstances, would be very stringent.

iv) Automatic rules could be agreed when signing an agreement with the Fund, by which the restrictiveness of policies would be eased should evidence of "overkill" become clear. In practice, such easing has been granted ex-post to some Asian countries, but the negotiation process was too cumbersome and easing only came with a significant lag, when the contractionary effects of policies had surpassed by significant amounts that which had been assumed in the program.

v) Finally, regular official evaluation of IMF programs, either by an autonomous division in the Fund (as it is done in the World Bank) or by outside analysts, should be introduced and the major conclusions of these evaluations, when reviewed by the Board, should be explicitly introduced into regular Fund practice.

7. The role of private sector involvement in preventing and resolving crises

A number of proposals have been put forward for *ex-ante* measures directly involving the private sector, to be designed and put in place before crises occur (for a useful recent overview of such measures, IMF, 1999b). These proposals would not only help diminish severity of crises should they occur, but also (for example, by improving the pricing of risk) diminish the likelihood of crises occurring.

Measures involving the private sector can a) help limit moral hazard, that arises when lenders and investors are repeatedly bailed out, b) imply fairer burden-sharing between the official and private sector, should crises occur and c) most importantly, contribute to fairer burden-sharing between capital-recipient countries and their creditors and investors. Indeed, the standard crisis response in situations like East Asia – where creditors and investors suffer only fairly limited losses, whereas growth in the capital-recipient countries is undermined and there is an increase in unemployment and poverty – clearly needs modifying.

However, measures to involve the private sector (particularly in burden-sharing) need to be carefully designed, so as to avoid excessively discouraging desirable private flows to emerging markets, or too sharp increases in their cost. The views of developing countries therefore need to be carefully considered.

In what follows we will review some of the main measures under discussion, briefly evaluating their costs and benefits.

7.1 Contingent financing arrangements from commercial banks

At the heart of currency and financial crises is the issue of provision of sufficient liquidity in times of distress, particularly for countries that are potentially creditworthy in the long-term. Indeed, if sufficient liquidity is not provided in a timely fashion, there is a risk that liquidity crises can be turned into solvency problems, which increases the costs to all involved, and particularly to debtor countries.

An important reason for contingent financing arrangements is the existence of multiple equilibria, which imply that different outcomes – some better, some worse – are possible (Stiglitz and Bhattacharya, 1999). Individual lenders and investors, who believe that others are going to withdraw their money, do so because of the fear. The provision of temporary funds can limit a liquidity crisis, and stop it becoming a solvency crisis. Even better, the belief that there are funds available eliminates the incentive to pull out; as a result, the liquidity crisis can be avoided.

We have discussed above contingent finance provided by the IMF and other official bodies, and in particular, the recently created CCL. It seems impor-

tant that such official facilities are complemented by private contingent credit lines. Indeed, one of the possible pre-conditions for an IMF CCL is for the country to have "in place, or be putting in place, contingent private credit lines or similar arrangements" (IMF Summing Up by Chairman of Executive Board Meeting 99/48, available on IMF web-site).

An important operational issue is how private IMF credit levels would be co-ordinated if a CCL is approved. One possibility would be for the IMF to approve a CCL in broad terms, for private financing then to be sought, and for levels of contingent IMF credit to be finalised afterwards. Though this could reduce the scale of IMF lending, and improve burden-sharing between the official and private sector, it could have the problem of indeterminancy. Therefore, it may be easier for countries to arrange, for example, a full CCL first (including the actual levels of contingency lending) and then approach the private sector for complementary contingency lending.

It is interesting that Argentina, Indonesia and Mexico have already arranged such lines of credit with private banks, to be drawn upon in the event of difficulties. These arrangements – though having different modalities – all include a regular commitment fee. Mexico's creditor banks initially argued against the drawing, even though as IMF (1999d) rightly argues, Mexico had adhered strictly to the arrangement. However, the loan was disbursed when Mexico requested it. As Mexico's Finance Minister Gurria[27] argued, the creditor banks resented disbursing loans at the low spreads that had been pre-committed, at a time when spreads for Mexico and other emerging market countries were much higher. A possible way to overcome such problems could be to, for example, link the loan spread, when arranging the loan, to bond market yields prevailing at the time (Gray, 1999). This could encourage creditors, but could – in times of crises – increase the cost of such borrowing. The Argentina line has not been drawn, but its existence may have helped forestall market pressures.

This seems clearly an appealing mechanism. However, several questions remain. Firstly, would banks be willing to provide this kind of finance to a broad range of countries, including, for example, poorer ones? This issue is particularly relevant in the context of this paper, and may require further study. Secondly, do these facilities really provide additional financing in times of crises, or do they partly crowd out other lending? Even more seriously, could banks involved in extending credit lines adopt dynamic hedging strategies to offset their exposure, and as a consequence leave their overall exposure to the country the same? This would clearly neutralise the positive impact of such an arrangement.

[27] Presentation at HSBC, London in May 1999.

7.2. Restricting put options in debt contracts

To reduce risk of loans, creditors like to introduce put options, which give them the option (but not the obligation) of shortening the contractual maturity of loans of bonds. For example, a five-year loan – statistically recorded as such – can have a one-year put, which allows the creditor the option of asking for repayment in a year, increasing his/her flexibility. Debtors accept such put options because it allows for somewhat lower spreads; however, in doing so, they often under-estimate the risk that conditions may deteriorate significantly – as a result they may lose market access – and the put may be exercised.

Put options have become an important additional source of vulnerability for developing countries, including some low-income ones. These countries have increasingly accepted puts in the last years. Meanwhile, derivatives became more widespread, and the risk of crises increased (for example, in Brazil, the share of "putable" bonds increased significantly as the crisis approached). According to the IMF (1999c), a minimum estimate of 20 billion USD in loans and bonds is "putable" in 1999 alone, which is a very high figure.

It is therefore very important for countries to be far more careful than in the past about accepting put options, as well as other clauses that may increase countries' vulnerability to crises. It is also important to improve transparency and understanding of such modalitites in bond and loan issues, as the operations of financial intermediaries are often both complex and opaque. This may be particularly urgent for low-income countries, where there may – as yet – be less familiarity with such instruments. Technical assistance (from the IMF, the World Bank, BIS, or others) could thus be very valuable, particularly for poorer countries.

7.3 Debt standstills and orderly debt workout procedures

There has also been a growing international consensus on the need to create internationally sanctioned standstill provisions. The G-22 report examined alternative ways of achieving standstill-type arrangements, including ways in which the international community might be able to signal its approval for standstills in exceptional cases. Though countries should make every effort to meet the conditions of all debt countries in full and on time, in certain cases – the G-22 report accepted – a temporary suspension of payments could be a necessary part of the crisis resolution process. The preventive suspension of debt service and agreed rescheduling would help to solve the co-ordination problem, typical when creditors panic and rush for the door, and thus to help avoid some of the worse effects of such outflows. As a result, in a context of potential multiple equilibria, such a practice could lead to an equilibrium with higher output, less bankruptcies, and probably less long-term disruptions to capital flows.

The G-22 report went further in recognising that there may be extreme cases when an orderly and co-operative restructuring process would be aided by "an enhanced framework for future crisis management". This would allow the international community to signal its approval of a temporary payments suspension by providing financial support for the crisis country. The G-22 supported the IMF decision to extend its policy of lending to countries in arrears to private creditors. According to the G-22, this signal (and the explicit support, which the IMF would thus give to the standstill) would only be provided where the international community believed that the government's decision to suspend debt payments was the only reasonable course open to it, that it was implementing a strong programme of policy reform, and that it was making every effort to reach agreement with creditors. The IMF would be signalling confidence in the debtor's policies and long-term prospects, and indicating to creditors facing temporary standstills that their interests would best be served by reaching quick agreement with the debtors. A standstill imposed as part of such a co-operative and non-confrontational process would hopefully be less penalised by creditors.

UNCTAD (1998), which has provided one of the most forceful and detailed defence of the standstill mechanism, has suggested a possible second alternative procedure to implement standstills. This would allow countries to unilaterally call the standstill, but then to submit it for approval to an independent international panel within a specified period, whose sanction would then give it legitimacy. Such a procedure would be similar to WTO safeguard provisions allowing countries to take emergency actions. A third complementary possibility (Ocampo, 1999) would be to draft *ex-ante* rules under which debt service would be automatically suspended or reduced if certain macroeconomic shocks are experienced; such rules have sometimes been incorporated into debt re-negotiation agreements (for example, Mexican Brady bonds). A problem may be that crises have both common – but also different – features, which may make it more difficult *ex-ante* to define the macroeconomic shocks.

As regards any of these three alternatives, it can be argued that they would increase perceived country risk, and therefore could increase cost and limit access to international capital flows for developing countries. On the contrary, it may be argued that such a mechanism would only legally recognise default risks that already exist, and that it could actually reduce the default risk for individual operations. Alternatively, it could be argued that if especially initially there was some increase in interest rates – especially by short-term foreign lenders – this could be good as it would make those lenders focus more clearly on the risks involved in such lending. These risks extend beyond the parties to the transaction, to innocent bystanders – workers and small businesses – repeatedly hurt under existing financial arrangements (Stiglitz and Bhattacharya, 1999).

In some ways an even more radical proposal for a standstill has been made

by Buiter and Sibert (1999). They suggest a universal debt roll-over option with a penalty (UDROP); *all* foreign currency lending – private or sovereign, long or short, marketable or not – would have to have such a roll-over option for a specified period (for example, three or six months) at a penalty rate. The penalty rate would be high to discourage debtors using this option. In this proposal, the roll-over mechanism would be automatic, and activated only at the discretion of the borrower. As such it would be speedy. This proposal has the important attraction of simplicity, speed and universality (both for all debtors and all instruments). However, it has two problems. Firstly, it does not elaborate the legal and other mechanisms necessary to enforce it. Secondly, it seems somewhat unlikely that creditor countries' governments would accept such a mechanism, as it could be unattractive to creditors.

To some extent, of course, some kind of concerted standstill for one key category of debt – short-term, cross-border interbank credit lines – have been fairly successfully implemented in the recent crises in South Korea and Brazil, although the delays in arranging them led to fairly significant haemorrhaging of outflows before it was arranged. However, in South Korea, the concerted rollover of short-term bank lines was helpful in stabilising a critical situation and also facilitated a restructuring of interbank claims into sovereign guaranteed bonds. Also Brazil was able to secure agreement of international banks to maintain their exposure to Brazilian financial institutions. However, there is a widespread view that South Korea's success reflected specially favourable circumstances – such as the problem being limited to short-term debt, with the rest of the capital account fairly closed – which would be difficult to replicate in other countries. Furthermore, the fear has been expressed (IMF, 1999c) that concerted operations in one case could lead creditors to withdraw credit lines in advance of a crisis elsewhere for fear of a concerted rollover.

A broader standstill mechanism – than just concerted rollovers of short-term debt – seems very important to establish. However, the relative success of existing rollovers or partial standstills, provides a valuable precedent for a more structured standstill mechanism.

7.4 Amending sovereign bond clauses

The effective functioning of debt standstill and orderly debt workout procedures requires flexibility in debt contracts. In a national context, this is achieved by bankruptcy proceedings. Whilst this option is not yet available internationally (even though there have been several interesting proposals to establish one), a good "second best" is to have internationally state contingent contracts, i.e. to have flexibility for changing contracts if unforeseen circumstances arise.

After the Mexican peso crisis, the discussion of such changes has been particularly applied to international bonds, possibly because emerging bond

finance has rapidly grown, with gross flows of bond placements increasing from 6 billion USD in 1992 to over 40 billion USD in 1997 and 1998. This is particularly true for Latin America. Indeed, it is unclear to what extent changes in the bonds contracts would have had a significant impact on the East Asian crisis, where the greatest part of the problem related to short-term bank lending and not to bonds.

Specifically, Eichengreen and Portes (1995) proposed changing the contractual provisions governing sovereign debt to allow for: a) collective representation of bondholders in the event of a crisis, b) qualified majority voting on changing the terms and conditions of the debt contract and c) sharing of proceeds received from the debtor among creditors. These clauses would facilitate a more orderly resolution of crises, for example, by preventing a minority of dissident investors from holding up settlement. More broadly, it would help overcome problems associated with lack of creditor coordination, particularly the creditor "grab-race", whereby actions taken by individual creditors in pursuit of their self-interest can disrupt orderly debt workouts. Such "grab-race" may reduce the potential resources available to all creditors and help create a situation of panic.

The ideas for modifying bond contracts were supported by the 1996 G-10 Deputies report (after the Mexican crisis), by the G-22 Working Group on International Financial Crisis (after the East Asian crisis). The ideas have been both supported and developed further in IMF (1999b). However, little concrete progress has been made to date.

This lack of progress has two main reasons. On the one hand, most creditors are reluctant (see, for example, IIF, 1999), though some creditors especially in Europe, see possible advantages in modifying bond clauses (for an interesting discussion, see Gray, 1999). On the other hand, debtors are concerned that such clauses could restrict future access, in terms of volume, or at least in terms of cost. This concern must be evaluated seriously, as long-term bonds are an important mechanism for funding development. However, the view can also be taken that, once the market has accepted these changes, the clearer "rules of game" would actually improve market access.

In any case, it does not seem appropriate for international institutions like the IMF to impose, as part of conditionality, modifications to bond contracts on developing countries, as it has been recently suggested. A very positive way forward would be for G-10 sovereigns to include in their new bond issues the new contractual terms discussed above. This would have two positive effects: the G-10 would lead by example and they would help define a new market standard. If the completely creditworthy G-10 countries would modify their new bond contracts (it would be extremely unlikely that this would increase their spreads), it would become far more acceptable for developing countries to do so. Negative effects on availability and cost of new bonds for these countries would deteriorate far less than if they did it on their own. However, there seems to be some resistance amongst G-10 govern-

ments for them to undertake such changes. The reasons given are purely technical, the problems raised seem relatively small, so they could be easily overcome if political will was there. One problem is that not all G-10 countries are currently active in international markets; this could be overcome either by modifying bond clauses only for those G-10 countries currently issuing bonds or by G-10 countries issuing bonds beyond their normal funding program. Another, highly technical objection, is that modifying bond clause covenants, for those G-10 countries where secondary markets are very liquid and where parts of the bonds are "stripped", could lead initially to some fragmentation of that strips market.

It is important to point out that the problems for restructuring bonds do not apply to all types of bonds. Indeed, British-style bonds contain a number of important characteristics that facilitate an orderly restructuring. This is because they include provisions for the debtor, bondholders or the trustee (if there is one, see analysis below) to call bondholders meetings, and for a qualified majority of bondholders represented to agree to changing the terms of the bonds for all holders. Furthermore, under one of two categories of British-style bonds (called Trustee Deeds), individual bondholders are generally prohibited from accelerating the bonds and initiating litigation. As IMF (1999c) points out with British-style bonds it may be fairly easy to achieve high participation rates, as creditors that are reluctant to participate in changing conditions will know that they face the alternative of a modification of terms that can be imposed by a majority of bondholders. In the case of Trustee Deed bonds, the limits on individual creditors to initiate litigation provide further incentive to participate in an orderly restructuring.

However, there are difficulties in achieving an orderly bond restructuring after market access has been lost for countries with debt structured in the form of American-style international bonds – the most prevalent bonds issued by developing countries – or by German-style bonds. Those instruments do not include provisions for majorities to modify terms of bonds, and impose those changes on minority holders. Furthermore, in case of a default, the bonds have few limits on individual bondholders to start – and benefit from – litigation.

It is interesting that up to now there is *no* premium in favour of US-style bonds, that is investors have not discriminated in favour of those more "protected" instruments, possibly because they have not noticed the difference. This is rather encouraging, as it would imply that drawing on the precedent of UK-style bond clauses and generalising them would not increase the cost of borrowing for developing countries. However, reportedly, some of the major rating agencies have started to examine the terms of specific sovereign debt obligations, with distinctions being placed on technical nuances of different debt issues, which could possibly lead to differential pricing. Perhaps a problem has been the excessive publicity given to the possibility of amending conditions on developing country bonds (without actually doing it), which

has focussed too much attention on this issue. A more effective way could have been to modify the terms of new bonds – to make them similar to UK-style ones – without so much public discussion of the matter.

There is a second, more technical difficulty, for rescheduling bonds. Currently, these bear the modality of bearer bonds, which makes it far harder to get bondholders together, so they can agree restructuring or other changes. This problem can, however, be remedied for new issues by the appointment by the issuer of a single trustee, who is empowered to act for bondholders. Such trustees can: a) prevent bondholders taking unilateral action and b) provide a useful channel for communication and possible negotiation between bondholders and the debtor.[28]

The modification of bond terms has attracted a lot of debate and attention, and could have important positive effects in that in the medium-term it could contribute very significantly to orderly debt-workouts, and to a more level playing field amongst different categories of instruments. The initial impact on modifying debt servicing would be restricted by the fact that these changes would apply to new bonds only, and would not provide flexibility in the event of payments difficulties for the large existing stock of bonds. Furthermore, as discussed above, particularly if these changes were introduced only by developing countries, they could – especially initially – limit access and increase cost for them to this important source of funding.

Several of the issues discussed in this section are technically complex and have important implications for debtors and creditors. For this reason, several of them have not yet been fully resolved, though important progress has been made in these discussions. It is important that low-income countries, which have been largely absent from these discussions, not only be informed in detail of these discussions and their possible implications for their own links with the private sector, but also participate fully in these discussion in the future. In areas where there is technical agreement (for example, on the undesirability of having put options in debt contracts, as they may increase likelihood of future crises), it is important that low-income countries are given appropriate technical assistance by the IMF, bilateral donors or other relevant bodies.

[28] We thank Robert Gray for this point.

8. Brief conclusions

The concentration of private capital flows to middle-income countries is problematic in many respects. However, it has implied that low-income countries have suffered less directly from issues of capital flow volatility and contagion in recent financial crises. Nevertheless, the recent crises may have made future access to private capital more difficult for the low-income countries.

Considering public flows, low-income countries are – naturally – the major recipients of ODA, and in particular grants. As regards World Bank and IDA lending, a fairly high proportion has also gone to these countries. However, the declining level of World Bank lending in the 1990s (and especially in the 1995–97 period) is a source of concern.

IMF lending has been anti-cyclical and has increasingly concentrated on a few large borrowers – the countries suffering major currency crises. Large IMF lending substitutes private financing when it collapses or reverses. This has implied a concentration of official liquidity financing in middle-income countries. If a new financial architecture is implemented, and if it is effective in reducing or significantly moderating currency crises, then this somewhat perverse pattern of flows can be reversed, and more attention devoted to the needs of low-income countries.

In the short-term, there is an urgent need to reverse declines of ODA to low-income countries, to accelerate again multilateral lending to them, facilitate their access to the more stable forms of private flows (especially FDI), as well as significantly enhancing the reduction of HIPC debt. More broadly, there is a clear gap in current discussions of a new financial architecture in that these – and other – crucial issues of development finance of particular significance to low-income countries have not been included.

These issues must be directly integrated into the current discussion of a new financial architecture. This implies that separate – but linked – studies, task forces, etc. be organised (with large participation from the low-income countries, but also from the Bretton Woods institutions, the donor governments and the UN) on the major issues of development finance. The result of these studies and task forces should then be integrated into a broader international financial architecture, which would facilitate appropriate flows (both in terms of scale and stability), to both middle-income and low-income countries. We hope that this study has contributed both empirical, analytical and policy elements that will be useful for this very important endeavour.

As regards the reform of the international financial architecture, in the more narrow terms that it has till now been defined, it seems important to attempt to evaluate progress so far. A positive feature is that a fairly significant proportion of the proposals on the table by spring 1998 (for a review and analysis then, see, for example, Griffith-Jones, 1998b) have either been seriously studied or actually began to be implemented. This is particularly

true for those proposals that do not require significant institutional innovation.

Amongst the most positive steps is the creation of the FSF, the creation of new facilities of the IMF (including most recently and significantly the Credit Contingency Line, CCL), as well as improvements in information, particularly on developing countries. However, the way in which each of these steps have been implemented have serious limitations. Furthermore, in the area of amendment of bond clauses, little actual action has taken place.

As regards progress in global regulation of private flows, the rapid creation of the FSF is an important step forward. However, the current lack of participation of developing countries in the decision-making FSF is a serious limitation. Participation of developing countries – including low-income ones – in the FSF is urgent, as they are the main victims of the volatility that the FSF is attempting to stem. Secondly, the FSF may need to be strengthened in its decision-making power, as its purely co-ordinating and consensus-seeking role may not be sufficiently strong in the future.

Furthermore, it is unfortunate that certain regulatory changes, on which very broad consensus has been reached, have taken so long to be made. An example is the modification of capital adequacy rules to reduce regulatory incentives for short-term bank lending to developing countries. Progress needs also to be made on regulation of institutional investors, such as mutual funds.

The creation of the CCL is also potentially an important step forward to limit contagion, by encouraging countries to adopt policies that will discourage crises and by signalling to the markets that this facility is available. Both may help to avoid crises. However, there are several concerns regarding the way the CCL is being structured. Firstly, would the scale be sufficient to stem a crisis? Would low-income countries also receive CCL support if they had a contagion-caused crisis? Secondly, why is disbursement – in the stage of crisis threat – not automatic, for countries that have pre-qualified? Thirdly, why is the CCL not open to countries with current or expected regular IMF financing? Fourthly, will conditions be too restrictive, and thus make countries unwilling to negotiate the CCL?

Useful progress has also been made on improving information on developing countries. However, the possibilities and benefits of improved information have important limits. Furthermore, more limited progress has till now been made on the equally important issue of improving information on international financial markets. The latter is extremely important, and further initiatives need to be taken by the BIS and the FSF. Low-income countries should have easy access to this new information on international capital markets. Much emphasis has also been placed on the development of numerous standards, and their implementation by developing countries. A source of concern is that developing countries – especially low-income ones – do not on the whole participate much in the definition of those standards, though they are being asked to implement them. Both meeting standards and enhancing in-

formation puts an important burden on developing countries, especially low-income ones. As a consequence, technical assistance in this field, especially to the poorer countries, is a priority.

Some limited progress has been made on the issues of emergency measures involving the private sector during crises. This concerns the broadening of the power of IMF lending into arrears and the arrangement of concerted roll-over of credit for Brazil and Korea.

However, the larger issues have not yet been tackled, both because of their complexity and because of different interests and perspectives involved. It is important that there is concrete progress on orderly debt work-outs, including particularly changes in bond covenants. Interestingly, UK-issued bonds already have more flexible clauses, and these do not as yet carry higher spreads; this provides a very important precedent for modifying clauses in US and German bonds. It is, however, important that changes in these clauses are introduced both by developed and developing country borrowers, to avoid stigmatising and marginalizing developing country borrowers. In particular, modifying bond contracts should not be imposed by IMF conditionality on developing country debtors. However, developing countries could take the initiative in issuing bonds in the UK with the more flexible clauses.

There is still much to do on financial architecture. This is particularly so because recent crises have had an unacceptably high cost in terms of interrupting and – sometimes – reversing growth and development, increasing poverty, and discouraging future private investment, both by national and foreign investors. These currency crises also distract the international official community from the crucial task of increasing and improving official flows to low-income countries, which need to play a continued role in helping their growth and in supporting poverty alleviation in them.

Though our report has focused more on issues of international measures to prevent and better manage crises, clearly these need to be complemented by national measures, both in the prudential and capital account regulatory area and in macro-economic policy. These are also very important for low-income countries, even though they do not receive very large private flows. Indeed, even relatively small private volatile flows could destabilise small, low-income countries (with disastrous effects on poverty). Learning to manage sharp financial cycles with adequate policies is a slow process that needs accumulation of experience since the early stages of development, to avoid costly mistakes later on. Prudence in the liberalisation of certain categories of capital flows (the more volatile ones) to avoid excessive surges of such flows may be an important area, where low-income countries may benefit from being late-comers to the game. This should help minimise low-income countries' vulnerability to currency crises, which would be particularly costly for them as so many of their people are so close to the poverty line.

More generally, the traditional emphasis on crisis management needs to be changed to the management of booms, since it is in the periods of euphoria

from capital inflows and terms of trade improvement that crises are incubated. This implies introducing stronger counter-cyclical elements in the following areas:

(1) Macro-economic policy. Anti-cyclical fiscal devises can include fiscal stabilisation funds based on temporary public sector revenues, to be saved during booms and well-designed social safety nets that would be particularly valuable in times of crises. This would reduce spending during the boom and increase it during crises.
(2) Strengthening as well as increasing counter-cyclical elements of financial regulation and supervision, to prevent excessive risk taking. Indeed, prudential regulation must take into account not only the micro but also the macro economic risks typical for developing countries in an increasingly globalised and volatile world.
(3) If excessive short-term, potentially reversible, capital flows enter the economy, measures – such as Chilean style or Colombian style reserve requirements – clearly need to be taken.

There is one area of macro-economic policy, both in developing countries in general and for low-income countries, where further research is urgently required. This is the area of an appropriate exchange rate policy, for small, increasingly open economies in a world of large global capital flows. These flows provide new sources of volatility to developing countries and may further magnify the traditional source of volatility: terms of trade shocks.

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